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BLOG

The Impact on Equity Compensation Tax Withholding of the SEC's New T+1 Settlement Cycle

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Last year, the Securities and Exchange Commission adopted its final rule to shorten the settlement cycle for most broker-dealer securities transactions to one business day after the trade date (T+1). Previously, the standard settlement cycle was two business days after the trade date (T+2). Beginning on May 28, 2024, the T+1 settlement cycle applies to most broker-dealer securities transactions. For additional background on the transition to a T+1 settlement cycle, please see our prior blog post "U.S. to Transition to T+1 Settlements."

T+1 IMPACT ON EQUITY COMPENSATION SETTLEMENT AND TAX WITHHOLDING

The T+1 shortened settlement cycle applies to most broker-dealer transactions. This includes certain broker-facilitated transactions relating to equity compensation plans and, in turn, impacts when an employer is required to remit tax withholding deposits to the Internal Revenue Service (IRS).

IRS'S NEXT-DAY DEPOSIT RULE

Under IRS tax withholding rules, many employers are subject to the "next-day deposit rule" under Treasury Regulations section 31.6302-1(c). That is, notwithstanding an employer's monthly or semiweekly tax withholding deposit schedule, if an employer has amassed a tax withholding obligation of $100,000 or more as of any day during a deposit period, then it must remit the required tax withholding deposits to the IRS by the close of the following business day. The IRS commonly audits remittance of tax withholding deposits, and failure to timely and properly remit such deposits can lead to failure-to-deposit (FTD) penalties under section 6656 of the Internal Revenue Code. As shown below, the penalty amounts increase significantly based on the number of days the deposit is late. Specifically, the penalty jumps from 2% to 5% of the unpaid deposit if the payment is *six* calendar days late as opposed to *five* calendar days, and because the IRS bases the penalty on calendar days that include weekends and holidays when deposits cannot be made, the one day lost in the move from T+2 to T+1 settlement might mean more employers wind up paying a higher penalty amount.

NUMBER OF DAYS DEPOSIT IS LATE	AMOUNT OF THE PENALTY

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1–5 calendar days	2% of the unpaid deposit
6–15 calendar days	5% of the unpaid deposit
More than 15 calendar days	10% of the unpaid deposit
More than 10 calendar days after the date of first notice or letter (for example, CP220 Notice) **or** the day of a notice or letter for immediate payment (for example, CP504J Notice)	15% of the unpaid deposit

The “next-day deposit rule” clock generally starts for employers once employment taxes are required to be withheld. Under IRS guidance (that has been questioned), this technically occurs for nonqualified stock options (NQSOs) and stock-settled stock appreciation rights (SARs) at the time the executive exercises the award, and occurs for stock-settled restricted stock units (RSUs) at the time the employer initiates payment of the award. Under the next-day deposit rule, to avoid the imposition of an FTD penalty, tax withholding deposits would need to be funded within one business day of the exercise of NQSOs and SARs and within one business day of the date an employer initiates payment of an RSU.

LIMITED FTD PENALTY WAIVER FOR CERTAIN INCENTIVE EQUITY TRANSACTIONS

Certain broker-facilitated transactions involving incentive equity awards can make it challenging for an employer to meet the next-day deposit rule, particularly when cash generated from the transaction will be used by an employer to fund its deposit liability. For example, many employers permit employees to exercise NQSOs and SARs through a same-day sale or broker-assisted cashless exercise to fund the payment of tax withholding obligations. Similarly, employers granting RSUs may utilize a sell-to-cover transaction, whereby enough shares to cover the tax withholding obligation generated by the vesting and payment of the shares underlying the RSU are sold into the market by a third-party broker, who in turn remits the cash proceeds to the employer and the net shares to the participant. Under the technical IRS next-day deposit guidance discussed in the prior paragraph, it would have been impossible for an employer to fund the tax withholding deposit liability using the proceeds from the broker-assisted sales, since the employer had one business day from the exercise of an NQSO/SAR or payment of an RSU to make tax withholding deposits to the IRS, while under the prior T+2 settlement cycle the broker had two business days from the execution date of a trade to remit cash proceeds for tax withholding obligations to the employer.

Although no statutory relief exists, the IRS has historically permitted a limited administrative waiver of the FTD penalty for the next-day deposit rule under section 20.1.4.26.2(5) of the Internal Revenue Manual (IRM) used by IRS auditors. Essentially, the waiver permits employers to make tax-withholding deposits within one business day of the broker settlement date (i.e., when the employer received the funds from the broker), as opposed to one business day from the exercise date or payment date of the award. However, if the broker settlement date occurred more than three business days after the exercise date or payment date of the award, then the auditor would use the third business day after the award exercise date or payment date as the start date for the “next-business day deposit rule” clock. Notably, the IRS has only permitted this administrative waiver for tax withholding liability incurred in connection with the exercise of NQSOs and stock-settled SARs and the payment of stock-settled RSUs. Cash-settled awards, restricted stock and other equity awards are not eligible for this waiver.

The administrative waivers reflected in section 20.1.4.26.2(5) of the IRM were updated in March 2024 to reflect the forthcoming change from the T+2 to the T+1 settlement cycle. Now, in order for the administrative waiver to be available, the broker settlement date must occur within *two* business days after the exercise date or payment date of an award, as opposed to *three* business days. Importantly, following the change to the T+1 settlement cycle, even with the available administrative relief, employers now have one fewer day within which to calculate, withhold and remit tax withholding deposits funded through broker-facilitated market sales.

PRACTICAL RECOMMENDATIONS FOR EMPLOYERS PERMITTING SAME-DAY SALES AND SELL-TO-COVER TRANSACTIONS

1. **Ensure payroll teams and systems are prepared for, and remain compliant with, shortened remittance schedules.** Prior to any upcoming sell-to-cover events or sale-day sales, make sure internal teams are aware of the change in timing and connect with your stock plan administrator and/or third-party broker to ensure broker settlements occur within the IRS administrative waiver periods to minimize any potential FTD penalties. Employers with special handling arrangements that allow for large sell-to-cover transactions to be handled over several days to ensure a sale is made at the best possible price should consult with their brokers and legal advisors to ensure the arrangement still allows them to remain in compliance with the next-day deposit rule.
2. **To mitigate the loss of one day in the "next-day deposit rule" remittance timing, find other efficiencies.** Consider leveraging technology to efficiently calculate withholding tax obligations and automate payroll deposit processes. Additionally, to conform to the expedited settlement timeline, employers should consider calculating tax withholding using the closing or opening trading price *from the date prior to the trade execution date*. (The IRS rules do not necessarily require the use of the closing price on the execution date for purposes of calculating the required withholding amount; instead, the IRS rules merely require the use of any reasonable valuation method.) Employers will want to review their equity compensation plan document to determine how it addresses required withholdings and consult with counsel regarding whether a plan amendment is advisable. Generally, we would not expect such a plan amendment to require stockholder approval under applicable exchange rules.
3. **If meeting the new requirements is not feasible, consider alternatives to funding tax withholding obligations.** If permitted under their equity plans, employers could require some or all employees to self-fund their tax withholding obligations by remitting cash to their employer in lieu of a sell-to-cover transaction.

In many cases, the aforementioned method is not possible or desirable, and can lead to employee relations challenges with executives and rank-and-file employees alike. More palatable for employees, but often less feasible for early-stage companies, employers could move from same-day sales, broker-assisted cashless exercise and sell-to-cover transactions to net-settlement transactions. With net settlement, the employer would hold back a number of shares from an award equal to the award's tax withholding obligations as of the date of the award exercise or payment. The employer would then use existing cash reserves to make the tax withholding deposits to the IRS. One benefit of this practice is that it avoids the downward pressure on an issuer's stock price that can occur when a broker is exercising a large sell-to-cover transaction following a big RSU vesting event.

Employers could also take a mixed approach if they have enough cash on hand. The employer could make *estimated* remittance payments for tax withholding obligations prior to their due date to cut off any potential FTD penalty liability, and then make themselves whole once they receive funds from third-party brokers following the completion of same-day sales, broker-assisted cashless exercise and sell-to-cover transactions. We recommend employers consult with their tax and legal advisors when evaluating each alternative.

Please contact a member of the Winston & Strawn Employee Benefits and Executive Compensation Practice or Capital Markets Practice or your Winston relationship attorney for further information.

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