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Employers, Prep For Shorter Stock Awards Settlement Cycle

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Effective May 28, following recent changes to U.S. Securities and Exchange Commission and Nasdaq rules, most standard broker-dealer securities transactions will have to be settled within one business day after the deposit/withdrawal at custodian, or DWAC, date, also referred to as the trade date.

This will likely have significant federal employment tax implications for employers that compensate employees through nonqualified stock option or stock award programs, since employers will have one less day to calculate the withholding owed with respect to employees' equity compensation, and deposit that withholding with the Internal Revenue Service and state tax authorities.

This shortened settlement cycle is commonly referred to as a "T+1" settlement. Prior to this rule change, investors generally had two business days after the trade date to settle securities transactions, known as a "T+2" settlement cycle.

Under the new T+1 rule, an investor who buys securities generally must make payment to the facilitating broker-dealer no later than one business day after execution of the trade. On the other side of the transaction, a selling investor generally must deliver the securities to the facilitating broker-dealer no later than one business day after execution of the trade.

In the case of stock option exercises, or vesting and settlement of other stock awards, the stock will need to be delivered to employees' brokerage accounts no later than one day after the DWAC date. Accordingly, employers will need to make payroll deposits by the second business day after the DWAC date, instead of the third business day.

Under the federal employment tax deposit rules — see Internal Revenue Code Section 6302 and the U.S. Department of the Treasury regulations promulgated thereunder — employers generally must deposit payroll taxes on a monthly or semiweekly basis, depending on the amount of taxes reported during a specified look-back period.

Notwithstanding the general monthly and semiweekly rules, employers that accumulate $100,000 or more in employment taxes must deposit those taxes with the IRS by the close of the next banking day. This is known as the next-day deposit requirement.

Employers that fail to meet the next-day deposit requirement may be liable for failure-to-timely-deposit penalties under Internal Revenue Code Section 6656, which range from 2% for deposits that are one to five days late, or 5% for deposits that are six to 15 days late, to 10% for all undeposited taxes after the 15th day, and 15% if the employer does not respond promptly to an IRS penalty notice.

With respect to employee stock award transactions, the IRS has largely recognized that the deposit liability date — i.e., when employment taxes have reached $100,000 or more — is the next business day after the settlement date. Notably, in General Legal Advice Memorandum 2020-004, the IRS had incorrectly assumed that the DWAC date was the option exercise date, or the restricted stock unit/stock appreciation right vesting date.

However, shortly after issuance of that memorandum, the IRS issued updated instructions in Internal Revenue Manual Section 20.1.4.26.2(5), concluding that if payroll tax deposits are made by the third day after the DWAC date, then penalties are not appropriate.

This reference to the third day will automatically change to the second day after the DWAC date as a result of the imminent change from a T+2 settlement to a T+1 settlement cycle. That being the case, the IRS will begin its counting of days of lateness for Section 6656 penalty purposes one business day sooner.

Moreover, since the IRS arbitrarily counts days of lateness based on calendar days — even though bank deposits cannot be made on weekends and holidays — this one-day shortening of the deposit deadline makes it even more likely that IRS-imposed penalties might reach 5% instead of only 2%.

For example, assume that a restricted stock unit vests on July 1, which is a Monday, and the DWAC date is that day. The new settlement date is July 2, and the payroll tax deposits are due July 3.

But assume that the employer is unaware of the settlement date change, and does not make its deposits until July 9, after the long holiday weekend. These deposits are now six days late, and the deposit penalty would be 5% of all the late deposits.

If these deposits were made on July 8, the penalty would be only 2%, but under either scenario, it is clear that the reduction of the settlement date — and therefore, the liability date — by one day can significantly affect an employer's penalty exposure.

To avoid potential deposit penalties — whether employers make their own payroll tax deposits or hire a third-party payroll service provider to make deposits — employers should check to be sure that their scheduled dates of deposit for equity compensation are accelerated to accommodate the new T+1 rule.

Alternatively, funds can be deposited before the accelerated settlement date takes effect — and left on deposit with the IRS in each succeeding quarter by filing proper credit carryover instructions with each quarterly Form 941 — in order to be able to use the deposit allocation rules of Internal Revenue Code Section 6656(e) and Revenue Procedure 2001-58, 2001-2 C.B. 579.

Beginning May 28, employers that provide equity compensation in the form of publicly traded stock will have one less day to settle employee equity compensation stock transfer transactions for SEC and Nasdaq purposes. In turn, employers will likely have one less day to deposit corresponding payroll taxes with the IRS as a result of the upcoming change from a T+2 settlement standard to a T+1 settlement standard.

To avoid the potential for significant late deposit penalties, publicly traded employers should implement next-day stock settlement procedures, followed by next-day tax deposit procedures by internal equity compensation and payroll tax departments, in coordination with external DWAC transfer agents and employee brokerage firms.

Implementing expedited equity compensation stock settlement and payroll tax deposit procedures now will facilitate publicly traded employers' ability to timely meet payroll tax deposit deadlines attributable to equity compensation by the second business day after the trade date.

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