

Journal of Multistate Taxation and Incentives

Dept: Compensation and Benefits

Edited by Kathryn M. Jaques, Thomas J. McCord, and Harry J. Rubin

Executive Compensation and Employer Withholding: A Closer Look at a Complicated Issue

While, in some cases, there may be no rules at all, the rules that do exist can be very complicated, with heavy penalties for noncompliance.

By Paul R. Comeau and Timothy P. Noonan

PAUL R. COMEAU is a partner and TIMOTHY P. NOONAN is an associate with the State and Local Tax Practice Group in the Buffalo, New York office of Hodgson Russ LLP, a multinational law firm with offices in New York, Florida, and Toronto. The authors have previously written for THE JOURNAL.

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More than ever, recent corporate scandals have put the focus on executive compensation.¹ With this scrutiny on corporations and executives, focus escalates on every aspect of the executive's income--including simple issues such as tax withholding. For instance, the trouble surrounding Samuel Waksal and ImClone has been well-documented in the press. Waksal was charged last year with insider trading and pleaded guilty to bank fraud, securities fraud, and other felony counts. But this scandal also uncovered the fact that, over the past ten years, Waksal exercised \$130 million in stock options. Not coincidentally, the latest news from ImClone is that the New York Tax Department is investigating the company's failure to withhold tax on stock option income paid to Waksal and other ImClone executives.² The audit has been followed by Securities and Exchange Commission and Department of Justice inquiries.

So, while payroll withholding tax may not have been an important state and local tax topic in the past, it is becoming a significant and noteworthy issue. And with the focus on withholding tax policy and practice, it will become clear that the rules can be very complicated--and in some situations, there may be no rules at all. The following discussion will examine the rules applicable in the withholding tax area and the penalties that may be levied for noncompliance. The analysis will show that the imposition of withholding requirements on companies and their executives, especially concerning items of executive compensation, can be potentially burdensome and perhaps contrary to sound tax policy.

Withholding Taxes: An Overview

Normally, state withholding taxes are not incredibly complicated. Consider New York, for example. Under N.Y. Tax Law §671(a)(1), every employer maintaining an office or transacting business in the state and paying taxable wages for services rendered in New York must deduct and withhold from such wages "an amount substantially equal to the tax reasonably estimated to be due" from the employee at the end of the year. Although "transacting business" is not defined in the statute or regulations, the standard is similar to the concept of "nexus" in the corporate

¹ This issue is a frequent source of discussion and debate in major news outlets. See, e.g., "Wall Street Pain Stops at the Top--CEOs of Big Financial Firms Still Pull Down Fat Paychecks Despite a Dismal Environment," Wall St. J., 3/4/03, page C1; "The Boss's Pay: The WSJ/Mercer 2002 CEO Compensation Survey," Wall St. J., 4/14/03, page R6; "A Mutual-Fund Giant Is Stalking Excessive Pay," Wall St. J., 6/12/02, page C1; "In the Lead: Investors Have to Lead the Charge to Keep Big Bosses in Line," Wall St. J., 9/17/02, page A1.

² See "ImClone Says SEC Opens Tax Probe" (Reuters, 4/10/03).

and sales tax areas.³ Thus, if a business's employees work in New York on a regular basis or during an occasional visit to the state, the employer is obligated to withhold tax.

Residents. With respect to New York residents, employers are required to withhold the appropriate New York State personal income tax on all wages paid. And because New York residents are subject to the state's tax on all their income--regardless of source--where the employee's services are performed is irrelevant.⁴ Tax is withheld on *all* wages.

If the employer also withholds taxes in connection with services performed in another state, however, a credit may be claimed against the New York withholding tax. For example, if the employer withholds both New York and New Jersey taxes for an employee who works 40% of the time in the company's New Jersey office and 60% in the New York office, the employer may take a credit against the full New York tax for the New Jersey withholdings and remit to New York only the net amount.⁵

Employers may, of course, make inadvertent mistakes when determining resident withholding. The employee's resident status may not be known, or personnel and payroll department records may contain inconsistent information in that regard. The employee's primary work location may have changed or could be incorrectly reported. These and other "normal" errors may surface in a withholding tax audit.

Nonresidents. The rules for nonresidents working in New York can get a little more complicated. If all of the nonresident's services are performed exclusively in New York, tax must be withheld from all wages paid to the employee.⁶

If the nonresident employee works part of the time in New York and part-time outside the state, however, only the wages paid for services performed in the state are subject to withholding.⁷ In that instance, the wages allocable to New York for purposes of withholding is that portion of the employee's total compensation that "the total number of working days employed within New York State bears to the total number of working days employed both within and without New York State."⁸

³ See N.Y. Tax Law §671(a); see also 20 N.Y. Codes, Rules & Regs. §171.1.

⁴ See 20 N.Y. Codes, Rules & Regs. §171.5.

⁵ See 20 N.Y. Codes, Rules & Regs. §171.5(b).

⁶ See 20 N.Y. Codes, Rules & Regs. §171.6(a).

⁷ See 20 N.Y. Codes, Rules & Regs. §171.6(b).

⁸ See 20 N.Y. Codes, Rules & Regs. §171.6(b)(2)(ii). See also *Publication NYS-50: Employer's Guide to Unemployment Insurance, Wage Reporting, and Withholding Tax* (N.Y.S. Dept. of Tax'n & Finance, 1/1/01).

Workday allocation example. ABC, Inc. is a California company with an office in New York. The company has a New York-nonresident employee who, during a particular tax year, worked a total of 250 days, 100 of which were spent in California and 150 in New York. Under New York's rules, 60% (150 ÷ 250) of the employee's wages would be subject to New York withholding.

Technically, employers are not required to track the whereabouts of their employees on a daily basis but they are required to make a reasonable estimate, based either on the preceding year or on the employee's estimate, which the employee would provide at the beginning of the year on Form IT-2104.1 ("New York State, New York City, and City of Yonkers Certificate of Nonresidence and Allocation of Withholding Tax"). Moreover, if the situation changed during the year, the employer would be required to make adjustments to ensure adequate withholding. If the employer cannot make a reasonable estimation, it generally is required to withhold tax on all wages paid to the nonresident employee.⁹

Exhibit 1, accompanying this article, features a chart that can be used as a "decision tree" when determining New York withholding tax obligations for various types of employment situations.

The Suburban Restoration case. The harshness of New York's rule may be illustrated by the New York Tax Appeals Tribunal decision in *Matter of Suburban Restoration Co., Inc.*¹⁰ In that case, the taxpayer was a New Jersey construction company that employed, in New York State, several New York residents from whose wages the company appropriately withheld New York tax. At issue was the withholding--or, more appropriately, the lack of withholding--on four New Jersey resident employees who also worked for the company. Based on information received from a New York City agency that had hired the company, the New York Division of Taxation believed that those New York nonresident employees may have performed some services in New York during the tax years at issue. But the Division was unable to gather any further information during the audit, primarily because of the taxpayer's noncompliance.

At a subsequent hearing, the taxpayer's bookkeeper testified that none of the four employees performed any services in New York. The bookkeeper was unable to provide much evidence to support her statements, however, claiming that the records (i.e., daily reports showing workers' hours and locations) had long been destroyed. The Tribunal, noting that the taxpayer had the burden to prove workdays in and out of New York for its nonresident employees, held that the assessment was valid because the taxpayer's evidence was insufficient to show that the employees did not work in New York. That is, the Tribunal put an

⁹ See 20 N.Y. Codes, Rules & Regs. §171.6(b)(5).

¹⁰ N.Y.S. Tax App. Trib., DTA No. 816361, 2/8/01, *aff'd* 299 App. Div. 2d 751, 750 N.Y.S.2d 359 (3d Dept., 2002).

affirmative duty on the taxpayer to prove that the employees in question did not work in New York.

The implication of *Suburban Restoration* is troubling. First of all, the rules potentially could require an employer to track the whereabouts of its employees on a day-to-day basis. This is not always easy for a small company; it could be an administrative nightmare for large multistate or multinational companies that have executives traveling throughout the world. The potential exposure is huge. An employer that fails to adequately substantiate its employees' whereabouts could be required to withhold tax on *all* wages paid, and might be liable for interest and penalties. But the problems only begin there.

Is one day enough? Taken literally, New York's withholding obligations could extend quite far. If the wages paid to a nonresident employee working in New York exceed the employee's personal exemptions--a very low threshold--withholding is required.¹¹ For highly-paid executives, a company may have a New York withholding requirement if the executive visits New York just once a year.

Consider again ABC, Inc., the California company with an office in New York. Its California-based CEO--who is paid \$10 million annually--came into New York five times in one year: three times for board meetings, once to meet with a lender, and once for a deposition in connection with a lawsuit against the company. Overall, he worked 200 days during the year. Nonetheless, since at least part of his compensation--2.5% to be exact (five New York workdays compared with 200 total)--was related to New York services, New York withholding would be required on 2.5% of his income, or \$250,000. In this example, New York tax would have to be withheld on 2.5% of each paycheck the executive receives. And, of course, the executive would be required to file a New York nonresident income tax return.

While these consequences are obviously not a huge financial burden for either the executive or the out-of-state company, several problems nonetheless could arise from the broader application of these rules. First, the example presumes that only one executive came to the state. But what if several ABC executives came to a meeting? Withholding requirements may apply for all of them. Second, presumably ABC can prove the executive made only five trips to the state. As is clear from *Suburban Restoration*, ABC could have the burden to prove all the executive's workdays in and out of the state. Third, as will be seen in the discussion below, several different ways may be used to compensate executives--and a different, and often complicated, tax allocation method may apply to each. Employers are required to know and comply with all these rules. Finally, imposing withholding requirements based on such limited activities creates both political and tax policy concerns. In the above example, the ABC executive came to New York because (1) his company decided to have its board meetings there; (2) he was working with an in-

¹¹ 20 N.Y. Codes, Rules & Regs. §171.6(b)(4).

state bank; and (3) he was involuntarily called in for a deposition. Are these the types of activities that should give rise to tax obligations? Does a state want to discourage companies from having meetings there or conducting business with in-state banks or other local companies?

As noted above, New York is not alone here. Most states place few limits on their ability to require withholding on wages paid to nonresident employees working in-state. Still, a few exceptions exist. For example, Georgia has certain de minimis rules that only require withholding on wages paid to employees (1) who work in the state more than 23 days in a calendar quarter or (2) whose wages for services performed in Georgia exceed 5% of their total annual compensation.¹²

Connecticut also has a de minimis rule for certain isolated activities by nonresident employees. Under Connecticut's rules, an out-of-state employee's occasional presence in the state for management reporting or planning, training, attendance at conferences or symposia, and other similar activities that are secondary to the individual's primary out-of-state duties are not taken into account in determining Connecticut-source income.¹³ Thus, employers will not be forced to withhold Connecticut personal income tax on compensation paid in connection with their employees' casual or isolated activities in Connecticut.

Ohio, Pennsylvania, and some other surrounding states have reciprocal cross-border rules that impose taxes based only on residence, not on work location.¹⁴ These approaches can reduce the administrative burden.

Withholding on Executive Compensation: Stock Options

The possible extended reach of an employer's withholding obligation is not the only troubling issue that can arise in the withholding tax context. Indeed, employers may face even more difficulties trying to determine *how much* to withhold on particular types of income. Withholding on ordinary compensation is generally simple enough. Tax is withheld on wages paid during a particular tax year based on the employee's income level and number of exemptions. Complications may arise, however, when dealing with other types of income--e.g., income that is not necessarily "earned" during the year in which it is paid.

Income from employee stock options. State taxation of a nonresident's stock option income may be used to illustrate the complexity in this area. For federal purposes, an employee who receives a nonqualified stock option is generally not subject to income tax when the option is granted. When the option is

¹² See Ga. Code Ann. §48-7-100(10)(K). See also Ga. Code Ann. §48-7-1(11)(A).

¹³ See Conn. Agencies Reg. §12-711(b)-4(c)(2).

¹⁴ See, e.g., Ohio Rev. Code Ann. §5747.05(A)(3).

exercised, however, the gain attributable to the difference between (1) the option price (typically, the stock's fair market value at the time of grant) and (2) the fair market value of the stock on the option's exercise, is deemed taxable compensation. On a subsequent sale of the stock, the employee is subject to tax on any post-exercise appreciation, but that income generally is a capital gain and subject to tax accordingly.

New York's rules follow these federal principles, and are easily applied to state residents, because their New York taxable income is based on their federal taxable income. The rules for nonresidents, however, are much more difficult.

The problem started in 1986, in *Michaelsen v. New York State Tax Commission*,¹⁵ (a case dealing with qualified options, where all realized income, regardless of its nature, is recognized when the stock is sold), where the New York Court of Appeals (the state's highest court) ruled that nonresidents granted stock options in connection with their New York employment are taxed on income from the exercise of those options based on the difference between the option (or grant) price and the fair market value of the stock at the time the option is exercised. In addition, the court held that this difference constituted compensation for services rendered. Any further appreciation in the value of the stock after the exercise date, however, was investment income and therefore not taxable to a nonresident.

But the *Michaelsen* decision falls short in one very important respect. The case does not instruct nonresident taxpayers on how to allocate the taxable portion of their stock option income to New York when only some services are performed in New York during the "grant-to-exercise" period. Also, what if the taxpayer performs no work in New York during the year of exercise? Are workdays for prior years taken into account? *Michaelsen* did not address these questions.

Subsequently, however, in November of 1995, the New York Department of Taxation issued a Technical Services Bureau (TSB) Memorandum that provided specific rules in situations like this.¹⁶ This memorandum required that stock option income be allocated to New York based on the taxpayer's New York work days during the period between the grant and exercise of each option.¹⁷ The memorandum appears to have changed the Department's long-standing approach, which (as was the situation in *Michaelsen* and earlier cases) focused only on allocation factors in the year of receipt.

¹⁵ 67 N.Y.2d 579, 505 N.Y.S.2d 585, 496 N.E.2d 674 (1986).

¹⁶ See TSB-M-95(3)I, 11/21/95.

¹⁷ This grant-to-exercise allocation applies unless the employee exercises an option after terminating employment with the employer that granted the option. In that situation, the compensable period, and thus the allocation, is limited to the days worked both in and out of the state between the date of the option grant and the date of employment termination.

While these rules are complex, at least New York has issued guidance on how they should be applied. Indeed, nonresidents with stock option income may not like New York's rules, but at least they know what they are.¹⁸

Withholding on option income. With regard to exactly how *employers* are required to withhold tax on this income, the answer is much less clear. Several problems arise.

First, whether, under New York law, stock options even constitute "wages" subject to withholding is unclear. We understand that New York treats option income as compensation, and treats compensation as wages subject to withholding. Nevertheless, New York law distinguishes between "wages" and "remuneration for services ... which does not constitute wages."¹⁹ The latter may be subject to New York withholding only if the Tax Department has provided for withholding by regulation, and the employer and employee agree to such withholding.²⁰ Also, by statute, New York has extended its withholding requirements to certain nonwage payments, including certain deferred compensation, by treating the payment "as if it were wages."²¹ But stock option income is not among the types of payments enumerated for such treatment. This omission could imply that certain deferred compensation, such as stock option income, may not be "wages" for New York withholding purposes.

Even if stock options are "wages" subject to withholding, the proper formula for withholding on nonresidents still is unclear. The Tax Department's regulations state that in determining wages paid for services performed in New York, the employer should allocate the nonresident employee's "total compensation" to New York based on the ratio of the employee's days worked in the state compared with the employee's total days worked. This comparison is done for each tax year and is applied to wages received during the year. A nonresident employee who does not work in New York during the year has no tax liability. If options are "wages," and wages are subject to withholding in this manner, are these wages subject to withholding according to the same formula as other current compensation? Absent a special

¹⁸ The Tax Department attempted to retroactively apply TSB-M-95(3)I, *supra* note 16, to taxpayers who exercised options in years prior to 1995. In *Matter of Rawl*, N.Y. Div. of Tax App., ALJ Determination, DTA No. 813892, 12/10/98 (a case in which the taxpayer was represented by the authors' firm), the Division of Tax Appeals refused to allow the retroactive application of the "grant-to-exercise" rule contained in the memorandum, favoring instead an allocation based solely on factors for the year of exercise.

¹⁹ N.Y. Tax Law §671(a).

²⁰ N.Y. Tax Law §671(a)(2).

²¹ N.Y. Tax Law §671(b)(1).

rule in the regulations, this would seem to be the case.

With respect to these issues, the Tax Department has taken the position in withholding tax audits that employers should withhold the tax reasonably estimated to be due from the employee. For stock options, this position would mean that the employer should follow the methodology set forth under the 1995 TSB memorandum--the grant-to-exercise methodology.

This conclusion, too, is problematic. First of all, the memorandum might be invalid. That is, it sets forth a "rule" that dictates how taxpayers should allocate stock option income but, as a "rule," legally it may not be implemented through an interpretive document such as a TSB memorandum. Instead, New York's administrative procedures law requires that "rules" be instituted by duly promulgated regulations.²² The Tax Department's issuance of a new "rule" through a TSB memorandum arguably violates this state law. Thus, if the methodology espoused in the TSB memorandum is invalid, then clearly the state cannot require employers to comply with it for withholding tax purposes.

Second, even if New York's stock option withholding rules are valid, the application of the grant-to-exercise methodology for withholding tax purposes creates a heavy administrative burden for employers with personnel working in various states. Employers that customarily grant stock options to both resident and nonresident employees may never know how to adequately withhold the proper tax on these employees' stock option income. For instance, grant-to-exercise periods often span many years. An employee might have received options while living and working in another state or country. Over the multi-year period, the employee may have come to New York or may have lived in New York for a portion of the time. It may be impossible to look back to prior years for an estimate of New York services. Under the rules in New York, as well as in California, Colorado, Connecticut, and similar states (see Exhibit 2), employers would be expected to track the location of their employees during the grant-to-exercise period in order to adequately withhold the proper tax. Therefore, the employer should keep and maintain for many years the records substantiating employees' work days. If the employer fails to keep such records or make such estimation, full withholding could be required, as seen in *Suburban Restoration* (discussed above).

Thus, whether withholding is required with respect to stock options remains unclear, and even if it is required, New York law does not provide clear guidance as to how such withholding should be done. Again, this is not just a New York problem. Indeed, because the rules with respect to the taxation of stock options are different in many states, employers could be required to double- or even triple-withhold on stock option income paid to employees. A sampling of a few states demonstrates that personal income taxation of options--and the employer's withholding requirements on such income--varies widely. See Exhibit 2 for

²²

N.Y.S. Admin. Proc. Act §102(2).

examples of some different rules and withholding requirements.

Given the lack of attention paid to withholding taxes in general, employers could face significant exposure concerning the proper withholding on executive compensation. The current tax and legal climate calls for full compliance by businesses and executives. Many states, including as New York, have confusing or incomplete rules, making full, certain compliance difficult or impossible. Each company should examine its internal withholding approach, possibly doing a 50-state self-audit coupled with requests for clarification from applicable states.

Consequences of Noncompliance

As is clear from the above discussion, employers face several difficulties in determining *whether* withholding is required and exactly *how* to comply. This process can be cumbersome and difficult, perhaps not easily understood by even the most seasoned tax practitioner. The potential consequences an employer and its executives could face for making a mistake make this area particularly troublesome.

First, consider the real-world consequences of significant withholding tax errors. Indeed, withholding tax errors may be more likely on large companies' payments to their most highly-compensated employees--the CEOs, CFOs, etc. Given the current economic climate, much skepticism exists in the minds of the public about the honesty and integrity of large companies and their executives. More mistakes relating to how executives satisfy their tax obligations can only mean more negative media focus.

Moreover, one must not forget the normal tax penalties that could apply. New York, for example, imposes a wide array of penalties on both companies and responsible executives for their failure to properly comply with withholding tax rules. Responsible corporate officers such as the president or CFO may be personally liable for unpaid withholding taxes, which could total millions of dollars for a large company. This liability may exist even if the company has been discharged in bankruptcy, or if the statute of limitations for a company assessment has expired. See Exhibit 3 for a summary of New York's withholding tax penalties.

Conclusion

Employers face a difficult burden. They are expected to comply with a state's withholding tax requirements even for executives with very limited activity in a state. Those companies that willingly attempt to meet these obligations will find that compliance is very difficult, given the uncertainty and lack of clear guidelines. Many states, such as New York, have harsh rules but expect reasonable compliance. Some states focus on only the most highly paid executives who spend, for example, at least 10% of their time working in the state or who have an office or other work location in the state. Errors are detected during

withholding tax audits, or when the executives are audited, and patterns are examined. Those who seek guidance from a state and who make a good faith effort to comply, generally will find the state to be receptive. By contrast, those who ignore this problem or operate in a false or fraudulent manner may find that they have civil or criminal exposure, coupled with media attention, embarrassment, a collapsing stock price, and possible financial ruin. []

Practice Note: Reducing the Withholding Burden

Look at statutes, regulations, and other pronouncements of applicable states for possible ways to reduce the administrative burden of withholding on compensation paid to nonresidents-- whether executives or other employees. For example, Ohio, Pennsylvania, and some other surrounding states have reciprocal cross-border rules that impose taxes based only on residence, not on work location. (See, e.g., Ohio Rev. Code Ann. §5747.05(A)(3).) Connecticut has specific rules limiting tax liability for certain isolated activities in the state by nonresident employees, such as an occasional presence in the state for training, seminars, etc. (See Conn. Agencies Reg. §12-711(b)-4(c)(2).)

EXHIBIT 1 New York Withholding Decision Tree

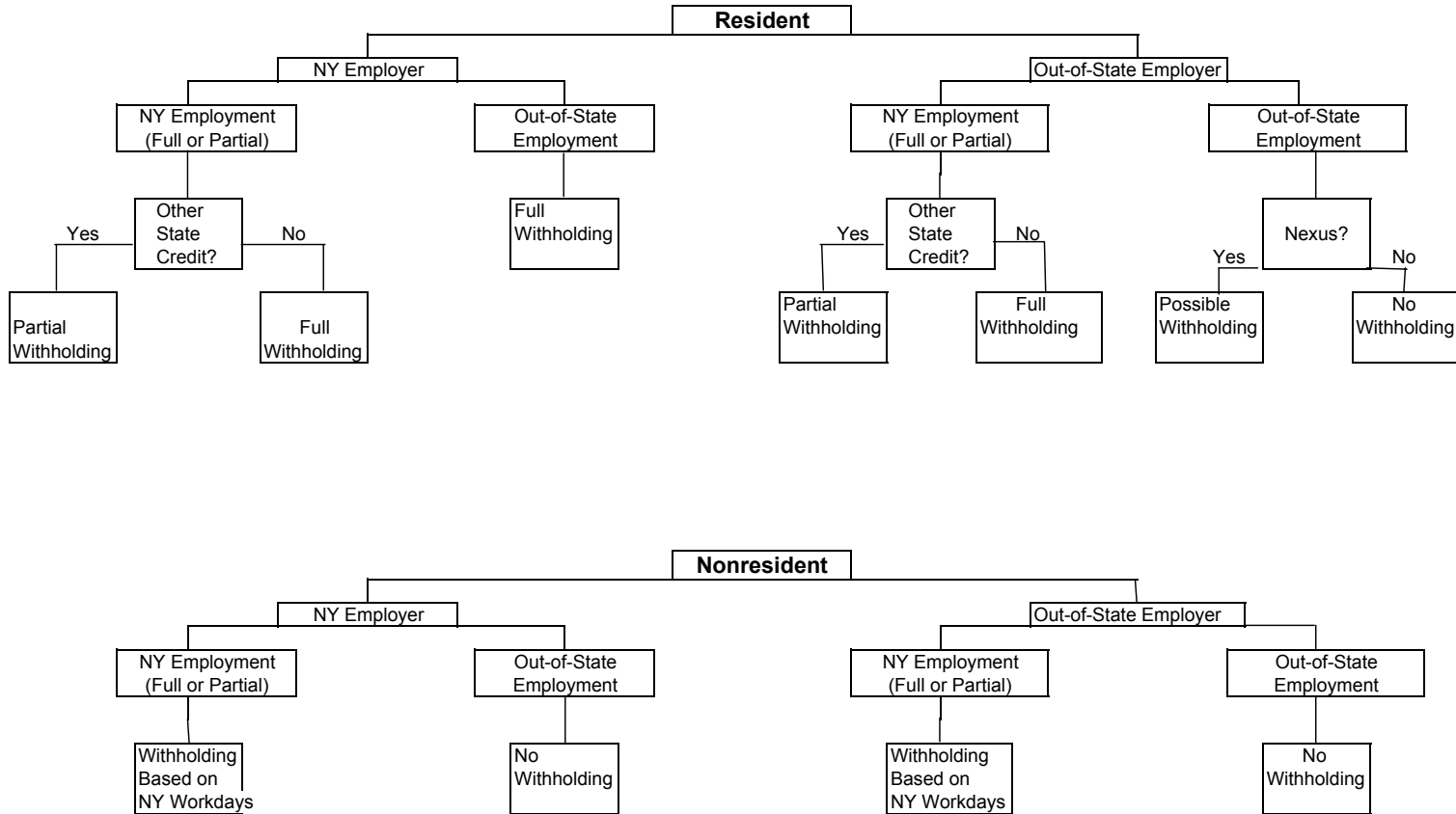


EXHIBIT 2**Multistate Taxation of Stock Options (treatment may vary for qualified vs. nonqualified options)**

State	Taxation of Stock Options for Nonresidents	Potential Employer Responsibility
California	Taxed to the extent of California workdays from date of grant to date of exercise. "FTB Tax News" (May 2001).	Accounting for employee's California workdays over multi-year period.
Colorado	Taxed if employee worked in Colorado prior to exercising the options. "FYI Income 6: Part-Year Residents and Nonresidents" (Colo. Dept. of Rev., Dec. 2001).	Accounting for employee's Colorado workdays over multi-year period.
Connecticut	Unclear. Regulations suggest that employee must work in Connecticut during year of grant AND year of exercise. Conn. Reg. 12-711(b)-18. Informal interpretation by Connecticut suggests they are taxed to the extent of Connecticut workdays from date of grant to date of exercise.	Accounting for employee's Connecticut workdays over multi-year period.
Georgia	No tax on a nonresident's exercise of options.	None.
North Carolina	Taxed to the extent of North Carolina workdays during year of exercise.	Accounting for employee's North Carolina workdays during the year of exercise only.
Ohio	Ohio has specific rules for former residents who exercise options. Ohio tax is imposed on value of the option's appreciation at the time the employee moved out of Ohio. "Ohio Tax Information Release," 3/11/96.	No workday accounting necessary. But employer is required to value options as of employee's date of residence change to determine proper withholding amount.
Oregon	Income from the exercise of options is taxable if the nonresident did any work in Oregon during the grant-to-exercise period. See <i>McBroom v. Dept. of Revenue</i> , 969 P.2d 380 (Ore., 1998). But Oregon has given no guidance on how to allocate for out-of-Oregon workdays.	Unclear. It is likely that the employer would have to account for employee's Oregon workdays over multi-year period.
Pennsylvania	Taxed to the extent of Pennsylvania workdays during year of exercise. See Pa. Office of Chief Counsel Ltr. Rul. PIT-00-068, 10/31/00; see also <i>Marchlen v. Township of Mt. Lebanon</i> , 746 A.2d 566 (Pa., 2000).	Accounting for employee's Pennsylvania workdays during the year of exercise only.

EXHIBIT 3

New York's Withholding Tax Penalties

Noncompliant Action or Inaction	N.Y. Tax Law Sections	Penalty
Non-willful failure to pay withholding tax	685(f) and (a)	5% of the tax required to be shown on the return for each month of noncompliance. Maximum penalty is 25%. Penalties (other than the 100% penalty) can apply even if tax paid by employee.
Willful failure to collect and pay over tax	685(g) and (i)	100% of the tax evaded, not collected, or not accounted for and paid over. Additional fraud penalty not to exceed \$1,000. Penalties (other than the 100% penalty) can apply even if tax paid by employee.
Failure to file return	685(a)(1)(A)	5% of the tax required to be shown on the return for each month of noncompliance. Maximum penalty is 25%.
Late or nonpayment	685(a)(3)	One-half of 1% of such tax if the failure is not for more than one month, plus an additional one-half of 1% for each additional month. Maximum penalty is 25%.
Deficiency due to negligence or intentional disregard	685(b)	5% of the deficiency and 50% of the interest.
Deficiency due to fraud	685(e) and (i)	50% of the deficiency and 50% of the interest. Additional fraud penalty not to exceed \$1,000.
Substantial understatement of liability	685(p)	10% of the underpayment.