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TAX INSIGHTS *from* ROBERTS & HOLLAND LLP

IRS Shines Spotlight On Executive Compensation Practices

By David E. Kahen

The Internal Revenue Service has undertaken a new initiative to verify that income and employment tax requirements relating to executive compensation are being complied with by both corporations and their top executives. It recently released a series of Audit Technique Guides (Guides) to be used by IRS agents in the audits of corporate tax returns of large and mid-sized companies. The Guides direct agents to expand their examinations so as to perform a detailed review of the treatment of compensation paid to officers, directors and other senior executives in order to verify compliance with income tax, as well as employment tax requirements. This will include comparing corporate reporting practices with reporting by executives on their personal tax returns.

This initiative is the culmination of what began as a pilot project undertaken by the IRS in 2003. Motivated by a growing public perception that executive compensation and lavish perquisites were spiraling out of control, and a concern that the increasing value and complexity of compensation arrangements was a fertile area for noncompliance and abuse, the IRS initiated a pilot program involving the audits of 24 large public companies in various industries. The IRS reportedly found significant compliance failures, ranging from non-reporting of compensation by executives, to inadequate corporate governance practices relating to incentive bonuses, non-qualified deferred compensation, golden parachutes and executive perks. These failures were attributed primarily to a lack of adequate corporate internal procedures and controls, even though plan documents themselves complied with the law.

From the experience gained with this pilot project, the IRS decided to expand the scope of its audits of corporate tax returns of large and mid-sized businesses (so-called LMSB taxpayers are those with assets over $10 million) by focusing on the following seven areas, some or all of which will be routinely examined as part of corporate tax return audits:

- Transfers of Compensatory Stock Options to Related Persons
- Non-Qualified Deferred Compensation Plans
- Stock-Based Compensation
- Section 162(m) Salary Deduction Limit
- Fringe Benefits
- Golden Parachutes
- Split Dollar Insurance

What Does This Mean To You?

If not already involved in an examination, you should take steps immediately to prepare for an audit of all forms of compensation paid to your top executives. As noted by the IRS, it is not enough for plan documents to comply with tax requirements. The IRS has urged that companies take the opportunity to review their compensation practices and make any necessary fixes before an audit begins. Examining agents will focus on the actual operation of the plans and the procedures and processes in place to ensure that income is properly reported and deductions taken in the appropriate periods, and that all taxes, including employment taxes, are properly reported and paid. Therefore, it will be necessary to determine that you have in place systems and procedures for monitoring the operation of these plans and compensation arrangements. This will require coordination among your general counsel, tax, human resources, benefits, and finance departments.

What Agents Will Be Doing?

The Guides are detailed roadmaps that provide very specific instructions. In each of the targeted areas, they describe the nature of the compensation or benefit, how to identify it, the basic tax rules, and the issues involved. They direct the agent to look beyond the income tax treatment by the corporation and the executive, to the reporting and employment tax areas. They explain to the agent how to find and identify issues by examining SEC Forms 10-K, Proxy Statements, Annual Reports, Board and Compensation Committee minutes, merger agreements, employment contracts, payroll records, expense accounts, and many other sources. Agents are directed to conduct interviews with corporate personnel outside the usual channels, such as the director of human resources and plan administrators. One of the Guides lists 21 questions about compensation for the agent to ask at his "initial" interview, as a starting point from which to develop his Information Document Requests.

During the pilot program the IRS requested the personal income tax returns of the company's executives as part of the corporate audit. Because companies have resisted asking executives for their personal tax returns, the IRS is now contacting the executives directly, or accessing their returns through their own system.

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Transfers Of Compensatory Options

The transfer of compensatory stock options to family limited partnerships, trusts or other related persons has been used by executives as a technique to defer the recognition of gain. The IRS considers such transfers to be abusive and has classified some such transfers as "listed transactions" (IRS Notice 2003-47). This notice described transactions in which an executive sold options to a related entity, and received in exchange a non-transferable, non-negotiable, unsecured promise to pay that provided for a balloon payment after 15 to 30 years, and sought to defer the recognition of income as wages until the obligation was paid.

Non-Qualified Deferred Compensation Plans

The focus is on the timing of the employer's deduction and the executive's recognition of income. The Guide suggests that agents scrutinize whether deferred amounts are being made available to executives through credit cards, debit cards, and check books, and whether executives are being permitted to borrow against deferred amounts. This would make them taxable under the "constructive receipt" doctrine. So too, amounts irrevocably transferred to a fund in which the executive has a non-forfeitable interest may be currently includible in his income, under the "economic benefit" doctrine, even though he may not be able to draw upon it currently. This would include amounts set aside in a trust or escrow account that is not subject to claims of creditors of the employer.

The tax rules applicable to non-qualified plans were changed substantially by the American Jobs Creation Act of 2004 (which enacted section 409A) for amounts deferred after December 31, 2004. The Guide focuses primarily on the rules applicable to the audits of taxable years ending on or before that date, but indicates that it will be expanded to include compliance with the requirements of section 409A.

Stock-Based Compensation

Since stock-based compensation, and particularly stock options, have become so significant a component of executive compensation, the IRS is concerned with the proper recognition of income upon vesting and disqualifying dispositions. Agents are directed to confirm that any loans made to executives to permit them to exercise options or purchase stock have not been canceled or reduced without payment.

The Guide directs agents to identify all the section 16(b) executives and stock-based compensation arrangements to determine that all compensation related to the various plans has been reported on the executives' W-2s, and that the appropriate employment taxes have been paid.

With respect to non-qualified stock options, the Guide notes that the exercise of such options generally results in compensation income, constituting wages for employment tax and withholding purposes, on the date of exercise, and that these amounts need to be reflected on Form W-2, unless the stock purchased is non-transferable and subject to a substantial risk of forfeiture.

Section 162(m) Salary Deduction Limit

Section 162(m), limits the tax deduction to $1 million per year for compensation paid by public companies to the CEO and the four most highly compensated executive officers other than the CEO. The Guide indicates that the IRS is focusing on issues relating to the "performance-based" exception to the $1 million cap. This includes: whether incentive plans were approved by shareholders as required for purposes of the exception; whether targets established under such plans were changed after the beginning of the performance period; and whether performance-based amounts are being paid to covered executives regardless of whether the specified targets were met. Also, where compensation is deferred from periods during which the executive was a covered employee to periods in which the executive was not within the covered group (a deferral that would generally avoid the application of section 162(m) to the deferred amounts), agents are directed to consider whether the amounts were constructively received in a year prior to the year of payment.

Fringe Benefits

The Guide advises agents that even though certain fringe benefits are taxable, employers may classify them under various expense accounts, and not as wages subject to employment taxes. Agents are directed to start with the assumption that the benefit is taxable, and then determine whether any statutory exclusion would exclude it from the executive's reportable compensation.

Among an extensive list of fringe benefits, the Guide notes numerous instances in which the deduction may be limited or disallowed and the benefit taxable to the executive. For example, while skyboxes at entertainment events are a very popular perk, the deduction for a skybox or other suite may be limited and personal use of a skybox by a corporate executive may be taxable to him. It notes that many corporations make expenditures for club dues and "disguise the deduction," urging agents to scrutinize employment contracts and severance agreements. Personal loans that are interest-free or at below-market rates, or loans where there is an actual forgiveness of debt or a failure to pursue collection where payments are not made, are to be scrutinized. Attention is also focused on non-cash awards and bonuses and the possible use of corporate credit cards for personal expenses.

Security-related transportation and other security costs, such as fortifying executives' homes with special "safe rooms" or other security devices, are also suggested as possibly constituting disguised compensation. Providing use of the employer's private aircraft for personal purposes to the executive or members of his family is addressed, noting that as the rules were tightened by the 2004 Jobs Act, the employer's deduction for such costs may be limited to the amount includible in the executive's income, where the goods, services or facilities provided are compensatory in nature (e.g., personal flights). Other perks such as wealth management and retirement planning are also addressed.

Suffice it to say that agents may be devoting considerable effort to this area.

Golden Parachutes

The Guide provides a nine-step approach to determining whether executives are subject to the 20% excise tax on excess parachute payments from a change-in-control and whether employers are improperly deducting such payments.

Split Dollar Life Insurance

The focus here is whether amounts paid by the employer are being treated appropriately under regulations applicable to arrangements entered into or materially modified after September 17, 2003. With respect to arrangements not subject to those regulations, agents are directed to see whether such arrangements are consistent with transitional guidance previously issued by the IRS.

What Should You Do?

The issuance of these Guides should serve to confirm that the IRS is serious about policing compliance with the tax reporting rules by public companies and their very visible top executives. If you suspect that you might have some skeletons in your closet, you would be wise to accept the IRS's advice and have a review undertaken of your practices and procedures before your next tax audit. And you would do well to expect that corporate tax audits will become more rigorous, time consuming and pervasive.