

Nonqualified Stock Options: Tax Withholding on Former Employees

It is well known that a company has to withhold income and employment taxes from an employee exercising nonqualified stock options.

What About Former Employees?

What is less well known is, what do you do if this person has left the employment of the company? What if they left employment years ago, and are not even in the payroll system anymore?

This is becoming more common because companies starting to extend exercise windows, sometimes for years. You can find a list of the companies who have extended the post-termination exercise periods under their stock option plans to something beyond the traditional 90 day window here: <https://github.com/holman/extended-exercise-windows>

So, What Do You Do?

So, what do you do when a former employee shows up to exercise a stock option that was granted to the person in connection with their employment? Do you withhold? Do you put them back in the payroll system? Or do you simply just issue the a Form 1099?

The answer is — it doesn't matter if an employee left employment years ago. It doesn't matter if the employee is no longer in your payroll system. If the option was granted in the context of employment, then you have to withhold income and employment tax withholding, even if the optionee is no longer an employee at the time of exercise. The character of the payment is wages.

KPMG wrote a helpful guide on this point, which says:

*“The taxable spread on the exercise of an NSO by an employee (or at vesting if the stock received on exercise remains subject to a SROF) is considered wages subject to employment tax withholding and must be reported by the employer on Form W-2, Wage and Tax Statement. **The employment tax withholding and Form W- 2 reporting requirements continue to apply on exercise of an NSO even when the employee option-holder terminates employment with the company prior to exercise of the option.**”*

<https://home.kpmg.com/content/dam/kpmg/pdf/2015/09/tnf-stock-option-sep8-2015.pdf>

The Treasury Regulations on point—26 CFR 31.3121(a)-1(i)—state as follows:

“Remuneration for employment, unless such remuneration is specifically excepted under section

3121(a) or paragraph (j) of this section, constitutes wages **even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them.**”

It is important to get this right, because if you do not withhold the income and employment taxes from the employee, the company can become liable for those amounts to the IRS.