# IRS Hot Topics

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## *What employers need to know about deposit penalties and equity compensation*

The IRS is continuing to pursue and assert penalties against employers for failing to make timely deposits following certain equity transactions. While many employers remain unaware of the strict deposit requirements, others are subjected to penalties as a result of misunderstanding guidance provided to IRS examiners in 2003.

The exercise of nonqualified stock options and often the vesting of restricted shares give rise to employment taxes. Employers continue to be subjected to unexpected deposit penalties. An employer is generally required to deposit employment taxes under the applicable monthly or semi-weekly deposit period rules. However, if on any day the employer accumulates employment taxes of $100,000 or more, those taxes must be deposited by the close of the next banking day.

Graduated rates under section 6656(b) are applicable for failure to make timely deposits of taxes as follows: 2% if the failure is not more than 5 days, 5% if the failure is more than 5 days but not more than 15 days, and 10% if the failure is for more than 15 days. The penalty will not apply to the extent a business can demonstrate that its failure was due to reasonable cause.

Nonqualified stock options are generally taxed at the time the employee exercises the options. The employee exercising the option must recognize ordinary income in the amount of the value of the stock received minus any amounts paid for the stock or the option (in general, the spread between the price at grant and the price at exercise times the number of shares exercised). The income recognized by the employee is treated as compensation to the employee, subject to income tax withholding, employment taxes, and included on Form W-2.

It is common for an employee to sell, on the day the option is exercised, either all of the stock, in a "cashless exercise" transaction to finance the stock purchase, or to sell some of the stock, in a "sell to cover" transaction to fund the employment tax withholding obligation resulting from the exercise. Often an employer may be required to withhold tax upon the actual exercise of nonqualified options. However, until the option is exercised, the resulting stock is sold, and the withholdings are transferred to the employer, the employer has nothing to withhold from, and no cash to transfer to the IRS.

Technically, section 83 provides that income from exercise of nonqualified stock options is included in income on the exercise date. However, the FICA and income tax withholding provisions generally do not impose a withholding obligation on the employer until wages are actually or constructively paid. Thus, it was argued that the shares (or the value of the shares) are not available to the exerciser of the options until the settlement date, and therefore, no actual or constructive payment of wages takes place until that time.

In an effort to provide guidance to field agents examining the issue, on March 14, 2003, the IRS issued a field directive related to the assertion of penalties for failure to deposit employment taxes. The directive remains in effect currently and addresses the issue of whether the exercise date or settlement date is the appropriate date for determining when the IRS will assert a deposit penalty regarding nonstatutory options. IRS examiners are advised not to challenge the timeliness of deposits if such deposits are made within one day of the settlement date, as long as the settlement does not occur more than three days after the exercise date.

The directive has provided considerable relief to employers that have implemented procedures ensuring that deposits are made within the three day window provided in the directive. Unfortunately, many employers remain unaware of the deposit requirements until the exercises become the subject of an IRS examination. Additionally, the directive is intended to address the deposit penalty matter relative to non-qualified stock option exercises only, but many employers are applying the guidance more broadly to other vesting events such as the lifting of restrictions on restricted shares of stock. It appears that for the IRS the matter is clear. When the issue is identified on examination, the agents are routinely applying the deposit penalty and frequently denying relief based on reasonable cause arguments submitted by the employer.

Given the current posture of the IRS, employers should not rely on making a successful reasonable cause argument if this issue becomes the subject of an examination. Rather, employers should review current practices around employment tax deposits resulting from exercises of nonqualified stock options and restricted stock events and ensure that, to the extent possible, processes are in place to meet the deposit requirements.

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