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Internal Revenue Service  
**Memorandum**

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subject: Timing of Income Inclusion and Application of Federal Insurance Contribution Act (FICA) taxes and Federal Income Tax Withholding for Stock-Settled Awards

This Generic Legal Advice Memorandum (GLAM) responds to your request for assistance. This GLAM may not be used or cited as precedent.

Issue

When does (i) income inclusion and application of FICA taxes and federal income tax withholding and (ii) the employer's obligation to deposit withheld employment taxes occur with respect to each of the following stock-settled awards?

Facts<sup>1</sup>

*Situation 1: Stock Option<sup>2</sup>*

On January 2, 2020, Employer (a publicly traded corporation) grants Employee a nonstatutory stock option to purchase 10 shares of Employer stock. The exercise price

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<sup>1</sup> This memo does not address the impact of an employer's ability to defer employment tax deposits under § 2302 of the Coronavirus, Aid, Relief and Economic Security Act for the period of March 27, 2020, through December 31, 2020.

<sup>2</sup> A stock option is a contractual right to purchase one or more shares of stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a specified price.

is \$10 per share, which is the fair market value of each share on the date of grant. On the date of grant, the stock option has no readily ascertainable fair market value as defined in Treas. Reg. § 1.83-7(b). The stock option does not provide for a deferral of compensation under I.R.C. § 409A and Treas. Reg. § 1.409A-1(b)(5)(i)(A). The stock option vests and becomes exercisable with respect to all 10 shares of Employer on January 2, 2021. Employee can exercise the stock option at any time from January 2, 2021 through January 2, 2024. The shares delivered upon exercise of the option are substantially vested as defined in Treas. Reg. § 1.83-3(b). On December 29, 2021, Employee exercises the option to purchase the shares. On the date of exercise, the fair market value of each share is \$15. On December 31, 2021, the shares are delivered to Employee's brokerage account. On the delivery date, the fair market value of each share is \$14.<sup>3</sup>

*Situation 2: Stock-Settled Stock Appreciation Rights (SAR's)<sup>4</sup>*

On January 2, 2020, Employer (a publicly traded corporation) grants Employee 10 stock-settled SAR's. The 10 stock-settled SAR's vest and become exercisable on January 2, 2021. Employee can exercise the SAR's at any time from January 2, 2021 through January 2, 2024. Each SAR entitles Employee to receive upon exercise a number of shares of the common stock of Employer equal to the excess of the fair market value of a share of Employer common stock on the date Employee exercises the SAR over the fair market value of a share of such stock on the date of grant, divided by the fair market value of a share of such stock on the date of exercise. The SAR's do not provide for a deferral of compensation under I.R.C. § 409A and Treas. Reg. § 1.409A-1(b)(5)(i)(B). The shares received upon exercise of the SAR are substantially vested as defined in Treas. Reg. § 1.83-3(b). On January 2, 2020, the fair market value per share of the Employer common stock was \$10. On December 29, 2021, when the fair market value of each share of Employer stock is \$25, Employee exercises all of the SAR's. On December 31, 2021, the shares are delivered to Employee's brokerage account. On the delivery date, the fair market value of each share is \$24.

*Situation 3: Stock-Settled Restricted Stock Unit (RSU)<sup>5</sup>*

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<sup>3</sup> The stock received upon exercise of the option is not "qualified stock" as defined in I.R.C. § 83(i).

<sup>4</sup> A stock-settled SAR is a right to stock based on the appreciation in value of a specified number of shares of stock during a specified period (such as a period beginning on the date of grant or some other specified date and the date of exercise of such right). Although less typical, the terms of the SAR may also provide that the stock will be paid on a specified date and not require the service provider to exercise the SAR. These facts do not contemplate or address the situation in which the SAR is settled only in cash.

On January 2, 2020, Employer (a publicly traded corporation) grants Employee a stock-settled RSU that entitles Employee to 10 shares of Employer's common stock if Employee continues to provide services to Employer until December 29, 2021. The terms of the RSU provide that payment of the shares will occur on the date the vesting condition is satisfied. The shares received upon payment of the RSU are not subject to a substantial risk of forfeiture. On December 29, 2021, Employee satisfies the vesting condition and Employer initiates payment of the 10 shares of stock. The fair market value of each share of stock is \$25 on December 29, 2021. On December 31, 2021, the shares are delivered to Employee's brokerage account. On the delivery date, the fair market value of each share is \$24.<sup>6</sup>

### Background

When a service provider exercises a stock award (such as a stock option or a stock-settled SAR) or the service recipient initiates payment under a stock award (such as a stock-settled RSU), the service recipient or a securities broker (broker) makes a request to the service recipient's transfer agent to transfer shares held in the service recipient's account with the transfer agent to the broker's account with the transfer agent.<sup>7</sup> The broker then holds the shares on behalf of the service provider until the service provider decides to sell the shares. If, at the time of exercise, the service provider elects to sell shares to pay the exercise price or satisfy the tax withholding obligations, then the broker instructs the transfer agent to sell those shares.

Due to Securities and Exchange Commission (SEC) regulations that apply to transfer agents and securities brokers, there is generally a short delay (settlement cycle) between the exercise of the option and settlement of the option exercise (delivery of the shares to the service provider's brokerage account or sale of the shares to cover the exercise price/withholding taxes). This same settlement cycle applies to the exercise of a stock-settled SAR as well as the payment under a stock-settled RSU. With respect to a stock-settled RSU, the short delay occurs between initiation of payment by the service recipient and delivery of the shares to the service provider's brokerage account. Prior to

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<sup>5</sup> A stock-settled RSU is an unsecured and unfunded promise by the service recipient to pay one or more shares of stock to the service provider at a future date following a specified vesting condition. The terms of a RSU typically provide that the payment of the stock will occur upon or within a short period of time following the satisfaction of the vesting condition. If payment occurs no later than two and a half months after the end of the taxable year in which the vesting condition was satisfied, then the payment is not considered deferred compensation. See Treas. Reg. § 1.409A-1(b)(4). If the payment occurs more than two and a half months after the end of the taxable year in which the vesting condition was satisfied, then the RSU provides for a deferral compensation and is subject to the requirements of I.R.C. § 409A. See Treas. Reg. § 1.409A-1(b)(1). These facts do not contemplate or address the situation in which the RSU is settled only in cash.

<sup>6</sup> The stock received upon settlement of the RSU is not "qualified stock" as defined in I.R.C. § 83(i).

<sup>7</sup> Not all service recipients use a transfer agent. A service recipient may act as its own transfer agent. If the stock of the service recipient is not publicly traded, then the service recipient would not typically have a transfer agent.

September 5, 2017, the settlement cycle could not exceed three days. On March 22, 2017, the SEC amended the settlement cycle regulations to provide that the settlement cycle could not exceed two days effective September 5, 2017. 17 C.F.R. § 240.15c6-1(a).

On March 14, 2003, the Large and Mid-Size Business (LMSB)<sup>8</sup> division issued the “Field Directive on Assertion of the Penalty for Failure to Deposit Employment Taxes” (2003 Directive). The purpose of the 2003 Directive was to “establish guidelines for examiners on assertion of the penalty for failure to deposit employment taxes owing as a result of exercise of nonqualified stock options.” Under Treas. Reg. § 31.6302-1(c), an employer is required to deposit employment taxes with an authorized financial institution on the next banking day after \$100,000 or more of employment taxes have been accumulated during the deposit period. Referencing the three day delay effective at the time, the 2003 Directive instructed LMSB Employment Tax Specialists to not challenge the timeliness of deposits required under Treas. Reg. § 31.6302-1(c), if such deposits are made within one day of the settlement date, as long as such settlement date does not fall more than three days from date of exercise.

In January 2012, the Internal Revenue Manual (IRM) at IRM 20.1.4.26.2, *Administrative Waivers* incorporated language allowing for an administrative waiver of the I.R.C. § 6656 failure-to-deposit (FTD) penalty in certain circumstances where the FTD penalty is asserted on a \$100,000 next-day deposit obligation of employment taxes arising from the exercise of a nonstatutory stock option within a deposit period. The administrative waiver allows for the penalty to be calculated using the settlement date of the stock option as the liability incurred date for the \$100,000 next-day deposit obligation in situations where settlement occurs within three business days of the exercise date. If settlement occurs more than three business days after the exercise date, the liability incurred date is the third business day after the exercise date for purposes of calculating the FTD penalty under the administrative waiver.

The administrative waiver of the FTD penalty addressed in the 2003 Directive and IRM is not the result of any statutory authority, but results from an Internal Revenue Service (IRS) management administrative decision. Stakeholders have requested that the administrative waiver of the I.R.C. § 6656 FTD penalty for nonstatutory stock options be extended to stock-settled SARs and stock-settled RSUs. The discussion below is a legal analysis with respect to income inclusion and application of FICA taxes and federal income tax withholding, without regard to the administrative waiver of the FTD penalty described above. The following discussion does not affect application of the administrative waiver described in IRM 20.1.4.26.2.

## Law

### *Overview of I.R.C. § 83*

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<sup>8</sup> LMSB division is now known as Large Business and International (LB&I) division. See IR-2010-88.

I.R.C. § 83 addresses the tax treatment of property transferred in connection with the performance of services. I.R.C. § 83(a) provides that if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of the fair market value of such property over the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. Treas. Reg. § 1.83-1(a) explains that the property is not taxable under I.R.C. § 83(a) until it has been transferred (as defined in Treas. Reg. § 1.83-3(a)) to such person and becomes substantially vested (as defined in Treas. Reg. § 1.83-3(b)) in such person.

### *Definition of Property for Purposes of I.R.C. § 83*

For purposes of I.R.C. § 83, property includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. Treas. Reg. § 1.83-3(e). An option without a readily ascertainable fair market value is not considered property for purposes of I.R.C. § 83. Specifically, I.R.C. § 83(e)(3) provides that I.R.C. § 83 does not apply to an option without a readily ascertainable fair market value. Instead, I.R.C. § 83 applies to the transfer of property pursuant to the exercise of such an option. With respect to such options, in relevant part, Treas. Reg. § 1.83-7(a) provides that I.R.C. § 83(a) applies to the transfer of property pursuant to the exercise of the option and the service provider realizes compensation upon the transfer at the time and in the amount determined under I.R.C. § 83(a).<sup>9</sup>

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<sup>9</sup> As described above, the grant of an option to purchase certain property generally does not constitute a transfer of such property. Treas. Reg. § 1.83-3(a)(2). In *Theophilos v. Comr.*, 85 F.3d 440, 445 (9th Cir.1996), however, the Ninth Circuit held that a contractual obligation to acquire stock is property for purposes of I.R.C. § 83 and the subsequent purchase of the stock is not. In 2000, relying on *Theophilos*, CC:IT&A issued a FSA concluding that a contract to purchase shares was property for purposes of I.R.C. § 83. See FSA 200029013.

Commentators have criticized *Theophilos*. For example, “[W]e do not believe the Ninth Circuit’s *Theophilos* decision is a correct interpretation of I.R.C. § 83.” *Mergers, Acquisitions, and Buyouts* (Ginsburg, Levin, et al. 2016); “Where the Ninth Circuit departed from the conventional understanding of Section 83 was in its holding that an executory contract constitutes ‘property.’” Paul J. Sax & Gary A. Herrmann, *Ninth Circuit’s Section 83 Decision May Reopen Planning Opportunities for Stock Compensation*, 85 J. Tax’n 87, 88 (1996).

In a subsequent decision involving beneficial ownership outside the context of I.R.C. § 83, the Ninth Circuit described the *Theophilos* decision as a case in which the service provider “acquired a beneficial interest in the stock not when he paid for the shares, but when the parties executed a shareholder agreement, two employee agreements, and other documents.” *Pahl v. Commissioner*, 150 F.3d 1124, 1130 (9th Cir. 1998). According to the Ninth Circuit in *Pahl*, the property in *Theophilos* was the stock instead of the contractual obligation to acquire it. Regardless of the Ninth Circuit decision in *Theophilos*, prior to the actual exercise of the stock option, the terms of typical employee stock option awards do not contractually obligate service providers to purchase the underlying shares. Consequently, the facts in

### *Definition of Transfer for Purposes of I.R.C. § 83*

Treas. Reg. § 1.83-3(a)(1) provides that, for purposes of I.R.C. § 83, a transfer of property occurs when the service provider acquires a beneficial ownership interest in such property. A “beneficial owner” is someone who does not have legal title to property but has rights in the property which are the normal incidents of owning property. *Miller v. United States*, 345 F. Supp. 2d 1046, 1050 (N.D. Cal. 2004). Such rights include the right to receive dividends on and vote the shares, the right to dispose of the shares as the beneficial owner sees fit, and the right to use the shares as collateral. *See United States v. Tuff*, 359 F. Supp. 2d 1129, 1133 (W.D. Wash. 2005); *Miller v. United States*, supra at 1050. Pursuant to Treas. Reg. § 1.83-3(a)(6), an indication that a transfer has occurred is the extent to which the service provider incurs the risk that the value of the property will decline. *See also Walter v. Commissioner*, T.C. Memo 2007-2, 7. A service provider incurs the risk that the value of the stock will decline when the number of shares and fair market value of the stock that the service provider will receive are fixed and determinable (regardless of actual receipt of the shares), which occurs on the earliest of the service provider exercising the stock award (for example, the stock option or stock-settled SAR) or the service recipient initiating payment under the stock award (for example, the stock-settled RSU).

### *Overview of FICA taxes and Federal Income Tax Withholding*

#### *FICA Taxes*

FICA taxes consist of the old-age, survivors, and disability insurance (social security) taxes imposed under I.R.C. §§ 3101(a) and 3111(a), the hospital insurance (Medicare) taxes imposed under I.R.C. §§ 3101(b)(1) and 3111(b), and the Additional Medicare Tax (AdMT) imposed under I.R.C. § 3101(b)(2).

FICA taxes are computed as a percentage of “wages” paid by the employer and received by the employee with respect to “employment.” In general, all payments of remuneration by an employer for services performed by an employee are subject to FICA taxes, unless the payments are specifically excepted from the term “wages” or the services are specifically excepted from the term “employment.”

I.R.C. § 3121(a) defines “wages,” for FICA tax purposes, as all remuneration for services, with certain exceptions not applicable here. I.R.C. § 3121(a)(1) provides that the social security portion of FICA tax is only imposed on wages up to the contribution and benefit base for social security each year (social security wage base). There is no wage base for the Medicare portion of FICA tax. Effective for tax years beginning after December 31, 2012, employees are also subject to AdMT (0.9 percent) on wages paid by an employer in excess of enumerated dollar thresholds that are dependent upon

each employee's filing status in a calendar year. See I.R.C. § 3101(b)(2).

In general, the employer is required to withhold and pay to the IRS the employee share of FICA taxes from wages when paid to the employee and to pay to the IRS the employer share of FICA taxes with respect to wages when paid to the employee. In the case of AdMT, which is only imposed on the employee, an employer must withhold and pay to the IRS AdMT with respect to wages for employment performed for the employer by the employee only to the extent the employer pays wages to the employee in excess of \$200,000 in a calendar year. This rule applies regardless of the employee's filing status or other income. See Treas. Reg. § 31.3102-4(a).

Treas. Reg. § 31.3121(a)-2(a) provides that wages are generally subject to FICA tax when actually or constructively received. Treas. Reg. § 31.3121(a)-2(b) provides that wages are constructively paid when they are credited to the account of or set apart for an employee so that they may be drawn upon by him at any time although not then actually reduced to possession. To constitute payment in such a case, the wages must be credited to or set apart for the employee without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that they may be drawn upon at any time, and their payment brought within his own control and disposition. Remuneration for employment that constitutes wages at the time the remuneration is actually or constructively paid is referred to as the general timing rule. See Treas. Reg. § 31.3121(a)-2(a) and Treas. Reg. § 31.3121(v)(2)-1.

I.R.C. § 3121(v)(2) provides for the FICA tax treatment of nonqualified deferred compensation (NQDC) plans.<sup>10</sup> Under I.R.C. § 3121(v)(2)(A), any amount deferred under a NQDC plan must be taken into account as wages for FICA tax purposes as of the later of (1) when the services are performed, or (2) when there is no substantial risk of forfeiture of the rights to such amount. This is referred to as the special timing rule.

Treas. Reg. § 31.3121(v)(2)-1(b)(3)(i) states that a plan provides for the deferral of compensation with respect to an employee only if, under the terms of the plan and the relevant facts and circumstances, the employee has a legally binding right during the calendar year to compensation that has not been actually or constructively received and that, pursuant to the terms of the plan, is payable to (or on behalf of) the employee in a later year.

Treas. Reg. § 31.3121(v)(2)-1(b)(4)(i) defines plans, arrangements, and benefits that do not provide for the deferral of compensation and thus are subject to the general timing rule rather than the special timing rule. Under Treas. Reg. § 31.3121(v)(2)-1(b)(4)(ii), the grant of a stock option, stock appreciation right, or other stock value right does not constitute the deferral of compensation for purposes of I.R.C. § 3121(v)(2). In addition,

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<sup>10</sup> The income tax treatment of NQDC is governed by the rules in I.R.C. §§ 451, 409A, 457(f) and 457A, as applicable. These rules are not determinative of the employment tax treatment.

amounts received as a result of the exercise of such items do not result from the deferral of compensation for purposes of I.R.C. § 3121(v)(2) if such amounts are actually or constructively received in the calendar year of exercise.

Because the grant of a stock option or a SAR does not constitute the deferral of compensation for purposes of I.R.C. § 3121(v)(2), the general timing rule under Treas. Reg. § 31.3121(a)-2(a) applies, that is, wages generally are subject to FICA tax when actually or constructively received.

Treas. Reg. § 31.3121(v)(2)-1(b)(4)(ii) defines a stock value right as a right granted to an employee with respect to one or more shares of an employer stock that, to the extent exercised, entitles the employee to a payment for each share of stock equal to the excess, or a percentage of the excess, of the value of a share of the employer's stock on the date of exercise over a specified price (greater than zero). The term stock value right does not include a phantom stock or other arrangement under which an employee is awarded the right to receive a fixed payment equal to the value of a specific number of shares of employer stock.

An RSU award is not a stock value right and therefore provides for the deferral of compensation for purposes of I.R.C. § 3121(v). Amounts paid pursuant to the settlement of an RSU award are NQDC for FICA purposes and are subject to FICA taxes as of the later of (1) the date on which the services creating the right to the amount are performed, or (2) the date on which the right to the amount is no longer subject to a substantial risk of forfeiture.

#### *Federal Income Tax Withholding*

I.R.C. § 3401(a) generally provides, with certain enumerated exceptions, that the term "wages" for federal income tax withholding purposes means all remuneration for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash.

I.R.C. § 3402(a) provides that every employer making a payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary of the Treasury.

Treas. Reg. § 31.3402(a)-1(b) generally provides that the employer is required to collect income tax by deducting and withholding the amount thereof from the employee's wages as and when paid, either actually or constructively. Further, wages are constructively paid when they are credited to the account of or set apart for an employee so that they may be drawn upon by him at any time although not then actually reduced to possession. To constitute payment in such a case, the wages must be credited to or set apart for the employee without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that they may be drawn upon at any time, and their payment brought within his own control and disposition.

Treas. Reg. § 31.3402(a)-1(c) provides, in part, that an employer is required to deduct and withhold the tax notwithstanding the wages are paid in something other than money (for example, wages paid in stocks or bonds) and to pay over the tax in money. If wages are paid in property other than money, the employer should make the necessary arrangements to insure that the amount of the tax required to be withheld is available for payment in money.

### *Revenue Rulings*

Rev. Rul. 67-257, 1967-2 C.B. 359, addresses whether liability is incurred by a company for the withholding of income tax under I.R.C. § 3402(a) with respect to the compensation amount in certain nonstatutory stock options allotted to its key employees. Under the plan, the company grants options to the employees to purchase shares to encourage an increase to their proprietary interest in the company. The options do not have a readily ascertainable value at time of grant. When the options allotted to the employees to buy shares of the stock are exercised, the employees have an unconditional right to receive the stock subject to the options upon payment of the option price.

The ruling holds that since the employees have an unconditional right to receive such stock upon payment of the option price, the excess of the fair market value of the stock on the date of exercise over the option price is compensation includible in the employee's gross income at the time the option is exercised. It concludes that such compensation is remuneration for services performed in the company's employ and, therefore, constitute wages subject to the withholding of income tax under I.R.C. § 3402(a). While the ruling does not explicitly address the timing of the income tax withholding, it implies that the compensatory amount is both includible in the employee's gross income and is wages subject to income tax withholding at the time the option is exercised, since it uses fair market value on the date of exercise to measure the compensation and wage amounts.

Although the ruling does not address the timing of FICA tax treatment of the compensatory amounts as wages under I.R.C. § 3121, the timing should be the same as for the income tax withholding of wages under I.R.C. § 3402; that is, the fair market value of the property received as wages should be determined with reference to the fair market value at the time the option is exercised. This results because both Treas. Reg. § 31.3121(a)-2(a) and Treas. Reg. § 31.3402(a)-1(b) provide the same general timing rules. Treas. Reg. § 31.3121(a)-2(a) provides that wages are generally subject to FICA tax when actually or constructively received. Treas. Reg. § 31.3402(a)-1(b) generally provides that the employer is required to collect income tax by deducting and withholding the amount thereof from the employee's wages as and when paid, either actually or constructively.

Rev. Rul. 79-305, 1979-2 C.B. 350, addresses the timing of when a transfer of stock to an employee is wages for FICA tax (I.R.C. § 3121(a)) and federal income tax

withholding purposes (I.R.C. § 3401(a)), and when it is includible in gross income under I.R.C. § 83. It concludes that the fair market value of the transferred stock at the time the risk of forfeiture lapsed is includible in the employee's gross income for the year in which the risk lapses and is wages at the time the risk lapsed.<sup>11</sup>

The ruling does not address the three specific situations of this memo, but is useful for its general analysis on the timing of a payment as wages for FICA tax and federal income tax withholding purposes. In the ruling, a corporation transferred stock, subject to a substantial risk of forfeiture, to one of its employees. Prior to the lapse of the substantial risk of forfeiture, the stock was not transferable. The employee made no election pursuant to I.R.C. § 83(b) to include the fair market value of the stock in gross income in the year of transfer. The substantial risk of forfeiture lapsed in a later year, and the stock had appreciated in value from the time of the transfer to the time of the lapse of the substantial risk of forfeiture.

The ruling cites to Treas. Reg. § 31.3121(a)-(2) that, "wages are paid by an employer at the time they are actually or constructively paid...[t]o be a constructive payment, the wages must be credited to or set apart for the employee without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that they may be drawn upon at any time, and their payment brought within his own control and disposition." The ruling also cites to a similar provision Treas. Reg. § 31.3402(a)-1(b) for federal income tax withholding purposes.

Additionally, the ruling cites to Treas. Reg. § 31.3401(a)-1(a)(4) that if a corporation transfers to its employees its own stock as remuneration for services rendered, the amount of such remuneration is the fair market value of the stock at the time of transfer. The transfer of stock mentioned in Treas. Reg. § 31.3401(a)-1(a)(4) refers to the transfer of an item of noncash remuneration not subject to substantial limitations or restrictions.

The ruling holds that when the substantial risk of forfeiture lapsed, the stock was made available to the employee without any substantial limitation or restriction and was available to be used by the employee at any time. Therefore, the fair market value of

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<sup>11</sup> See also Rev. Rul. 78-185, 1978-1 C.B. 304. The Ruling discusses a company with a stock purchase plan not qualifying under I.R.C. §§ 401 or 423. At the end of each month, the company makes contributions to the plan on behalf of each participant in an amount equal to a percentage of the dollar amount of the participant's contributions into the plan for that month. On the same day, the employer then credits the employee's account with the number of whole and fractional shares of the employer's common stock that the sum of the employer's and the employee's contributions for that month would purchase based upon the average of the closing prices of that stock on the New York Stock Exchange for each trading day of the month. There is no forfeiture provision for either the employee or employer contributions to the plan. The Ruling holds that the excess of the fair market value of the stock credited to an employee's account, on the date of the crediting of such stock to the employee's account, over the amount of the employee's contributions to the account is "wages" for purposes of FICA, FUTA, and income tax withholding.

the stock at the time when the substantial risk of forfeiture lapsed is wages for purposes of FICA tax and federal income tax withholding. At the time the risk of forfeiture lapsed, the fair market value of the transferred stock is also includible in the employee's gross income under I.R.C. § 83(a).

*Deposit Rules for FICA Taxes and Federal Income Tax Withholding*

Treas. Reg. § 31.6302-1 provides the deposit rules for FICA taxes and federal income tax withholding. In general, Treas. Reg. § 31.6302-1(a) provides that an employer is either a monthly depositor or a semi-weekly depositor based on an annual determination.

Treas. Reg. § 31.6302-1(b) generally provides that an employer is a monthly depositor for the entire calendar year if during the lookback period the aggregate amount of employment taxes reported is \$50,000 or less; conversely, an employer is a semi-weekly depositor for the entire calendar year if during the lookback period the aggregate amount of employment taxes reported exceeds \$50,000. The lookback period for each calendar year for employers filing Form 941, "Employer's QUARTERLY Federal Tax Return," is the twelve month period ended the preceding June 30. A monthly depositor immediately becomes a semi-weekly depositor for the remainder of the calendar year and for the following calendar year on the first day the employer is subject to the One-Day (\$100,000) rule in Treas. Reg. § 31.6302-1(c)(3).

Treas. Reg. § 31.6302-1(c)(1) generally provides that monthly depositors must deposit employment taxes accumulated with respect to payments made during a calendar month by electronic funds transfer by the 15th day of the following month. Treas. Reg. § 31.6302-1(c)(2) generally provides that semi-weekly depositors with payment dates of Wednesday, Thursday and/or Friday must deposit on or before the following Wednesday, while semi-weekly depositors with payment dates of Saturday, Sunday, Monday and/or Tuesday must deposit on or before the following Friday.

However, Treas. Reg. § 31.6302-1(c)(3) provides that notwithstanding Treas. Reg. §§ 31.6302-1(c)(1) and (2), if on any day within a deposit period (monthly or semi-weekly) an employer has accumulated \$100,000 or more of employment taxes, those taxes must be deposited by electronic funds transfer in time to satisfy the tax obligation by the close of the next day (or if the next day is a Saturday, Sunday, or legal holiday in the District of Columbia, the next succeeding day that is not a Saturday, Sunday, or legal holiday). This exception to the monthly and semi-weekly rules is known as the One-Day rule (also often referred to as the "Next-Day Deposit Rule").

Treas. Reg. § 31.6302-1(e) generally defines the term "employment taxes," in relevant part, to mean the employee portion of the tax withheld under I.R.C. § 3102, the employer tax under I.R.C. § 3111, and income tax withheld under I.R.C. § 3402 (with

certain exceptions).<sup>12</sup>

### *Overview of the I.R.C. § 6656 FTD Penalty*

When the Code requires any person to deposit any amount of tax, and the person fails to make the deposit by the prescribed date, the person is liable for a penalty that ranges from 2% to 15% of the applicable tax, depending on when the deposit is eventually made. I.R.C. § 6656(a). But the person is not liable for the FTD penalty if the person can show that the “failure is due to reasonable cause and not due to willful neglect.” *Id.*

### Analysis

#### *Situation 1: Stock Option*

An employee acquires a beneficial interest in the underlying shares of stock upon exercising a stock option. For example, in *Walter*, the Tax Court ruled that, upon the exercise of a stock option, the employee became the beneficial owner of the underlying stock because, upon exercise, the employee incurred the risk that the value of the stock would decline.<sup>13</sup> *Walter*, TC Memo 2007-2, at 7. Rev. Rul. 70-335, 1970-1 C.B. 111, holds that stock is considered transferred on the date the employee delivers to the grantor corporation written notice of the stock option exercise with full payment even though the plan provides that the employee has no interest in the stock until issuance of the stock certificates. In both *Walter* and Rev. Rul. 70-335, the employee incurred the risk that the value of the stock would decline and thus acquired beneficial ownership of the stock upon exercise of the stock option. When the employee exercises a stock option (thus initiating the process pursuant to which the employer transfers the stock), the number of shares and fair market value of the stock received by the employee are fixed and determinable, even though the value of the stock may decrease or increase prior to actual delivery of the shares (for example, during the period of delay between

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<sup>12</sup> Cf. Rev. Rul. 75-191, 1975-1 C.B. 376. The Ruling discusses the application of the FTD penalty to various situations. In Situation 1, Employer X did not withhold or make deposits, and in Situation 2, Employer Y made timely deposits of taxes withheld on only a portion of the remuneration paid. The Ruling concludes that the FTD penalty “does not apply in case of failure to deposit FICA and income taxes which should have been withheld from compensation paid to employees, but which were not withheld. As defined in [the I.R.C. § 6302 regulations], the taxes required to be deposited are those taxes which were withheld, together with any employer tax imposed by the Federal Insurance Contributions Act. Accordingly, Employers X and Y are each subject to a penalty only on the amount of underpayment of the employers’ share of FICA tax for failure to deposit this tax on or before the prescribed deposit date, unless each establishes reasonable cause for such failure.”

<sup>13</sup> In concluding that an employee acquired a beneficial ownership of shares of stock on the date of exercising the stock options, the court in *Walter* also explained that the employee’s exercise of the stock options constituted an “unconditional acceptance of [the employer’s] offer under the stock option grants and created a contract between [the employer] and petitioner for the sale of the exercised shares of stock.” *Walter*, TC Memo 2007-2, at 6. In other words, an employee acquires a beneficial ownership in stock under a stock option when the employee is contractually obligated to purchase the underlying shares. This is consistent with the definition of transfer in Treas. Reg. § 1.83-3(a) and the Ninth Circuit’s description of *Theophilos* in *Pahl*.

exercise and delivery of the shares to the employee's brokerage account). The employee's ability to (1) pledge the stock as collateral for a loan to exercise the option, and (2) direct the sale of shares to repay the loan or to satisfy the tax withholding obligation upon exercising the stock award are also indications of beneficial ownership. Accordingly, for purposes of I.R.C. § 83, the transfer of shares of stock occurs on December 29, 2021, the date on which Employee exercises the stock option.

When an employee exercises a stock option, I.R.C. § 83 applies to the transfer of stock pursuant to the exercise and compensation is realized upon such transfer at the time and in the amount determined under I.R.C. § 83(a). See Treas. Reg. § 1.83-7(a). To determine the amount of compensation realized, I.R.C. § 83(a) provides, in relevant part, that the excess of the fair market value of the transferred property over the amount (if any) paid for such property shall be included in the gross income of the person who performed such services. In other words, the amount of compensation realized is the excess of the fair market value of the stock on the date of exercise over the exercise price. In accordance with Treas. Reg. § 1.83-7(a), such compensation is included in gross income upon exercise of the option because that is when the transfer of the underlying stock occurs for purposes of I.R.C. § 83.<sup>14</sup> Accordingly, on December 29, 2021, \$50 [10 shares x (\$15 FMV on date of exercise - \$10 exercise price)] is includible in Employee's gross income.

Even though the fair market value of each share is \$14 on December 31, 2021 when the shares are delivered to Employee's brokerage account, the value of the shares on the delivery date is not taken into account in determining the amount of compensation income includible under I.R.C. § 83 nor the wage amount subject to FICA taxes or federal income tax withholding. At the time Employee exercised the stock option on December 29, 2021, when the fair market value of the stock was \$15 per share, Employee incurred the risk that the value of the stock would decline.

On December 29, 2021, when Employee exercises the option to purchase the shares, Employee has beneficial ownership of the stock. Furthermore, when Employee exercises the option, the stock was made available to the Employee without any substantial limitation or restriction and was available to be used by the Employee at any time.<sup>15</sup> Therefore, on December 29, 2021, the \$50 stock payment constitutes wages that have actually or constructively been received by the Employee and is subject to FICA taxes and federal income tax withholding at that time.

If, in conjunction with other wage payments, Employer has accumulated \$100,000 or more in employment taxes upon the \$50 stock payment date of December 29, 2021, then pursuant to the One-Day rule, Employer has an obligation to deposit such

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<sup>14</sup> See *also* Rev. Rul. 67-257, 1967-2 C.B. 359, which holds that because the employees have an unconditional right to receive stock upon payment of the exercise price, the excess of the fair market value of the stock on the date of exercise over the option price is compensation includible in the employee's gross income at the time the option is exercised.

<sup>15</sup> See Rev. Rul. 67-257. *Cf.* Rev. Rul. 78-185; Rev. Rul. 79-305.

employment taxes by the close of the next day, December 30, 2021. If the Employer does not deposit such employment taxes by December 30, 2021, then under the Code the IRS may impose an FTD penalty upon the Employer unless it is shown that such failure is due to reasonable cause and not due to willful neglect.

*Situation 2: Stock-Settled Stock Appreciation Rights (SAR's)*

A stock-settled SAR is, in substance, a stock option without an exercise price. Upon exercising the stock-settled SAR, an employee acquires a beneficial ownership in the underlying shares of stock because the employee incurs the risk that the value of the stock would decline. Accordingly, the transfer of shares of stock occurs on December 29, 2021, the date on which Employee exercises the stock-settled SAR. Therefore, on December 29, 2021, \$150 [10 SAR's x (\$25 FMV per share on date of exercise - \$10 FMV per share on date of grant)], which is the fair market value of 6 shares on the date of exercise ( $\$150 \text{ total FMV} / \$25 \text{ FMV per share on date of exercise} = 6 \text{ shares}$ ), is includible in Employee's gross income.

Even though the fair market value of each share is \$24 on December 31, 2021 when the shares are delivered to Employee's brokerage account, the value of the shares on the delivery date is not taken into account in determining the amount of compensation income includible under I.R.C. § 83 nor the wage amount subject to FICA taxes or federal income tax withholding. At the time Employee exercised the stock option on December 29, 2021, when the fair market value of the stock was \$25 per share, Employee incurred the risk that the value of the stock would decline.

On December 29, 2021, when Employee exercises the stock settled SAR, Employee has beneficial ownership of the stock. Furthermore, when Employee exercises the option, the stock was made available to the Employee without any substantial limitation or restriction and was available to be used by the Employee at any time.<sup>16</sup> Therefore, on December 29, 2021, the \$150 stock payment constitutes wages that have been actually or constructively received by the Employee and is subject to FICA taxes and federal income tax withholding at that time.

If, in conjunction with other wage payments, Employer has accumulated \$100,000 or more in employment taxes upon the \$150 stock payment date of December 29, 2021, then pursuant to the One-Day rule, Employer has an obligation to deposit such employment taxes by the close of the next day, December 30, 2021. If the Employer does not deposit such employment taxes by December 30, 2021, then under the Code the IRS may impose an FTD penalty upon the Employer unless it is shown that such failure is due to reasonable cause and not due to willful neglect.

*Situation 3: Stock-Settled Restricted Stock Unit (RSU)*

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<sup>16</sup> Cf. Rev. Rul. 67-257; Rev. Rul. 78-185; Rev. Rul. 79-305.

When the employer initiates payment under the RSU, the employee acquires a beneficial ownership in the underlying stock. When the employer initiates payment, the number of shares of stock to be transferred and the fair market value of the stock become fixed and determinable. At this time, the employee incurs the risk that the stock's fair market value may decrease or increase prior to actual delivery of the shares (for example, during the period of delay between the time the employer initiates payment and delivery of the shares to the employee's brokerage account). The employee's ability to direct the sale of stock to satisfy the tax withholding obligation is another indication of beneficial ownership. Thus, upon initiation of the payment, the employee is considered a beneficial owner of the stock and the stock is considered transferred for purposes of I.R.C. § 83. Accordingly, the transfer of shares of stock occurs on December 29, 2021, the date on which Employer initiates payment of the 10 shares of stock.<sup>17</sup>

I.R.C. § 83(a) determines the amount of compensation realized upon the transfer and provides, in relevant part, that the excess of the fair market value of the transferred property over the amount (if any) paid for such property shall be included in the gross income of the person who performed such services. If the employee did not pay for the stock issued under the RSU, then the amount of compensation included in the employee's gross income is the fair market value of the stock on the date that the employer or broker initiates the payment. Accordingly, because Employee paid nothing for the shares, on December 29, 2021, \$250 (10 shares x \$25 FMV on date of transfer) is includible in Employee's gross income.

Even though the fair market value of each share is \$24 on December 31, 2021, when the shares are delivered to Employee's brokerage account, the value of the shares on the delivery date is not taken into account in determining the amount of compensation income includible under I.R.C. § 83. At the time Employer initiated payment on December 29, 2021, when the fair market value of the stock was \$25 per share, Employee incurred the risk that the value of the stock would decline.

I.R.C. § 3121(v)(2) determines the FICA tax treatment of NQDC plans. A RSU award is not a stock value right and therefore provides for the deferral of compensation. Amounts paid pursuant to the settlement of an RSU award are NQDC for FICA purposes and are subject to FICA taxes as of the later of (1) the date on which the services creating the right to the amount are performed, or (2) the date on which the right to the amount is no longer subject to a substantial risk of forfeiture. On December 29, 2021, when Employer initiates payment, the Employee's right to the shares of stock transferred is no longer subject to a substantial risk of forfeiture. Thus, the fair market value of the shares of stock transferred in the amount of \$250 is an amount paid subject to FICA taxes at that time.<sup>18</sup>

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<sup>17</sup> This analysis would also apply to a stock-settled SAR whose terms provide that the stock will be paid on a specified date and do not require the service provider to exercise the SAR.

<sup>18</sup> Cf. Rev. Rul. 67-257; Rev. Rul. 78-185; Rev. Rul. 79-305.

As stated above, on December 29, 2021, when Employer initiates payment, Employee has beneficial ownership of the stock. Furthermore, when Employer initiates payment, the stock is made available to the Employee without any substantial limitation or restriction and was available to be used by the Employee at any time. Therefore, on December 29, 2021, the \$250 stock payment constitutes wages that have been actually or constructively received by the Employee and is subject to federal income tax withholding at that time.<sup>19</sup>

If, in conjunction with other wage payments, Employer has accumulated \$100,000 or more in employment taxes upon the \$250 stock payment date of December 29, 2021, then pursuant to the One-Day rule, Employer has an obligation to deposit such employment taxes by the close of the next day, December 30, 2021. If the Employer does not deposit such employment taxes by December 30, 2021, then under the Code the IRS may impose an FTD penalty upon the Employer unless it is shown that such failure is due to reasonable cause and not due to willful neglect.

### Conclusion

In summary, the fair market value of the underlying stock is includible in the Employee's gross income as compensation when the stock is considered transferred for purposes of I.R.C. § 83, which occurs on the earliest of (1) when the Employee exercises a stock award (such as a stock option or a stock-settled SAR) or (2) the Employer initiates payment under the stock award (such as a stock-settled RSU).

For FICA and federal income tax withholding purposes, the stock payments in the above situations are considered wages of the Employee when actually or constructively received, except that for FICA purposes in Situation 3, the settlement of an RSU award is subject to FICA taxes the later of (1) the date on which the services creating the right to the amount are performed, or (2) the date on which the right to the amount is no longer subject to a substantial risk of forfeiture.

On the date the stock payments in the above situations are considered wages for FICA and federal income tax withholding purposes, if the Employer has accumulated \$100,000 or more in employment taxes, then the Employer must deposit the employment taxes by the close of the next day pursuant to the One-Day rule. If the Employer does not deposit such employment taxes by the close of the next day, an FTD penalty may be assessed.

### *Situation 1: Stock Option*

On December 29, 2021, when Employee exercises the stock option, the transfer of shares of stock occurs for purposes of I.R.C. § 83 and \$50 is includible in Employee's

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<sup>19</sup> *Id.*

gross income on this date. This amount also constitutes wages subject to FICA taxes and federal income tax withholding on this date. If, in conjunction with other wage payments, the Employer accumulates \$100,000 or more in employment taxes on this date, then the Employer must deposit any accumulated FICA taxes and federal income tax withholding by the close of the next day, December 30, 2021.

*Situation 2: Stock-Settled Stock Appreciation Rights (SAR's)*

On December 29, 2021, when Employee exercises the stock-settled SAR, the transfer of shares of stock occurs for purposes of I.R.C. § 83 and \$150 is includible in Employee's gross income on this date. This amount also constitutes wages subject to FICA taxes and federal income tax withholding on this date. If, in conjunction with other wage payments, the Employer accumulates \$100,000 or more in employment taxes on this date, then the Employer must deposit any accumulated FICA taxes and federal income tax withholding by the close of the next day, December 30, 2021.

*Situation 3: Stock-Settled Restricted Stock Unit (RSU)*

On December 29, 2021, when Employer initiates the payment of shares of stock, the transfer of shares of stock occurs for purposes of I.R.C. § 83 and \$250 is includible in Employee's gross income on this date. This amount also constitutes wages subject to FICA taxes and federal income tax withholding on this date. If, in conjunction with other wage payments, the Employer accumulates \$100,000 or more in employment taxes on this date, then the Employer must deposit any accumulated FICA taxes and federal income tax withholding by the close of the next day, December 30, 2021.

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Please call Danchai Mekadenaumporn at (202) 317-6798 if you have any further questions.