Employment Taxes:
The 101 Course

Presentation for:
Executive Compensation Academy
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Presentation by:
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Housekeeping: Questions

- Questions during this presentation
  - We encourage questions (even though your audio lines are muted)
  - To submit a question, simply type the question in the blank field on the right-hand side of the menu bar and press return
  - If time permits, your questions will be answered at the end of this presentation. And if there is insufficient time, the speaker will respond to you via e-mail after this presentation

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  - This presentation is being recorded for internal purposes only
- Continuing education credits
  - A purpose of the webinar series is to provide FREE CE credits
  - To that end, each presentation is intended to provide 1 credit hour in the following areas:
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About Emily Cabrera

Emily Cabrera, Partner
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- Emily practices in the areas of taxation, executive compensation and employee benefits
- Before entering private practice, Emily:
  - Obtained her B.A. at Harvard University
  - Obtained her J.D. from the University of California at Berkeley School of Law
    - Membership Development Editor, California Law Review
    - Law and Economics Fellowship
    - Prosser Prize for Property and Corporate Tax Law
    - Fenwick Tax Award
- Emily is licensed to practice in:
  - Texas
  - California

Upcoming 2021 Webinars

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- 2021 webinars:
  - Upcoming Proxy Season: Compensatory Thoughts from ISS (Annual Program) (1/7/21)
  - Proxy Disclosure Tips on COVID-Related Compensation Decisions (2/11/21)
  - Executive Compensation Clawbacks: A Robust Analysis of Design Features (3/11/21)
  - Finding Value: How to Negotiate Compensatory Economic Drivers in a Change in Control Transaction (4/8/21)
  - Is a Global Employment Company the Solution to Help Manage Internationally Mobile Employees? (5/13/21)
  - Training Course on Designing an Equity Incentive Plan (6/10/21)
  - Training Course on Stock Option Awards and Stock Appreciation Rights (7/8/21)
  - Training Course on Restricted Stock and Restricted Stock Unit Awards (8/12/21)
  - Preparing for Proxy Season: Start Now (Annual Program) (9/9/21)
  - How to Properly Hire and Fire an Executive Officer (10/14/21)
  - A Review of Unique Non-Employee Director Compensation Arrangements (11/11/21)
  - Thoughts on Maximizing the Deductibility of Compensatory Arrangements (12/9/21)

Sign up here: https://www.huntonak.com/en/insights/executive-compensation-webinar-schedule.html

Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded issuers, and involve substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human Resources

- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation

Our Compensation Practice – What Sets Us Apart (cont.)

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- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

Corporate Governance

- Implement "best practices"
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy

Purpose of this Presentation

- The purpose of this presentation is to discuss employment tax obligations for employers. Most employers must withhold, deposit, report, and/or pay the following employment taxes:
  - Federal income tax,
  - Social Security tax,
  - Medicare Tax, and
  - Federal Unemployment Tax ("***FUTA***")

*This webinar is limited in scope to federal taxes

- To that end, this presentation covers:
  - An overview of each type of tax,
  - When the employment tax obligations arise and what compensation is covered,
  - Specific employment tax considerations relating to nonqualified deferred compensation and equity grants,
  - Requirements relating to depositing employment taxes,
  - Reporting of employment taxes, and
  - Liability for failure to meet obligations

Income Tax Withholding – Obligation

- In general, every employer must deduct and withhold income tax on the amount of wages that are actually or constructively paid to an employee
  - The tax applies regardless of:
    - The irregular performance of the employee's services,
    - The frequency of the payments,
    - The amount of wages paid at any one time, or
    - Whether the employer-employee relationship still exists at the time of payment

- For the purposes of withholding, an "employer" is defined as:
  - any individual, corporation, partnership, trust, estate, joint-stock company, association, syndicate, or other unincorporated organization, group, or entity that pays remuneration for services, whether legal or illegal

- Generally, no income tax withholding (or payment) obligation for independent contractors

Income Tax Withholding – Compensation Covered

- The following types of compensation are generally subject to income tax withholding:
  - Salaries and wages
  - Overtime pay
  - Back pay or retroactive pay increases
  - Bonuses
  - Commissions
  - Vacation pay and accumulated sick leave
  - Distributions from a deferred compensation plan
  - Awards and prizes
  - Taxable fringe benefits
  - Severance pay
- The following types of compensation are generally exempt from income tax withholding:
  - Employer contributions to a qualified plan
  - Elective employee contributions and deferral to a plan containing a qualified cash or deferred compensation arrangement
  - Qualified benefits under a cafeteria plan (Section 125 plan)
  - Deferrals under a nonqualified deferred compensation plan
  - Wages paid to the beneficiary or estate of deceased worker

Income Tax Withholding – Regular and Supplemental Wages

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- Regular wages are amounts that are paid at a regular hourly, daily or similar periodic rate for the current payroll period or at a predetermined fixed determinable amount for the current payroll period
  - Wages that vary from payroll period to payroll period (such as commissions, reported tips, bonuses or overtime pay) are not regular wages, except that an employer may optionally treat tips and overtime pay as regular wages
- Supplemental wages are wage payments to an employee that are not regular wages. For example, these include, but aren't limited to:
  - Bonuses,
  - Settlement or exercise of equity compensation grants,
  - Commissions,
  - Payments for accumulated sick leave,
  - Taxable noncash fringe benefits,
  - Property subject to Section 83 of the Code,
  - Distributions from a nonqualified deferred compensation plan, and
  - Severance pay, etc.
- Compensation not subject to income tax withholding is not considered to be regular wages nor supplemental wages

Income Tax Withholding – Methods for Regular Wages

- Income taxes are withheld from each paycheck based on the employee's Form W-4 (Employee's Withholding Certificate) and the withholding tables published by the IRS

- The Form W-4 provides information on the employee's filing status, number of dependents, adjustments based on multiple jobs or working spouse and additional income, deductions or withholdings
  - Form was redesigned for 2020 to reflect changes in the tax law
  - New employees must fill out a Form W-4
  - Continuing employees are not required to fill out a new Form W-4, but may do so (or may be encouraged to do so)

- Publication 15-T (Federal Income Tax Withholding Methods) authorizes several methods for determining the proper withholding amount

Income Tax Withholding – Form W-4

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- In addition to identifying information and filing status (single, married filing jointly, head of household, etc.), the current Form W-4 has the following optional steps:

Step 2:
Multiple Jobs or Spouse Works

Complete this step if you (1) hold more than one job at a time, or (2) are married filing jointly and your spouse also works. The correct amount of withholding depends on income earned from all of these jobs.

Do **only one** of the following.

(a) Use the estimator at *www.irs.gov/W4App* for most accurate withholding for this step (and Steps 3–4); **or**

(b) Use the Multiple Jobs Worksheet on page 3 and enter the result in Step 4(c) below for roughly accurate withholding; **or**

(c) If there are only two jobs total, you may check this box. Do the same on Form W-4 for the other job. This option is accurate for jobs with similar pay; otherwise, more tax than necessary may be withheld . . . . . . ▶ ☐

TIP: To be accurate, submit a 2021 Form W-4 for all other jobs. If you (or your spouse) have self-employment income, including as an independent contractor, use the estimator.

Complete Steps 3–4(b) on Form W-4 for only ONE of these jobs. Leave those steps blank for the other jobs. (Your withholding will be most accurate if you complete Steps 3–4(b) on the Form W-4 for the highest paying job.)

Step 3: Claim Dependents	If your total income will be $200,000 or less ($400,000 or less if married filing jointly):		
	Multiply the number of qualifying children under age 17 by $2,000 ▶ $		
	Multiply the number of other dependents by $500 . . . . ▶ $		
	Add the amounts above and enter the total here	3	$
Step 4 (optional): Other Adjustments	**(a) Other income (not from jobs).** If you want tax withheld for other income you expect this year that won't have withholding, enter the amount of other income here. This may include interest, dividends, and retirement income	4(a)	$
	(b) Deductions. If you expect to claim deductions other than the standard deduction and want to reduce your withholding, use the Deductions Worksheet on page 3 and enter the result here	4(b)	$
	(c) Extra withholding. Enter any additional tax you want withheld each **pay period** .	4(c)	$

Income Tax Withholding – Methods for Supplemental Wages

- On supplemental wages paid in one calendar year, up to $1 million in the aggregate, the following methods may be used (in the discretion of the employer):
  - Optional Flat Rate Method – Withhold at a flat 22% federal income tax rate
    - Method may be used if supplemental wages are either not paid concurrently with regular wages or are separately stated on the payroll records of the employer
    - Income tax must have been withheld from employee's regular wages during the calendar year of the payment of the preceding calendar year
  - Aggregate Method – Aggregate the supplemental wages with regular wages during the payroll period and apply the federal income tax withholding rate based on the employee's Form W-4

- Special rule for employees that earn more than $1 million in supplemental wages (not including regular wages) in one calendar year
  - Mandatory Flat Rate Method – Withhold at a flat 37% federal income tax rate

- An employee has no discretion to effectuate the income tax withholding rate if either the Option Flat Rate Method or Mandatory Flat Rate Method is used

- Under the Aggregate Method, an employee may adjust their withholding rate by filing a revised Form W-4

FICA Taxes – Compensation Covered

- Some types of compensation are treated differently for purposes of income tax withholding and FICA tax withholding, including:
  - Elective employee contributions and deferrals to a plan containing a qualified cash or deferred compensation arrangement
    - Subject to FICA, but exempt from income tax withholding
  - Wages paid to beneficiary or estate in the same calendar year as worker's death
    - Subject to FICA, but exempt from income tax withholding
  - Deferrals to a nonqualified deferred compensation
    - Generally subject to FICA, but exempt from income tax withholding

FICA Taxes – Rates

- Federal Insurance Contributions Act ("***FICA***") taxes are comprised of two components (Social Security and Medicare Taxes)

- The current rate for the Social Security tax is 6.2% for the employer and 6.2% for the employee
  - Social Security taxes apply only up to the wage base
    - 2020 wage base of $137,700
    - 2021 wage base of $142,800

- The current rate for the Medicare tax is 1.45% for the employer and 1.45% for the employee
  - There is no wage base for Medicare taxes

- The current rate for the Additional Medicare tax is 0.9% for the employee only
  - Required to begin to be withheld in the pay period in which wages in the calendar year exceed $200,000

- The "general timing rule" provides that wages are generally subject to FICA tax when actually or constructively received
  - The "special timing rule" will be addressed later in the presentation

FICA Taxes – Multiple Employers and Common Paymaster

- Each employer is required to withholding Social Security taxes from wages regardless of what other employers in the year may have withheld
  - The employee can get a refund for the excess Social Security taxes withheld
  - However, there is no corresponding ability for the employer to receive a refund of the employer-paid portion of the Social Security taxes

- Common paymaster provisions enable related corporations to be treated as a single employer for purposes of the FICA and FUTA wage base
  - The common paymaster must (i) employ the same employees concurrently with one or more related corporations, and (ii) disburse compensation on behalf of itself and the other related corporation(s) that concurrently employ the employees
  - When a common paymaster disburses all of an employee's wages from all related corporations in the group that concurrently employ the employees at issue, the common paymaster is treated as the only employer for purposes of FICA and FUTA, and a single FICA and FUTA wage base applies

FICA Taxes – Corporate Transactions

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- When corporate transactions meet certain requirements, wages paid by the predecessor are treated as if paid by the successor for the purposes of applying the Social Security and FUTA wage base and for applying the Additional Medicare tax withholding threshold
  - Asset Purchase – The successor rule applies if:
    - The successor during a calendar year acquired substantially all the property used in a trade or business, or used in a separate unit of a trade or business, of the predecessor;
    - The employee was employed in the trade or business of the predecessor immediately prior to the acquisition and is employed by the successor in its trade or business immediately after the acquisition; and
    - Wages were paid during the calendar year in which the acquisition occurred and prior to the acquisition
  - Statutory Merger or Consolidation
    - Rev. Rul. 62-60 provides that if a corporation absorbs another corporation in a statutory merger or consolidation, the resulting entity is regarded as the same taxpayer and same employer as the absorbed corporation for FICA and FUTA purposes

FUTA Taxes

- Unemployment insurance is a joint federal-state program designed to provide cash benefits during temporary periods of unemployment
- The FUTA tax rate is 6.0% and applies to the first $7,000 paid by an employer to each employee during a calendar year (employer-paid only)
  - Generally, a credit is available for state unemployment taxes paid (depending on the state)
- As with Social Security taxes, the general rule is that each employer has its own wage base with respect to FUTA taxes

Nonqualified Deferred Compensation

- Deferred compensation is subject to income tax withholding, FICA taxes, but potentially at different times

- Under the “special timing rule,” amounts deferred under a nonqualified plan are required to be taken into account for FICA purposes on the later of:
  - When the services are performed, and
  - When the employee no longer has a substantial risk of forfeiture

- Under the “non-duplication rule,” once an amount deferred under a nonqualified deferred compensation plan is taken into account, neither that amount, nor income attributable to that amount, is treated as wages for purposes of FICA again

- The “rule of administrative convenience” allows FICA withholding for certain transactions to occur on any date later than, but within the same calendar year, as the date otherwise required to be take into account
  - Under the “lag method,” collection of taxes can be delayed another 3 months (*i.e.*, until March 31st of the following year), but employer must pay interest at the applicable federal rate for the period into the following year for which such payment is delayed

Nonqualified Deferred Compensation – Non-Account Balance Plans

- For non-account balance plans, amounts are not required to be taken into account under FICA until the amount deferred is reasonably ascertainable
  - A benefit from a non-account balance plan is generally reasonably ascertainable when the time and form of payment is known and the only factors to determine the benefit are interest, mortality and cost of living assumptions

- The employer should consider how to satisfy FICA taxes due
  - Require employee to make a payment
  - Withhold from amounts due to the employee
  - Reduce future payment stream
    - May be done under Section 409A, in the discretion of the employer

Overview of Equity Awards

- Restricted stock is governed by Section 83 of the Code
  - Generally, subject to income tax withholding as well as FICA/FUTA when the award vests
- Restricted stock units designed to comply with Section 409A are subject to the same rules as nonqualified deferred compensation
  - Subject to income tax withholding when settled
  - Subject to FICA/FUTA when the award vests
- Incentive Stock Options
  - Not subject to income tax withholding or FICA/FUTA, even in the event of a disqualifying disposition
    - Form W-2 should reflect ordinary income in the event of a disqualifying disposition
- Nonqualified Stock Options
  - Difference between exercise price and fair market value on date of exercise is ordinary income and subject to income tax withholding and FICA/FUTA taxes

Accelerated Vesting Due to Retirement

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- There are two types of vesting schedules that contain "retirement" provisions that act to accelerate vesting:
  - Those with performance-based vesting provisions, and
  - Those with time-based vesting provisions

- For agreements with performance-based vesting provisions that provide for accelerated vesting upon retirement:
  - The continued application of the performance-based metrics within the award agreement should act as a substantial risk of forfeiture. Such is the answer even though the employee has a "contractual" right to benefits (to the extent the performance condition is satisfied) due to his or her attaining retirement age
  - For the above reasons, there is no taxation to the employee due to his or her attaining retirement age. This means no income tax withholding obligation and no FICA/FUTA is triggered at retirement age
  - Instead, FICA/FUTA would be triggered when the performance condition becomes satisfied
    - For restricted stock, income taxation would also be triggered when performance condition becomes satisfied
    - For restricted stock units that comply with Section 409A, income taxation would be triggered upon settlement

Accelerated Vesting Due to Retirement (cont.)

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- For agreements with only time-based vesting provisions that provide for accelerated vesting upon retirement:
  - For restricted stock, the substantial risk of forfeiture under Section 83 is eliminated when the employee attains retirement age and the award is subject to income tax withholding as well as FICA/FUTA taxes
  - Absent the agreement being designed to comply with Section 409A, the employee would have taxable income when he or she attains retirement age (subject to income tax withholding and FICA/FUTA taxes)

- If the agreement is designed to comply with Section 409A, *e.g.*, having the award payout upon his or her separation from service even though he or she previously attained retirement age, then:
  - FICA/FUTA is triggered upon the employee attaining retirement age, and
  - Income tax withholding would be deferred until the employee incurred a separation from service

Net Withholding

- Net withholding allows an employee to satisfy his or her employment tax liability by having shares “withheld” and the employer remitting the appropriate taxes

- The Financial Accounting Standards Board allows employers to effectuate tax withholding of equity awards up to the maximum individual statutory rate without triggering liability classification for accounting purposes

- If net withholding is permitted in connection with restricted stock units upon retirement eligibility, the calculations become complicated
  - Shares withheld for FICA taxes are subject to federal income tax withholding

Depositing Taxes

- Federal deposit rules – generally
  - Semi-weekly deposits are required if the employer reports total employment taxes exceeding $50,000 on IRS Form 941 for a 4-quarter look-back period beginning July 1 and ending June 30
  - Monthly deposits are required if the employer reported $50,000 or less in total employment taxes during the look-back period
- For a semi-weekly depositor, the deposit dates are:
  - For wages paid on Saturday, Sunday, Monday and/or Tuesday, the employer must deposit by the following Friday
  - For wages paid on Wednesday, Thursday and/or Friday, the employer must deposit by the following Wednesday
- Next day deposit rule
  - Under this rule, if an employer accumulates $100,000 or more in employment taxes on any day during a deposit period, then it must deposit these taxes by the end of the next business day
  - This rule is often triggered due to vesting of equity awards, payouts of bonuses, regular wage payments, etc.

Depositing Taxes (cont.)

- How is the next day deposit rule satisfied in situations where the employer is waiting for the employee to remit his/her withholding dollars to the employer?
  - Over withhold on other cash compensation due to the employee (assuming the next day deposit rule coincides with payroll and there is sufficient payroll to satisfy the deposit obligation)
  - Subject to satisfying Section 402 of SOX, the employer could estimate the probable withholding and deposit the amounts early to the IRS, then on the required due date the employer could then direct the IRS as to how that early deposit should be allocated
  - The employer could require the employee to transfer to the employer, in advance of the deposit due date, the estimated withholding obligation (and when the actual deposit is calculated, any overage can then be returned to the employee)
  - Implement net withholding

- Deposits for FUTA taxes must be deposited by the end of the month following the end of the quarter in which the tax due exceeds $500

Reporting

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- Form 941 – Employment Tax Return
  - Used to report:
    - Federal income taxes withheld
    - Social Security taxes withheld
    - Medicare taxes withheld
    - Employer’s share of Social Security and Medicare taxes
    - Employment tax deposits made for the quarter
  - Due by the end of the month following the last month of each quarter
  - Some employers with small payrolls may instead file a Form 944

- Form 940 – Employer’s Annual Federal Unemployment (FUTA) Tax
  - Used to report:
    - FUTA taxes paid
  - Due by January 31, or if all FUTA taxes were deposited when due, February 10

- Income statements, due by January 31 of the following year
  - Form W-2
  - Form 1099

Reporting of Nonqualified Deferred Compensation

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- Amounts deferred under a nonqualified deferred compensation plan need to be reported on Form W-2 at two separate events:
  (i) lapse of substantial risk of forfeiture for FICA, and
  (ii) at distribution for income taxes

- At lapse of substantial risk of forfeiture:
  - The value of the compensation is included in Box 3 and Box 5 of the employee's Form W-2 (but not Box 1)
  - The amount of Social Security and Medicare taxes withheld is reported in Boxes 4 and 6, respectively
  - Additionally, the employer may elect (but is not required) to report the value of the deferral in Box 12, Code Y

1 Wages, tips, other compensation	2 Federal income tax withheld
3 Social security wages	4 Social security tax withheld
5 Medicare wages and tips	6 Medicare tax withheld
7 Social security tips	8 Allocated tips
9	10 Dependent care benefits
11 Nonqualified plans	12a See instructions for box 12 Code
13 Statutory employee ☐ Retirement plan ☐ Third-party sick pay ☐	12b Code
14 Other	12c Code
	12d Code

Reporting of Nonqualified Deferred Compensation

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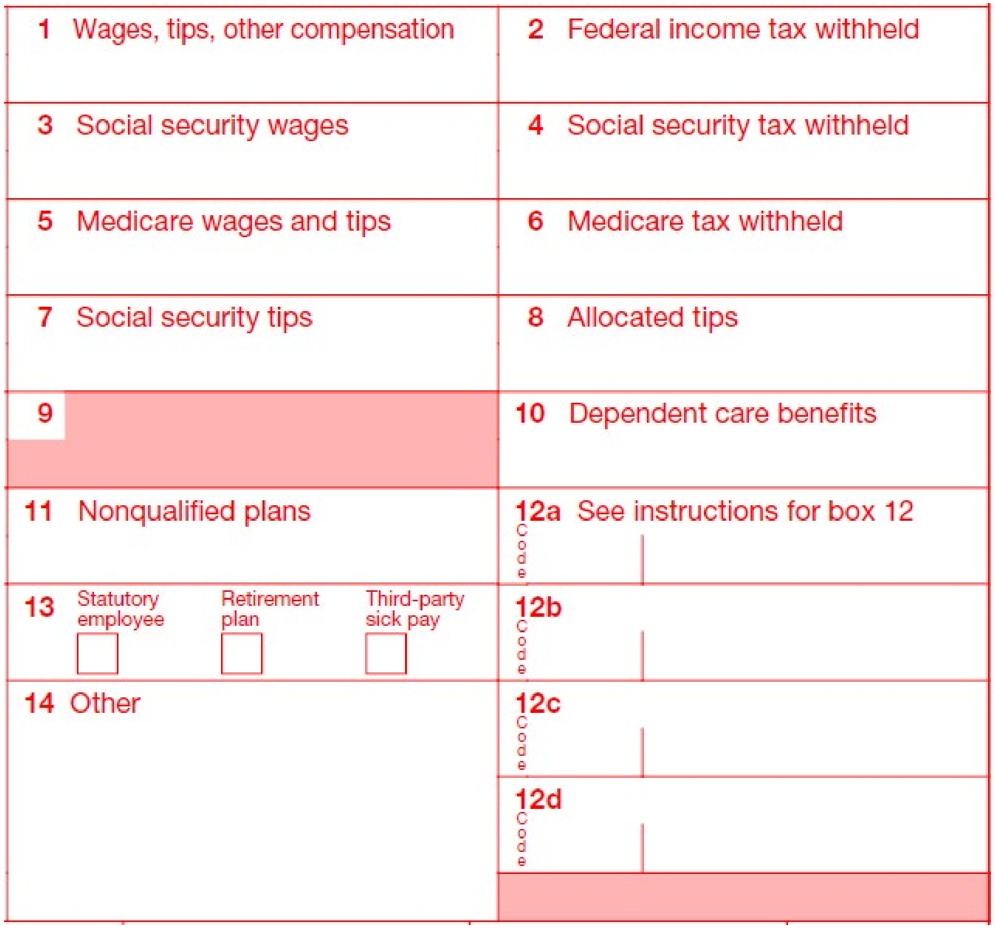
- At distribution:
  - The employer needs to include the value being distributed in Box 1 (but not in Boxes 3 and 5), along with the applicable income tax withholding in Box 2
  - In addition, the employer needs to include the distribution amount in Box 11 of the employee's Form W-2



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9	10 Dependent care benefits
11 Nonqualified plans	12a See instructions for box 12 Code
13 Statutory employee / Retirement plan / Third-party sick pay	12b Code
14 Other	12c Code
	12d Code

Liability

- The Internal Revenue Code of 1986, as amended (the "Code"), imposes various kind of civil penalties for noncompliance with the provisions concerning the reporting and payment of employment and withholding taxes, including
  - Failure to deposit employment taxes
    - 2% of the underpayment if the deposit is 1-5 days late
    - 5% of the underpayment if the deposit is 6-15 days late
    - 10% of the underpayment if the deposit is 16 or more days late
    - 15% in certain situations where the employer received notice from the IRS
  - Underpayment is due to negligence or intentional disregard of rules and regulations
    - 20% accuracy civil penalty
  - Willful failure to collect and pay over withholding taxes
    - 100% civil penalty
  - Failure to file information returns
    - Between $50 and $250 for each failure, depending on when the failure is corrected

- The employer is responsible for the payment of income and FICA taxes even if not collected from the employee

- Corporations and individuals may also be criminally prosecuted under the Code for failure to pay any tax or file a return in the proper manner and at the time required (requires affirmative act and willfulness)

Don't Forget Next Month's Webinar

- Title:
  - Upcoming Proxy Season: Compensatory Thoughts from ISS (Annual Program)

- When:
  - 10:00 am to 11:00 am Central
  - January 7, 2021