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Stock Option Compensation—Warnings for the Unwary

Stock options are a popular form of compensation provided to employees of corporations. Although commonly used, compensatory stock options involve a number of tax issues that are frequently overlooked by employers. This article discusses several tax considerations that employers should keep in mind when issuing and administering options.

Compensatory stock options typically take the form of incentive stock options ("ISOs") issued to employees, which must meet the criteria set forth in section 422 of the Code, or nonqualified stock options ("NSOs") issued to employees and other service providers, which are not required to meet such criteria. The tax treatment to both the granting employer and the option holder varies depending on whether the options are ISOs or NSOs.

Income Inclusion

The tax treatment of NSOs is generally governed by section 83, unless section 409A applies (see below for a discussion of when stock options are subject to section 409A). Under section 83, the timing of income inclusion depends on whether the option has a readily ascertainable fair market value ("FMV") when the option is granted.[1] If the option does have a readily ascertainable FMV, the option is taxable at grant. However, U.S. stock options issued to employees seldom have a FMV that meets the definition of "readily ascertainable." If an option fails to meet this definition (that is, the option is deemed *not* to have a readily ascertainable FMV at the time of grant), the option becomes taxable at exercise.

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[1] Options have a readily ascertainable FMV at grant under two circumstances: (1) if the option is actively traded, it is treated as having a readily ascertainable FMV or (2) if not actively traded, the option is treated as having a readily ascertainable FMV if: (a) it is transferable by the employee; (b) the option is exercisable immediately in full by the employee; (c) the option or the property subject to the option is not subject to any restriction or condition having a significant effect upon the option FMV; and (d) the FMV of the option privilege is readily ascertainable. Section 1.83-7(b).

An NSO that does not have a readily ascertainable FMV at grant is taxed on the spread between the FMV of the underlying stock and the exercise price on the date the option is exercised. An exception to this rule is triggered when the stock received on exercise is subject to a substantial risk of forfeiture, or "SROF" (that is, the stock is not vested), and a section 83(b) election[2] is not made. In this situation, tax is triggered later—at the time of vesting, based on the spread between the FMV of the underlying stock on the vesting date and the exercise price of the option. The taxable amount is includible as ordinary income.

With respect to an ISO, neither the grant nor exercise of an ISO generally gives rise to a taxable event.[3] But there is an alternative minimum tax adjustment when an ISO is exercised, assuming the stock received on exercise is vested. In addition, if the stock received on exercise of an ISO is held until the later of (1) one year from the date the ISO was exercised and (2) two years from the date the ISO was granted, then the employee is generally taxed at capital gain rates on the future disposition of the stock. If there is a disposition of the stock before these holding period requirements are met (i.e., a "disqualifying disposition"), the stock transfer causes a taxable event in the calendar year of the disqualifying disposition and the employee may recognize a portion of the spread as ordinary income.[4]

Employment Tax Withholding, Depositing, and Reporting

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.[5] Option exercises by service providers other than employees (e.g.,

Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

2 A section 83(b) election allows an employee that receives non-vested property from an employer to include in gross income in the year of transfer the excess of the FMV of the property at the date of transfer over the amount (if any) paid for the property. A section 83(b) election cannot be made at the date of grant of an option if such option has no readily ascertainable FMV because section 83(a) does not apply at that time.

3 Sections 421(a) and 422.

4 Section 421(b).

5 Section 31.3121(a)-1(i).

outside board of directors and independent contractors) are reported on Form 1099-MISC (Box 7) and withholding is typically not required.[6]

Employers are required to deduct and withhold income and Federal Insurance Contributions Act ("FICA") taxes from employees' wages on the exercise of an NSO (or upon the later vesting of stock).[7] An employer must generally withhold on regular wage payments in accordance with the exemptions claimed by the employee on Form W-4, *Employee's Withholding Allowance Certificate*.[8] The Form W-4 may show the employee is exempt from income tax withholding if certain conditions are met.[9] If an employee files an invalid Form W-4 or has indicated that the form includes false information and the employee fails to provide a corrected certificate on request (and a prior certificate is not on file), the employer must withhold as if the employee is a single person claiming no exemptions.[10]

Employers generally are required to deposit employment taxes on either a monthly or a semi-weekly basis.[11] However, Treasury regulation section 31.6302-1(c)(3) requires an employer to deposit employment taxes by the close of the next business day after $100,000 or more of employment taxes have been accumulated during a deposit period. According to a 2003 IRS Field Directive,[12] agents "should not challenge the timeliness of deposits required under Treas. Reg. § 31.6302-1(c), if such deposits are made within one day of the [option exercise] settlement date, as long as such settlement date does not fall more than three days from date of exercise." Despite the apparent relief provided by this IRS policy, procedures should be established to ensure that sufficient cash is available for deposit on a timely basis.

A disqualifying disposition of stock received upon exercise of an ISO results in compensation income reportable on Form W-2.[13] However, income resulting from a disqualifying disposition is not subject to FICA,

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6 If the service provider fails to provide a valid taxpayer identification number, backup withholding would apply to the reportable amount.

7 Sections 31.3402(a)-1(b) and 31.3102-1(a).

8 Section 3402(f)(2)(A).

9 Section 31.3402(n)-1(a).

10 Section 31.3402(f)(2)-1(e).

11 Sections 31.6302-1(c)(1) and (2).

12 March 14, 2003.

13 Section 1.421-2(b)(1)(i).

income tax withholding, or Federal Unemployment Tax Act (FUTA) tax.[14] Thus, if an ISO is exercised followed by a disqualifying disposition, the resulting compensation income must be reported in Box 1 of Form W-2, but such wages are not reportable as FICA wages nor subject to FICA tax, (Boxes 3 – 6 should be blank).[15] The employer must report the exercise of an ISO by filing Form 3921, *Exercise of an Incentive Stock Option Under Section 422(b)*, with the IRS and furnishing the form to the employee for the year the ISO is exercised.

Penalties

Failure to File or Furnish Form W-2

Employers are required to file Form W-2 with the IRS, as well as furnish the form to employees. If an employer fails to perform either of these requirements (including failure to include all required information or including incorrect information on the form), penalties may be imposed.[16] The penalties (which were recently increased) are generally $250 for each information reporting failure (i.e., both a failure to file and failure to furnish may result in a combined $500 penalty per employee), although lower penalties apply if reporting failures are corrected by August 1.[17] The total penalty amount for all such failures during any calendar year cannot exceed $3 million for filing failures with the IRS and $3 million for failures related to furnishing employee wage statements. Lower annual limitations apply to employers with gross receipts of not more than $5 million.

For an intentional disregard of the filing requirements, penalties under sections 6721 and 6722 increase to the greater of $500 or 10 percent of the aggregate dollar amount of the items required to be reported correctly. Additionally, in the case of intentional disregard, the $3 million annual limit does not apply. Whether a failure is due to intentional disregard is generally determined based on the facts and circumstances. Failing to

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[14] Sections 421(b), 3121(a)(22), and 3306(b)(19).

[15] Notice 2002-47, 2002-2 C.B. 97.

[16] Section 6721 imposes penalties with respect to information returns filed with the IRS. Section 6722 imposes penalties with respect to statements required to be furnished to payees, including employees.

[17] These increased penalty amounts are effective for returns required to be filed and statements required to be furnished after December 31, 2015, in accordance with Code sections 6721(a) and 6722(a), as amended by the Trade Preferences Extension Act of 2015, Pub. L. No. 114-27, § 806.

take prompt corrective action upon discovery of a failure is relevant in determining whether a reporting failure was due to intentional disregard.[18]

For example, assume an employer grants NSOs and ISOs to its officers and employees. The employer has experience with employment tax reporting and withholding on option exercises. An officer exercises vested NSOs and ISOs when the aggregate spread between the stock FMV and the exercise price is $2 million and does a same-day sale of the ISO shares (a disqualifying disposition). The employer does not withhold employment taxes and does not file or furnish a Form W-2 showing the $2 million of compensation income.

The potential penalty for failure to file a correct Form W-2 with the IRS is $250 and for the failure to provide Form W-2 to the employee, another $250. However, if the IRS determines that the employer intentionally disregarded the information reporting requirements, the penalty could increase to 10 percent of $2 million (i.e., $200,000) for failure to file Form W-2 with the IRS and another 10 percent penalty for failure to furnish Form W-2 to the employee. Thus, in this example, the intentional disregard penalty could be $400,000 for failing to comply with the information reporting requirements with respect to a single Form W-2.

Failure to Withhold

A disqualifying disposition of ISO shares triggers income inclusion that should be reported on Form W-2, but despite the requirement to report wages, employment tax withholding is not required. As discussed above, this is not the case with respect to the exercise of NSOs as wage withholding is required. An employer that fails to withhold federal income tax (under section 3402(a)) and FICA tax (under section 3102(a)) on NSO exercises by employees remains liable for tax that should have been withheld.[19] An employer is also liable for payment of its share of FICA tax under section 3111.

Wages associated with stock options are treated as supplemental wages and accordingly, employers can withhold at the flat supplemental wage withholding rate (currently 25 percent) if certain conditions are met (including that supplemental wages do not exceed $1 million). Withholding at the highest individual tax rate (currently 39.6 percent) is required to the

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[18] Section 301.6721-1(f)(2) and (3).

[19] Sections 3403 and 3102(b).

extent supplemental wage payments exceed $1 million in a calendar year.[20] The IRS generally uses the supplemental wage withholding rate to determine an employer's liability for failing to withhold federal income tax on wage payments. Liability may also apply when an employer fails to comply with required state tax withholding.

If a withholding tax failure occurs, an employer's liability (for the amount that should have been withheld) can be abated if the employer establishes that the wage payments were reported on the employee's federal income tax return and that all federal income taxes due on that return were paid.[21] Form 4669, *Statement of Payments Received*, can be used for this purpose; the form is completed in part by the employer and in part by the employee. Unless the employee states on Form 4669 that self-employment tax was paid on the wage amounts, the employer remains liable for both the employee and employer shares of FICA tax (otherwise, only the employer's share would be owed). Note that an employer remains liable for potential penalties related to the failure to withhold even when liability for payment of the amount that should have been withheld is abated.

Failure to Timely Deposit

An employer is required to make timely deposits of employment taxes with the IRS. A penalty ranging from 2 to 10 percent of the deposit amount can be imposed on employers that fail to make timely deposits.[22] The amount of the penalty is determined based on the length of time before the failure is corrected.[23] Penalties generally do not apply if the failure to make a timely deposit was due to reasonable cause and not to willful neglect.[24]

Based on the IRS's position in Revenue Ruling 75-191, 1975-1 C.B. 376, a late deposit penalty does not apply if tax was not withheld. The IRS

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[20] Sections 31.3402(g)-1(a)(2) and 31.3402(g)-1(a)(7). Note that for supplemental wages in excess of $1 million (even if paid in one lump sum), the lower flat withholding rate of 25 percent can be utilized on the first $1 million paid.

[21] Section 3402(d).

[22] The penalty increases to 15 percent if a required tax deposit remains unpaid more than 10 days after an IRS notice requesting payment.

[23] A 2 percent penalty applies for deposits that are not more than 5 days late; a 5 percent penalty applies for deposits more than 5 days but not more than 15 days late; and a 10 percent penalty applies for deposits more than 15 days late.

[24] Section 6656(a).

ruling states, "[t]he failure to deposit penalty imposed by section 6656 of the Code does not apply in case of failure to deposit FICA and income taxes which should have been withheld from compensation paid to employees, but which were not withheld." In such a case, however, a late deposit penalty can still be imposed on the employer's share of FICA tax.

Negligence

Code section 6662 imposes a 20 percent penalty on an underpayment of tax required to be shown on a return when the underpayment is attributable to a taxpayer's negligence. For purposes of this penalty, negligence includes a taxpayer's "failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return."[25] Note there is no disclosure exception to the negligence penalty as the minimum standard for making a disclosure—a reasonable basis position—satisfies the standard for avoiding a negligence penalty. A return position will generally satisfy the reasonable basis position if the position is reasonably based on one or more authorities.[26]

A penalty under section 6662 does not apply if a taxpayer can show there was reasonable cause for the underpayment and the taxpayer acted in good faith.[27] Such a determination should consider all pertinent facts and circumstances, which would generally take into account the taxpayer's efforts to determine the proper tax liability.

Interest-Free Adjustments

An employer who has made an error and underpaid federal employment taxes may have the opportunity to correct the error on an interest-free basis.[28] An interest-free adjustment is generally available by filing an amended employment tax return (Form 941-X) by the due date of Form 941 for the calendar quarter during which the error is "ascertained" and paying the underpayment balance due.[29] The regulations provide that "an error is ascertained when the employer has sufficient knowledge of the error to be able to correct it."[30] Although FICA tax adjustments can be

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25 Section 1.6662-3(b)(1).

26 Section 1.6662-3(b)(3).

27 Section 1.6664-4.

28 Section 6205.

29 Sections 31.6205-1(b)(2) and 31.6205-1(c)(2).

30 Section 31.6205-1(a)(5).

made to correct Form 941 filing errors for any quarterly return period open under the statute of limitations period,[31] income tax adjustments must generally be made within the same calendar year the wages were paid. For a more detailed discussion of the interest-free adjustment provision, see What's News in Tax, Certain Late Taxes Can Be Paid Interest Free, by Steven Friedman (August 10, 2015).

Employer Deduction

Generally, an employer is entitled to a deduction when an NSO is exercised if vested stock is transferred to the employee. This deduction is permitted under the employer's normal method of accounting.[32] However, if the stock transferred on exercise of the option is not vested, a deduction is allowed for the tax year of the employer in which or with which ends the employee's tax year in which such amount is included in the gross income of the employee.[33] A deduction is allowed for the amount of compensation included in the employee's gross income to the extent the amount meets the deductibility requirements under section 162 (e.g., constitutes reasonable compensation, is within section 162(m) limitations, etc.). The employer's deduction for disqualifying dispositions of ISOs is permitted in the year of the disqualifying disposition.[34]

For this purpose, the amount included in an employee's income means the amount reported on his or her original or amended return or included in income as a result of an IRS audit of the employee.[35] If the employer timely complies with the applicable Form W-2 reporting requirement, the employee is deemed to have included that amount in gross income. In the case of a disqualifying disposition of stock received on exercise of an ISO, a Form W-2 or Form W-2c (as appropriate) must be provided to the employee or former employee, and filed with the IRS, by the date on which the employer files its tax return claiming a deduction for that amount.

31 The statute of limitations for each quarterly period within a calendar year runs from April 15th of the succeeding year. Section 6501(b)(2).

32 Section 1.83-6(a)(3).

33 Sections 83(h) and 1.83-6(a)(1).

34 Section 421(b).

35 Section 1.83-6(a)(2).

Disallowed Deductions—"Included" in Income

Taxpayers have litigated the meaning of "included" in income and the courts have come to varying conclusions when employees did not include the compensation in income. In *Venture Funding, Ltd. v. Commissioner*,[36] the employer transferred stock to certain employees as compensation. The value of the stock was not included by the employer on Forms W-2 or 1099-MISC issued to these employees for the year of the transfer, and the employees did not report the value of the stock received in their gross income. The employer claimed a deduction of over $1 million for the transfer of stock on its return filed for the year the transfer occurred. The Tax Court disallowed the deduction and found that an employer who did not report or make any income tax withholdings with respect to stock transferred to its employees was not entitled to deduct the stock's compensatory value until the employees actually included that amount in their gross income.

In *Robinson v. United States*,[37] restricted stock was transferred to the Chief Operating Officer ("COO") of the company and he made a section 83(b) election to be taxed on the stock as of the grant date. In making the election, the COO valued the bargain element of the stock (the excess of FMV of the stock over any consideration paid) to be zero, resulting in no income at the time of transfer and all gain on a subsequent sale entitled to capital gain treatment. The company, however, later estimated the value of the stock at transfer, less the consideration paid by the COO, to be over $20 million. The COO failed to notify anyone at the company of his section 83(b) election. After his separation from the company, it discovered the COO's election, issued a corrected Form W-2, and filed for a refund based on the section 83(h) deduction for the compensatory value of the stock at the time of transfer. The appellate court for the Federal Circuit held that "included," under section 83(h), means the amount included as a matter of law, not the amount actually reported on an employee's tax return. The court acknowledged that its decision conflicted with the Tax Court and Sixth Circuit in *Venture Funding, Ltd.*, but the court concluded that the company was entitled to a deduction based on the amount that was legally required to be included in gross income, without regard to the amount that was actually included on the employee's return.

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36 110 T.C. 236 (1998), *aff'd*, 198 F.3d 248 (6th Cir. 1999).

37 335 F.3d 1365 (Fed. Cir. 2003), *rev'g* 52 Fed. Cl. 725 (2002).

Section 409A

In the American Jobs Creation Act of 2004, Congress added a statutory provision, Code section 409A, that governs nonqualified deferred compensation plans. In the process, Congress indicated that the definition of "nonqualified deferred compensation" should be broad enough to include other types of compensation that are not usually considered deferred compensation, such as stock options that fail to meet certain requirements.

Exemption from Section 409A

Options that qualify as ISOs are exempt from section 409A. NSOs are generally exempt from section 409A if they meet the following requirements:[38]

(1) The option is issued on the common stock of the employer;

(2) The exercise price is never less than the FMV[39] of the underlying stock on the date the option is granted and the number of shares subject to the option is fixed on the original date of grant;

(3) The transfer or exercise of the option is subject to taxation under the rules of section 83 described above; and

(4) The option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of the exercise or disposition of the option or the time the stock acquired pursuant to the exercise of the option first becomes vested.

Section 409A Failures

NSOs are subject to section 409A if they fail to meet any of the requirements for exemption listed above. A common reason why an NSO may fail to satisfy these requirements is that the exercise price is determined to be less than the FMV of the stock on the date of grant (often referred to as "discounted options"). This is particularly common when the stock was not publicly traded at the time the option was granted

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38 Section 1.409A-1(b)(5)(i)(A).

39 There are specific guidelines to determine the FMV of stock for purposes of section 409A that are set forth in the regulations, including requirements for establishing the value of stock that is not readily tradable on an established securities market. Section 1.409A-1(b)(5)(iv).

and the exercise price was not based on a valuation that meets the requirements of Treasury regulation section 1.409A-1(b)(5)(iv)(B).

Although NSOs that are subject to section 409A may be structured to comply with section 409A, this is not often the case. Among other requirements, section 409A restricts payment of deferred compensation to six permissible events, including separation from service, death, disability, change in control, fixed date or schedule, and unforeseeable emergency. By their terms, stock options often may result in payment upon exercise that may occur at any time during the option's term and is within the employee's control, and thus is not in compliance with any of the permissible payment events under section 409A.

If an arrangement is subject to, and fails to satisfy the requirements of section 409A, the amount involved is treated as current compensation as soon as it is "vested" (that is, no longer subject to a SROF). With respect to NSOs that are subject to, and noncompliant with section 409A, compensation includible in income upon vesting is equal to the spread between the FMV of the stock at vesting less the exercise price. The employee must also include in income any additional appreciation as of the end of each subsequent year until the option is exercised, canceled, or otherwise terminated. The employer must withhold on this current compensation.

In addition to acceleration of timing for income inclusion, the option holder is subject to a 20 percent additional income tax on such amounts included in income as a result of the section 409A failure. Finally, if the tax on amounts that fail section 409A (including the additional 20 percent income tax) are not timely paid, the individual may also be subject to a premium interest tax based on the underpayment rate plus one percentage point on the underpayment of tax that would have been due had the amount been included in income in the year of vesting. The 20 percent tax and the interest based tax are not subject to employer withholding, but the individual must pay the tax with his or her income tax return. For employee stock options, employers must report income resulting from section 409A failures on Form W-2 in Box 1 and in Box 12 with code Z. With respect to section 409A failures related to nonemployees, income must be reported on Form 1099-MISC in Boxes 7 and 15b. California has similar penalties for section 409A failures, but the additional income tax is at a five percent rate.

Although the additional section 409A income tax and premium interest tax are not an employer obligation, if the employer chooses to gross up the employee for these amounts, the gross up payments are considered additional compensation in the year paid and are subject to income and FICA tax withholding and reporting.

In Notice 2008-113, 2008-2 C.B. 1305, the IRS provided limited correction procedures for unexercised NSOs when the exercise price is erroneously established at less than the FMV of the underlying stock on the grant date. Pursuant to the notice, these NSOs can generally be corrected during the calendar year of grant by increasing the exercise price to the stock FMV on the grant date. For non-insiders (not a director, officer, or 10 percent owner), the relief also applies when the noncompliant options were granted in the immediately prior calendar year. However, certain reporting requirements apply. If the noncompliant NSOs are not vested and will not become vested by the end of the current calendar year, it may be possible under proposed Treasury regulation section 1.409A-4 to restructure the options before the end of the current calendar year to comply with the section 409A permissible payment events discussed above.

Conclusion

Stock options are an integral component of many compensation packages, and have the potential to provide advantages to both the granting employer and to the option holder. As described above, however, there are many traps for the unwary which can lead to unintended—and potentially very costly—consequences. To avoid these negative consequences, and to ensure that the intended benefits of the stock options may be realized, employers should review the current procedures implemented for their existing stock option programs and consider the tax issues discussed above prior to implementing new programs or issuing new options. In the event any failures or errors are discovered, employers may be able to mitigate the resulting expense by taking prompt corrective action. Further, employers can limit future failures by putting procedures in place to facilitate proper administration of the options and compliance with withholding, depositing and reporting requirements, and taking proper and timely employer deductions.

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