

Common U.S. Tax Withholding and Reporting Errors with Respect to Certain RSUs

September 29, 2017 – Cross-Border Counselor

by Marianne O'Bara

A Canadian company (the employer) historically has not issued equity-based awards to employees of its U.S. subsidiaries, but it now is considering doing so. Past posts have addressed potential U.S. income tax pitfalls and the need for careful review of the plan and award agreements prior to the grant of restricted stock units (RSUs) and deferred share units (DSUs) to individuals who are subject to U.S. federal income tax on compensatory income. You can read the DSU blog entry [here](#) and the RSU blog entry [here](#).

Let's assume careful review and drafting have addressed potential U.S. tax issues in terms of the written documents. What are common mistakes that can arise in administering the U.S. awards? A common error with respect to RSUs awarded to U.S. employees is to overlook the correct timing of U.S. employment tax obligations (as distinguished from federal income tax withholding obligations). Confusion can arise when, for U.S. tax purposes, the substantial risk of forfeiture lapses earlier than the year in which the RSUs will be settled/paid out. For purposes of this discussion, when we use the term "vesting" it means the lapse of a substantial risk of forfeiture. Below are examples of how confusion can arise.

Many RSUs provide for immediate settlement upon satisfaction of service-based vesting conditions. In such a case (and absent any "retirement vesting" provision as discussed below) federal income tax and FICA are due essentially at the same time, i.e. when the RSUs vest and are paid out. Some RSUs by their terms delay the income tax event by deferring the payment until an event or date that will occur later than vesting. However, in contrast to income tax withholding, which occurs when shares or cash in settlement of RSUs are actually or constructively received, the FICA tax event cannot be delayed. FICA tax is due for RSUs upon vesting, even if payment/settlement is delayed.

One common oversight is failing to take into consideration the impact that "retirement vesting" in an RSU award will have on FICA tax timing. In the absence of retirement vesting provisions, an RSU that has a service-based vesting period frequently will be

Related Capabilities

- Canada Cross-Border Transactions

settled (shares delivered or cash settlement) immediately upon vesting. In such a case, both federal income and FICA withholding will apply at the time of vesting/settlement. In contrast, if an RSU award provides that it will not be forfeited if the individual retires prior to the scheduled vesting date, the RSU will be vested when the participant becomes *eligible* to retire (because there will be a lapse of the service-based substantial risk of forfeiture), notwithstanding that settlement of the RSU may not occur until the original settlement date. Even if the RSU will be settled on the earlier of the scheduled vesting date and the date of retirement, this will not solve the problem. This is because the risk of forfeiture lapses when the participant is eligible to retire, whether or not he or she in fact retires at that time. Thus FICA taxes will be due at grant if the individual already has met the criteria for retirement, or at the time during the vesting period that an individual first meets the criteria for retirement. This obligation to withhold and pay employment taxes before the RSUs are settled/paid out may be an unpleasant surprise for the employer and the participant.

There are some alternative timing rules for FICA withholding that can provide some (but not complete) relief. We'll discuss them in a future post.

As a reminder, U.S. taxpayers are taxed on worldwide income, regardless of where they reside. U.S. taxpayers are: (i) U.S. citizens regardless of residency; (ii) non-resident aliens ("green card" holders); and (iii) non-citizens, non-green card holders who have a "substantial presence" in the United States under the U.S. income tax laws (but exceptions to this category apply – careful analysis of the facts and applicable tax treaties required).