

TAX MANAGEMENT COMPENSATION PLANNING JOURNAL

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Executive Compensation Audits — Planning Now to Avoid Trouble Later

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INTRODUCTION

With the recent disclosures involving the executive compensation paid to executives at such employers as Enron Corp., WorldCom, Tyco International, the New York Stock Exchange and others, the Internal Revenue Service (IRS or Service) has undertaken a major initiative to examine the executive compensation, fringe benefit, and perquisite practices of employers. Following completion of this initiative, the IRS expects to develop significant data

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on these programs for purposes of being in position to assess the income reporting and withholding practices of employers.

For purposes of this article, we have examined each of the eight areas identified by the IRS under its recently announced Pilot Program ("Pilot Program"). We will also discuss some of the related employer practices likely to be the focus of the IRS's inquiries. Finally, we will address possible planning strategies to bring nonconforming tax positions into compliance.

IRS PILOT PROGRAM — EXECUTIVE COMPENSATION

The Pilot Program, which began in the summer of 2003, involves the review of executive compensation and benefit reporting and withholding practices of primarily large employers. At present, the Pilot Program appears to be limited to 24 companies. When completed, however, the Pilot Program will form the basis of an ongoing, national examination into the executive compensation and fringe benefit practices of a wide range of employers.² As a practical matter, the IRS will likely focus on

² According to Alan Tawshunsky, IRS Assistant Chief Counsel for Employee Benefits, the objective of the Pilot Program is "to build a knowledge base." Mr. Tawshun-

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public companies that can typically be expected to offer executive benefits and perquisites of the type discussed in this article.

This audit initiative focuses on compensation arrangements provided by large employers to their corporate officers, directors and other senior executives. The Large and Mid-Size Business Division (“LMSB”)³ of the IRS has undertaken this Pilot Program in an effort to develop sufficient data (from these 24 companies) to be used to formulate audit guidelines in this area and to permit the training of IRS examiners. Following the development of audit guidelines, the IRS can be expected to review executive compensation programs with increasing frequency as part of its corporate audits.

SCOPE OF EXECUTIVE COMPENSATION AUDITS

The IRS is expected to begin the audit process in the context of a request to review an employer’s corporate tax return (Form 1120). Executives will likely be impacted by this initiative in that the Service may seek to examine the executive’s federal income tax returns in an effort to confirm the treatment of certain executive compensation payments made by his or her employer. Depending on what information the IRS develops, the review may be followed by a corresponding examination of the executive’s Form W-2s to confirm consistent treatment with respect to the reporting of income and applicable withholding of employment taxes.

The IRS has identified the following eight areas that it believes present the most significant opportunities with respect to an employer’s obligation to properly report executive income or withhold appropriate employment taxes. We can anticipate that these areas will now be part of the Service’s comprehensive audit of corporate returns and that these issues will now be expected to be a much higher priority with the IRS in corporate audits.

- **Nonqualified Deferred Compensation.**
Nonqualified deferred compensation plans

sky further indicated that the IRS was attempting to develop an infrastructure to conduct audits of executive compensation practices on a wider basis. Mr. Tawshunsky also confirmed that IRS agents plan to examine executives’ personal income tax returns in order to compare them to deductions taken by their employers. “Tax Administration-Executive Compensation Review to Expand Beyond 24 Companies, IRS Official Says,” 21 *Daily Tax Rep.* (BNA), at G-4 (Feb. 3, 2004).

³ LMSB is a division of the IRS that is responsible for examining corporations, subchapter S corporations, and partnerships with assets of more than \$10 million. LMSB is organized along business industries and handles complicated tax issues and accounting principles faced by companies that, for the most part, have global operations.

have been on the IRS’s radar screen for many years. The areas that the IRS is likely to examine and pursue include compliance with the deduction requirements under §404(a)(5) of the Internal Revenue Procedure Code of 1986, as amended (“Code”), application of employment taxes on deferred amounts, application of the doctrines of constructive receipt and economic benefits, and the use of offshore and rabbi trusts.

- **Stock-Based Compensation.** With the significant increase in equity compensation in the 1990s, a greater percentage of an executive’s compensation is now drawn from stock-based programs. Because this form of compensation is now such a significant part of an executive’s overall compensation package, the IRS will be examining whether employers have, among other things, reported income in connection with the exercise of nonqualified stock options and the lapse of restrictions on restricted stock and whether appropriate employment taxes have been withheld.
- **\$1 Million Cap on Deductible Compensation.** The level of compensation paid to top executives in publicly traded companies has increased significantly over the last 10 years. In many cases, the combination of salary, bonus and stock-based grants may total in the millions of dollars. Section 162(m) of the Code limits the deductible amount of an executive’s remuneration to the extent such remuneration for the taxable year exceeds \$1 million — unless the remuneration is tied to performance-based compensation or is attributable to certain other types of payments described more fully later in this article. The IRS anticipates that, in many cases, the criteria for certain of the exceptions may not have been fully met, resulting in the payment of nondeductible compensation by the employer.
- **Golden Parachute Payments.** Corporate transactions involving a change in control can result in a number of payments being accelerated and may include the vesting of grants or awards under a number of stock-based programs. The determination of an executive’s base amount (used for purposes of determining the existence of excess parachute payments), the timing of any pre-change in control agreements, valuations of accelerated payments and the use of non-

compete agreements raise significant tax reporting issues and may be subject to differing interpretations between the IRS and employers.

- **Split-Dollar Life Insurance.** Split-dollar life insurance has received a significant amount of attention from the IRS in recent years. Under this new IRS initiative, the IRS will carefully review the amount and timing of income recognized to ensure that the income was properly reported, taxes were properly withheld, and the employer did not take any improper deductions.
- **Fringe Benefits and Perquisites.** Fringe benefits and perquisites encompass a wide range of practices and may involve significant payments by employers. Oftentimes, such practices begin informally within the corporate environment and are not always fully known by an employer's tax and accounting departments, resulting in a failure to properly report and withhold on the value of such payments or benefits.
- **Transfers of Compensatory Options to Family Limited Partnerships.** These transactions occur when an executive who has been granted a nonqualified stock option transfers that option to a related party, a family limited partnership, or a trust, in exchange for a debt that is generally unsecured, nonnegotiable and may have a balloon payment feature. These arrangements are being challenged because they are generally not at arm's length and are, apparently, improperly designed to defer taxation of the executive.
- **Offshore Employee Leasing Arrangements.** The IRS is closely scrutinizing offshore transactions involving the leasing of employees back to U.S. employers under circumstances where the arrangement focused principally on avoiding U.S. taxation and generally eliminating employment taxes.

EXECUTIVE COMPENSATION PRACTICES AND CONCERNS

We will examine each of the eight topics in some detail in order to more fully describe some of the areas that will likely be the focus of the IRS's audit initiative and may prove to be problematic for employers. When possible, we will also identify some positions in support of a client's tax position and possible strategies in response to IRS concerns.

Nonqualified Deferred Compensation Plans

The time and manner of income deferral under nonqualified deferred compensation plans has long been a concern of the IRS. Although the Service has not had much success in litigating issues in the area of nonqualified deferred compensation,⁴ it continues to maintain a number of positions with respect to the timing of deferral elections, plan enrollments and distribution elections under such plans.⁵

In view of the prevalence of nonqualified deferred compensation programs among large employers, the IRS can be expected to look closely at several issues, including the following:

- **Deferral Elections.** In reviewing the application of the constructive receipt rules, the timing of deferral elections will likely be subject to careful examination. To the extent executives had the ability to make deferral elections after the period of covered service has commenced, the Service may attempt to take the position that taxable income should have been recognized in the year of the deferral election (i.e., the election to defer was not valid), thus resulting in the employer having had to report income to the executive in the year of the deferral election and properly withhold tax on such amounts in that year. The risk of this situation arising is particularly likely where elections to defer are submitted after the period of service has already commenced or after the services are otherwise performed or substantially completed. This situation may occur most frequently in elections to defer bonus payments that may be submitted after the period for which the bonus has been earned is already complete. In view of the IRS's litigation history in this area (see footnote 4), the IRS's position on such elections may not be supported by the courts.
- **Distribution of Deferred Compensation.** The IRS may also seek to assert the position that changes in the form or timing of deferred compensation distributions, after the period of service but before the amount becomes due and ascertainable, result in constructive receipt. Similarly, deferral plans

⁴ See, e.g., *Veit v. Comr.*, 8 T.C. 809 (1947), *acq.*, 1947-2 C.B. 4; *Veit v. Comr.*, 8 T.C.M. 919 (1949); *Comr. v. Oates*, 207 F.2d 711 (7th Cir. 1953), *aff'g* 18 T.C. 570, *acq.*, 1960-1 C.B. 5; *Martin v. Comr.*, 96 T.C. 39 (1991).

⁵ See Rev. Proc. 71-19, 1971-1 C.B. 698; Rev. Proc. 92-65, 1992-2 C.B. 428.

that rely on employer discretion as to the timing of distributions,⁶ allow the executive to extend the deferral period, or automatically tie the deferral plan distribution election to an election made under the qualified retirement plan are likely targets of IRS reviewers. Although hardship withdrawals have been addressed by the IRS in Rev. Proc. 92-65, the Service will be looking to determine if the provisions of Regs. §1.457-2(h)(4) and (5) regarding an “unforeseeable emergency” have been followed and that a legitimate hardship existed so as to permit the early distribution. While the IRS’s position in this area is well known, courts have not necessarily been willing to acquiesce in that position.

- *FICA and Medicare (Hospital Insurance) Taxes.* The application of the Federal Insurance Contributions Act (“FICA”), including the Medicare (Hospital Insurance) portion of the FICA tax, to account balance and non-account balance deferred compensation plans can be expected to elicit significant IRS scrutiny. The IRS will likely focus on the application of the FICA rules to the vesting of deferred compensation and the employer’s continuing obligation to apply the Medicare portion of FICA tax to all of an executive’s wages for the year.⁷ We can also anticipate that the IRS will examine any excess earnings or interest credits applied to deferred balances by employers.
- *Executive Benefit Funding.* From the IRS’s perspective, this category will encompass issues associated with the funding of non-qualified deferred compensation arrangements through grantor or “rabbi” trusts. While grantor trusts that are subject to the claims of an employer’s creditors are not generally considered to be funded by the

IRS,⁸ the IRS’s examination of executive compensation practices will be certain to examine such arrangements from the employer’s perspective to ensure that the employer has not prematurely taken any federal income tax deductions on contributions to the grantor trust until such time as amounts are paid by the trust to eligible executives and recognized as income by those executives. On the other hand, offshore grantor trusts that have been established in foreign jurisdictions raise additional issues as to whether, by virtue of being in a foreign jurisdiction, the assets may be considered available to the creditors of the grantor (employer) in the event of the grantor’s insolvency. Under such circumstances, it may be very difficult and expensive to reach assets held in a trust settled in a foreign country, thus making such a trust provision effectively inoperative. The IRS has also informally questioned whether executives covered by these offshore grantor trusts may exercise too much control over the trust or its assets so as to treat the executives as having an economic benefit in the offshore trust assets.

Split-Dollar Life Insurance

While the IRS has not had a lot of success in challenging nonqualified deferred compensation arrangements, it has managed to clarify the treatment of split-dollar life insurance programs through the recent issuance of a series of regulations.⁹ These regulations apply to split-dollar life insurance that was entered into or materially modified after September 17, 2003. For those arrangements entered into before the effective date of the regulations, the IRS will be applying the rules as set forth in Notice 2002-8.

As will be discussed briefly below, the rules that applied to split-dollar life insurance arrangements were previously surrounded by uncertainty. With the issuance of Notice 2002-8 and the new final regulations, however, the rules have become clearer, yet increasingly complex, with compliance issues arising based on when the policy was entered into, whether there have been any material modifications, whether the policy is eligible for certain grandfathering treatment, and whether the insurer continues to offer life

⁶ Plan provisions that permit employer discretion regarding the timing of distributions or changes to deferral elections may be problematic if the employer simply acquiesces in the executive’s request. *See, e.g.*, PLR 8830069, *modifying* PLR 8739031.

⁷ FICA taxes will apply to executives’ nonqualified deferred compensation at the later of the date when the services for which the deferred compensation is earned are performed or when there is no substantial risk of forfeiture of the rights to such amount. §3121(v)(2)(A); Regs. §31.3121(v)(2)-1(a)(2). All section references herein are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise indicated.

⁸ Employer contributions to a rabbi or grantor trust do not result in immediate taxation to executives. *See, e.g.*, GCM 39230 (Jan. 20, 1984); PLR 8849030.

⁹ *See* Regs. §§1.61-22, 1.83-3(e), 1.83-6(a)(5), 1.301-1(q) and 1.7872-15.

insurance rates to the general public that are consistent with the rates being provided to the employer (for assessing the cost of life insurance protection to executives).

Although these new rules have reduced the popularity of split-dollar life insurance plans, some companies have chosen to continue split-dollar plans entered into before the final regulations (“grandfathered plans”), while others may have considered some other form of split-dollar life insurance going forward. There are significant incentives for companies to preserve the grandfathered status of split-dollar life insurance plans, and any modifications to grandfathered plans will be carefully examined by IRS reviewers. With respect to the IRS audit initiative, we anticipate that the IRS will focus on those plans that attempt to provide tax-free retirement distributions, that understate cash value at the time of transfer, that fail to report FICA taxes, or that use term rates inconsistent with criteria established under the regulations.

We also anticipate that the IRS will scrutinize transactions intended to qualify for the December 31, 2003 safe harbor roll-out deadline but that, for any number of reasons, were not fully completed in time. A spokesperson for the IRS has previously stated that taxpayers had plenty of advance warning in connection with the safe-harbor roll-out deadline since Treasury released Notice 2002-8 in January 2002.

For ongoing plans, we expect the IRS to monitor split-dollar plans for material changes that will require application of the split-dollar regulations issued in September 2003, rather than the more favorable rules under Notice 2002-8. For plans that rely on the split-dollar regulations issued in September 2003, we expect the IRS to strictly enforce the requirements for split-dollar loan taxation.

\$1 Million Limit on Deductible Compensation

A huge public outcry arose in response to the attention given to the significant rise in executive compensation paid to senior executives in the late 1980s and 1990s. As more and more of these compensation practices were disclosed, Congress enacted §162(m) of the Code, which was intended to limit the amount of remuneration that a publicly held corporation could deduct in connection with paying a covered employee.¹⁰ While this provision was intended to restrict the

¹⁰ Treasury Regulations define a “covered employee” as any employee of the taxpayer who, on the last day of the taxable year is (a) the chief executive officer of the taxpayer or is an individual acting in such a capacity; or (b) an employee having the total compensation for the taxable year that is required to be reported to shareholders under the Securities Exchange Act of 1934 by rea-

amount of executive compensation payments that are deductible, over time, employers have taken advantage of a number of the statutory exceptions that may apply to such remuneration. In the IRS’s view, however, these exceptions have not always been properly applied by employers and, upon review, may prove to have resulted in employers improperly taking deductions for executives’ remuneration in excess of the \$1 million restriction.

- *Review of Covered Employees.* The “covered employee” test is applied on the last day of the taxable year. Therefore, if a chief executive officer or a person who is acting in such a capacity or one of the top four highest paid executives fail to hold such a position on the last day of the taxable year, then the compensation deduction limit for the employer with respect to that executive will not apply. For individuals who are not in one of the identified positions on the last day of the taxable year, however, it must be clear that such individuals do not reasonably foresee resuming their duties in the foreseeable future.¹¹
- *Applicable Employee Remuneration.* For purposes of determining the remuneration¹² subject to the employer’s deduction limitation, the IRS will closely examine the aggregate amount to be claimed as a deduction by the employer for the services performed by the executive. Once this aggregate amount has been identified, the Service will examine whether any remuneration paid is subject to the exceptions relating to commission payments, is performance-based compensation, or relates to a binding contract entered into and continuously effective since February 17, 1993.
- *Performance-Based Compensation.* This exception category is one of the more significant categories for employers and one

son of such employee being among the four highest compensated officers (other than the chief executive officer) for the taxable year. Regs. §1.162-27(c)(2)(i)(A), (B).

¹¹ See Regs. §1.162-27(c)(2); PLR 199910011.

¹² “Remuneration” for this purpose means any remuneration (including benefits) in any medium other than cash and may not include certain payments not treated as wages for purposes of FICA (e.g., under certain qualified plans or arrangements) or any benefit that it is reasonable to believe would be excludible from the executive’s gross income, including salary reduction contributions under §3121(v)(1). It will be adjusted for any remuneration that is disallowed under the parachute rules of §280G. §§162(m)(3)(E), 280G, 3121(a)(5)(A)-(D); Regs. §1.162-27(c)(3)(ii).

that must be carefully documented in order to pass IRS scrutiny. In order for corporations to assert that the remuneration paid to executives qualifies as performance-based compensation, the employer must establish that: (1) the performance goal was pre-established, substantially uncertain at the time established, and in writing and in place not later than 90 days after the period of measured service commenced; (2) an objective compensation formula existed, including the method of computing the compensation payable if the goal was attained; (3) the formula must preclude discretion to increase the amount of compensation payable upon attainment of the goal; (4) the compensation must satisfy the performance-based criteria on a grant-by-grant determination; (5) the compensation must not have been payable without regard to the performance goal being attained; and (6) special rules with respect to the grant or award of stock options and stock appreciation rights that require the approval of the Board of Directors' compensation committee¹³ must be satisfied.¹⁴ In addition, in order for the performance-based compensation rule to apply, the compensation must be payable on account of the executive satisfying one or more performance goals, the material terms of which have been disclosed to and approved by the majority of shareholders. The compensation committee must also certify that the performance goals and any other material terms were satisfied before payment.¹⁵

Golden Parachute Arrangements

“Golden parachute” payments can provide significant deductions to employers and tremendous value to executives. These payments often involve a number of

¹³ The “compensation committee” means the committee of directors (including any subcommittee of directors) of the publicly held corporation that has the authority to establish and administer performance goals and to certify that performance goals are attained. For purposes of §162(m), the compensation committee must be comprised solely of two or more outside directors. Regs. §1.162-27(c)(4), (e)(2).

¹⁴ The plan under which the option or right was granted or awarded must also state the maximum number of shares with respect to options or rights that may be granted or awarded during a specified period to any employee, and the amount of compensation the employee could receive must be based solely on an increase in the value of the stock after the date of the grant or award. See Regs. §1.162-27(e).

¹⁵ §162(m)(4)(C); Regs. §1.162-27(e).

different types of compensation and may include cash, equity and additional perquisites. Before enactment of §280G of the Code, termination agreements made with senior executives in connection with a corporate transaction were generally only subject to corporate deduction limitations for reasonable compensation.

On occasion, the magnitude of these change in control agreements exceeded the bounds of reasonable compensation. Congress concluded that restrictions needed to be imposed on the payments to executives following a change in control and, thus, adopted Code §§280G (defining excess parachute payments) and 4999 (imposing an excise tax in connection with excess parachute payments).

From an employment tax and withholding perspective, golden parachute payments to executives are generally considered wages for employment tax purposes.¹⁶ Thus, employers must withhold and deposit FICA and income taxes and pay unemployment taxes on these payments in the same manner as any other wage payment. The employer must also withhold the 20% excise tax assessed on excess parachute payments that are wages as if it were a tax imposed under Code §3402 (pertaining to income tax collections at the source of the payment).¹⁷

Summarized below are several potential pitfalls that an entity engaging in a change in control may want to consider with respect to preparing for a possible future IRS examination.

- *Determination of “Disqualified Individuals.”* A “disqualified individual” is an individual who, during the “disqualified individual determination period,” is an employee, independent contractor or other person specified in the regulations who performs services for the employer or who is an officer, shareholder or highly compensated individual of the employer.¹⁸ There are many defining, technical criteria in the above definition that are not always easily interpreted. In a change in control situation, for example, it is important to look at each of the criteria in order to properly identify each “disqualified individual” in the population set. The IRS will be looking to determine if an employer has failed to properly identify disqualified individuals who may have been subject to the §280G excess parachute provisions. Special or unique situations involving management companies performing services for the employer subject

¹⁶ Announcement 84-132, 1984-53 I.R.B. 28.

¹⁷ See §4999(c)(1); Announcement 84-132, 1984-53 I.R.B. 28.

¹⁸ Regs. §1.280G-1, Q&A-15.

of the change in control and various share ownership interests in such entity are certain to merit close attention.

- *Determination of the “Base Amount”.* In order to determine the existence of a parachute payment and, ultimately, excess parachute payments, the disqualified individual’s “base amount” must first be carefully established. The base amount is calculated by averaging the disqualified individual’s compensation paid by the employer and included in the taxable income during the five taxable years immediately preceding the year in which the change in control occurs.

The disqualified individual’s compensation includes wages and salary, bonuses, severance pay, nonqualified pension benefits, deferred compensation payments, vesting of restricted stock, the exercise of stock options, and the continuation of health and welfare benefits.¹⁹ Forms of compensation such as excludible fringe benefits, while not included in the base amount, may be treated as parachute payments under Code §280G.²⁰ These can frequently be inappropriately valued and, therefore, could also affect the determination of an individual’s “base amount.”

- *Identifying Parachute Payments.* A “parachute payment” is defined as any payment that is in the nature of compensation to, or for the benefit of, a disqualified individual that is contingent on a change in ownership or control of the employer or in the ownership of a substantial portion of the assets of the employer. Generally, a payment is treated as contingent on a change in control if the agreement was entered into within one year of the change in control and the full amount of the payment would be treated as a parachute payment. However, the regulations allow for the presumption that a payment is contingent on the change in control to be rebutted with clear and convincing evidence that the payment is not contingent. For purposes of an IRS review, many payments may be viewed as comprising compensation contingent upon a change in control. It is important to consider every payment received by the disqualified individual in the 12 months preceding a change in control.

¹⁹ Regs. §1.280G-1, Q&As-34-36.

²⁰ Regs. §1.280G-1, Q&A-34(c).

- *Valuation of Accelerated Payments.* The Treasury Regulations state that if a payment is accelerated due to a change in control, the amount that should be considered contingent on the change in control is the sum of: (1) the present value of the acceleration (based on 120% of the applicable federal rate under Code §1274(d), compounded semiannually); and (2) an amount reflecting the lapse of the obligation to continue to perform services (the value of the lapse of an obligation will be at least equal to one percent for each month between the date of the acceleration and the original payment date). For example, assume that a disqualified individual vests in \$10,000 worth of stock options at the time of a change in control that normally would have vested after six months. If the applicable interest rate is 2%, then the present value of the acceleration is approximately \$99 ($\$10,000 - \$10,000/1.01$). Additionally, the value attributable to the lapse of the obligation to perform services is \$600 ($\$10,000 \times .06$). Therefore the total value attributable to the acceleration of stock options is approximately \$699. Naturally, these valuations are sensitive to many different assumptions and each of those assumptions needs to be carefully analyzed and documented in order to support the taxpayer’s position in the context of any IRS examination.²¹

- *Valuation and Application of Non-Compete Agreement.* The IRS recognizes that an agreement not to compete may rise to the level of an agreement to provide personal services on or after a change in control, and such compensation attributable to the value of the non-compete agreement would not be included as a parachute payment under §280G.²² Although the regulations provide some guidance on the information necessary to support the value to be attributed to

²¹ Revenue Procedures 98-34 and 2003-68 set forth a methodology to value stock options for, among other things, gift and estate tax and §280G (golden parachute) valuations. These Revenue Procedures allow for stock options to be valued using any valuation method that is consistent with Generally Accepted Accounting Principles (GAAP), specifically FAS 123, and additionally provide a safe harbor table based on the Black-Scholes valuation methodology. Historically, most organizations used the Black-Scholes model for these valuations. However, new accounting standards have offered a wide latitude in valuation models and have advocated the use of lattice-based models (binomials) that consider the exercise patterns of the option holders

²² §280G(b)(4)(A); Regs. §1.280G-1, Q&A-42(b).

a non-compete agreement, any such valuation should be supported by an independent valuation report that demonstrates the financial implications to the employer in the event the executive were to compete following his or her termination of employment. In each case, however, the value to be placed on an agreement not to compete appears to be limited to reasonable compensation. It is doubtful the same rules extend to non-solicit or non-disparagement agreements, as they would not substantially constrain the disqualified individual's ability to perform services.²³

It is important to note that in examining the value assigned to a non-compete provision, the IRS will likely consider the enforceability of the provision (for example, the State of California may not enforce such agreements based on statutory and public policy reasons),²⁴ the age of the executive, likelihood that he or she would return to the workforce, and the probability of the employer organization actually enforcing the non-compete agreement against the executive.²⁵

Executive Perquisites and Fringe Benefits

With all of the publicity and newspaper articles devoted to executive compensation arrangements, it is no surprise that the IRS has included executive perquisites and fringe benefits on the list of topics to be examined. Not only have the types of perquisites grown with the growth of corporate businesses and new technologies, the reporting and withholding rules have also become fairly complex and require a fair amount of recordkeeping to justify their tax treatment by employers and ultimate reporting obligations with respect to executives.

While a list of all of the potential perquisites and fringe benefits that may be available and subject to reporting and withholding obligations is beyond the scope of this article (and perhaps any article), we will focus on some of the more popular programs and some of the traps that an unwary employer may be exposed to in connection with the employer's income reporting and withholding obligations.

²³ Regs. §1.280G-1, Q&A-42(d), *Ex. 4*.

²⁴ *See* Ca. Bus. & Prof. Code §16600 (2004) (except as otherwise provided under California law, every contract by which anyone is restrained from engaging in lawful profession, trade, or business of any kind is to that extent void).

²⁵ Regs. §1.280G-1, Q&A-43(b), (d), *Ex. 3*.

In general, fringe benefits include all benefits provided by an employer other than cash salary or wages for services rendered by executives. Fringe benefits may take many forms, including cash payments, goods and services, property, corporate privileges and a wide range of other forms of recognition. From the perspective of the IRS, while certain forms of cash and noncash benefits made available to executives are includible in an executive's gross income, Code provisions specifically exclude cash and noncash benefits involving incidental and various statutory fringe benefits. In view of the complexity of the fringe benefit rules, confusion arises as employers attempt to identify the nature of the payments, goods or services, and then either inadvertently ignore or improperly attempt to determine the appropriate tax treatment to be accorded the fringe benefits received by executives. There are several exclusions that may be applicable to executive programs, including working condition fringes,²⁶ no-additional cost services,²⁷ qualified employee discounts,²⁸ de minimis fringe benefits,²⁹ qualified transportation fringe benefits,³⁰ qualified moving expense reimbursements,³¹ and qualified retirement planning services,³² along with a host of other programs that permit payments to be excluded from an executive's gross income.³³

With respect to fringe benefits under §132, amounts excludible from an executive's gross income are not required to be reported in the executive's gross income and are thus not subject to the withholding and employment tax requirements.³⁴ To the extent that an employer intends to avail itself of the income exclusion rules and rely on one of the various forms of excludible fringe benefit programs, however, the critical issue (and the one most vulnerable to IRS scrutiny) will be whether the fringe benefit program has been properly designed and administered in accordance with the Code and Treasury Regulations, and whether the employer has properly substantiated the executive's entitlement to the income exclusion. To the extent reliance on the fringe benefit exclusion rules was inappropriate, the employer will need to address how

²⁶ §132(a)(3), (d); Regs. §1.132-5.

²⁷ §132(a)(1), (b); Regs. §1.132-2(a)(5).

²⁸ §132(a)(2), (c)(1); Regs. §1.132-3.

²⁹ §132(a)(4), (e)(1); Regs. §1.132-6.

³⁰ §132(a)(5), (f); Regs. §1.132-9.

³¹ §132(a)(6), (g).

³² §132(a)(7), (m).

³³ Other programs providing for the exclusion from income include employer-provided health insurance, employer-provided educational assistance, the use of employer-provided athletic facilities, and qualified military base realignment and closure fringe benefit payments. §§106, 127, 132(j)(4) and (n).

³⁴ §62(a)(2); Regs. §1.62-2(c)(2)(i), (3), (4).

to properly report the executive's proportionate income and employment taxes associated with such plan, program or arrangement.³⁵

- *Nondiscrimination Rules and Fringe Benefits.* Highly compensated employees cannot exclude no-additional cost services, qualified employee discounts or meals provided by an employer-operated eating facility from their gross income unless these fringe benefits are provided on a nondiscriminatory basis. The IRS can be expected to examine the operation of these programs to determine if the benefits are made available on substantially the same basis to each person in a group of employees that does not discriminate in favor of highly compensated employees. To the extent that these fringe benefits are not provided on a nondiscriminatory basis, they would only be excluded from the gross income of those employees who receive the benefit and are not members of the discriminatory group.³⁶
- *Working Condition Fringe Benefits.* Working condition fringe benefits can be subject to intense scrutiny by the IRS. The use of company cars by executives for business and personal use, for example, immediately raises issues with respect to an employer's proper tax reporting and withholding obligations. The general rule is that an executive will not be subject to tax on the value of a working condition fringe benefit if the executive would have been able to deduct the property or service under §162. Thus, an executive will not realize income from the use of the employer's vehicle in the performance of his or her employment responsibilities, nor does an incidental use of the employer's vehicle for personal reasons result in the value being includible in the employee's gross income. Whenever there is more than a de minimis use of an employer's vehicle for personal use, however, an allocation of income between personal and

³⁵ To the extent that the property, services or use of a facility do not qualify for exclusion under §132 or other Code provisions, it would be taxable to the executive under Code §61 (definition of gross income) or §83 (property transferred in connection with the performance of services) and includible in the executive's wages for employment tax purposes. §§61, 83, 132.

³⁶ §§132(j), 414(q); Regs. §1.132-8. Special nondiscrimination rules also apply to qualified retirement planning services under §132(m)(2) and (a)(7).

business use will be required.³⁷ To the extent of any personal use, such use is taxable to the executive as compensation under one of several reporting methods (e.g., the annual lease value method). To the extent the vehicle is employer-provided, the working condition fringe exclusion may apply to that portion of the value of the vehicle corresponding to its percentage of business use or, alternatively, to the business miles driven.

- *Nondeductibility of Spousal Travel.* Similarly, while an employer's deduction for travel expenses in connection with an executive's spouse or dependents will be disallowed unless the requirements of §274(m)(3) are satisfied (i.e., the spouse or dependent must also be an employee of the same entity paying the executive's travel expenses, the spouse or dependent must be traveling in connection with the business, and the spouse or dependent must have been otherwise able to deduct the travel-related expenses), the working condition fringe benefit rules may permit the employer to exclude the travel costs from the executive's gross income, provided that the expenses would qualify as a deduction by the executive under §162.³⁸ Employers can anticipate the IRS focusing on the record-keeping requirements related to substantiation of the business use or purpose of any such expense.³⁹ For this reason, it is critical that employers maintain adequate records or sufficient evidence corroborating the executive's own statements in support of the business purpose.
- *Financial Counseling.* Financial counseling is one of the more common executive perquisites/fringe benefits and has become fairly common for executives in the corporate world. Financial counseling may be treated as a working condition fringe benefit and thus excludible from the executive's gross income. Alternatively, in lieu of treating such counseling as a working condition fringe benefit, financial counseling may also be deductible by the executive under §212 of the Code (relating to expenses for production of income). More recently, §§32(a)(7) and (m) provide for an exclusion

³⁷ Regs. §1.132-5(b).

³⁸ Regs. §1.132-5(t)(1).

³⁹ See, e.g., §274(d); Regs. §1.274-5T(c)(3)(ii)(A), (C).

for qualified retirement planning services provided on a nondiscriminatory basis to employees and their spouses.⁴⁰ It is important to note that to the extent the IRS reviews the qualified retirement planning services, the IRS can be expected to raise the issue that the retirement planning exclusion may not extend to tax preparation, legal or accounting services related to such planning.

Equity Compensation Arrangements

In recent years, a significantly greater portion of an executive's total compensation has been comprised of various forms of equity compensation. Equity-based compensation for most organizations is frequently in the form of restricted stock, performance-based stock, nonqualified stock options ("NQSOs"), and incentive stock options ("ISOs"). In view of the substantial number of equity-based grants and awards being issued to executives by employers, the IRS can be expected to focus on the timing of any corporate deductions, the reporting of income, and the withholding of taxes for executives. Summarized below are several potential situations that an employer organization needs to evaluate to make certain its existing stock-based compensation programs conform to IRS guidance.

- *Incentive Stock Options.* To the extent an employer grants ISOs to its executives, the employer is not entitled to a deduction with respect to the issuance of the ISO or its exercise.⁴¹ To the extent the executive makes a disqualifying disposition of the ISO by, for example, disposing of the stock prematurely, the employer may deduct the amount recognized by the executive as ordinary income in the year of the disqualifying disposition.⁴² With respect to ISOs, the IRS has issued proposed regulations⁴³ that may be relied upon for ISOs granted on or after

June 9, 2003.⁴⁴ The proposed regulations indicate that no income will be recognized by an executive upon the grant or exercise of an ISO because the grant does not constitute the transfer of property under §83.⁴⁵

- *Nonqualified Stock Options.* The employer has no obligation to pay any employment taxes or to withhold any federal income tax upon the grant of NQSOs. NQSOs are not generally taxed to the executive because the option itself (not the underlying employer stock) does not generally have a readily ascertainable fair market value at that time of the grant.⁴⁶ Thus, the employer's ability to take a deduction and its obligation to withhold federal income taxes will not arise until income is recognized by the executive at the time the option is exercised.⁴⁷ To the extent compensation is paid to executives in the form of stock options, such compensation will be treated as wages for purposes of employment taxes and withholding requirements.⁴⁸
- *Restricted Stock.* The issues surrounding restricted stock will center largely on the timing of when the restriction lapses, any elections by the executive under §83(b), and the reporting and withholding obligations of employers under such circumstances. With respect to the IRS's audit initiative, there are several areas that may present concerns for employers and their executives. In this regard, §83(b) elections present several issues in connection with deductions taken by employers, income reporting by executives, and applicable withholding. Frequently, an executive will make a §83(b) election upon receiving an award of restricted stock. (Normally, in the absence of a §83(b) election, federal income taxes are due when the restriction on the stock lapses, and the employer is entitled to a deduction at that time.) Section 83(b) elections permit the executive to take into taxable income the fair

⁴⁰ For purposes of the qualified retirement planning services, the nondiscrimination requirements provide that the planning services must be available on substantially the same terms to each member of the group of employees normally provided education and information regarding an employer's qualified employer plan. §§132(m)(2)-(3), 219(g)(5).

⁴¹ §421(a)(2), (b); Prop. Regs. §1.421-2(a)(1)(ii).

⁴² §421(b).

⁴³ Prop. Regs. §1.421-2(a), (f); see also Prop. Regs. §31.3121(a)-1.

⁴⁴ For ISOs exercised before January 1, 2003, the IRS will not assess FICA tax upon the exercise of the option and will not treat the disposition of the stock acquired pursuant to the exercise of the option as subject to income tax withholding. Notice 2001-14, 2001-6 I.R.B. 516.

⁴⁵ Prop. Regs. §1-421-2(a)(1)(i); see also Regs. §1.83-3(a)(2).

⁴⁶ §83(e)(3).

⁴⁷ §83(h).

⁴⁸ §§3401, 3402(a); Regs. §§31.3121(a)-1(e), 31.3401(a)-4, 31.3402(a)-1(c); see, e.g., Rev. Rul. 79-305, 1979-2 C.B. 350; Rev. Rul. 67-257, 1967-2 C.B. 359.

market value of a stock award at the time of the grant of the award and pay federal income taxes at that time. Because the §83(b) election permits the executive to pay federal income tax at the time of the award, the employer's deduction occurs at the time of the §83(b) election and not at the time the restrictions lapse; capital gain taxes (short or long-term) are payable by the executive once the stock is later sold.

- *Dividends on §83(b) Elections.* With the enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003, P.L. 108-27, the federal income tax rate on dividends was lowered to 15%. From an executive's perspective, the executive may believe that this tax rate would also apply to dividends on restricted stock. Restricted stock grants, however, are treated for federal income tax purposes as being subject to a substantial risk of forfeiture under §83. Thus, until the restrictions lapse, the value of the dividends received are treated as additional compensation to the executive (under Regs. §1.83-1(a)(1)) and are deductible by the employer at that time. After the restrictions lapse, however, an executive will become eligible for the special 15% tax rate on stock dividends. If an executive has made a §83(b) election, effectively recognizing the tax treatment at the time of the award of the restricted stock, then the executive will be eligible for the special dividend tax rate throughout the restricted period.⁴⁹ As the table below illustrates, however,

executives who do not make a timely §83(b) election may find that they have not paid sufficient federal income tax on their restricted stock dividends. With the increased use of restricted stock programs as long-term incentive programs, the IRS can be expected to carefully review the timeliness and impact of §83(b) elections, their implication on dividend payments and deductions taken by employers, and the income recognized by executives.

Example: The example below illustrates the tax effect of filing a §83(b) election on a grant of 10,000 shares of restricted stock valued at \$20.00 on the date of grant, with an annual dividend of \$1.00 and an expected stock appreciation of 10% annually. The example assumes a federal income tax rate of 35%. The example demonstrates the additional taxation owed by an executive in connection with his or her restricted stock under circumstances where the executive did not timely submit the §83(b) election, yet availed himself or herself of the 15% rate on stock dividends. (While the total savings to the executive from filing a §83(b) election is \$16,294 (\$115,214-\$98,920), an additional \$6,000 (\$10,500-\$4,500) of savings would be attributable to the §83(b) election under the new dividend tax rules.)

⁴⁹ Regs. §1.83-2(a); Rev. Rul. 83-22, 1983-1 C.B. 17.

	Shares Vesting	Dividends Paid	Stock Price	Taxes with no §83(b) election			Taxes with §83(b) election		
				Tax on Vesting	Tax on Sale	Tax on Dividends	Tax at Grant	Tax on Sale	Tax on Dividends
Grant Date - 1/1/2004			\$20.00				\$70,000		
Tranche 1 - Vests 1/1/2005	2,000	\$10,000	\$22.00	\$15,400		\$3,500			\$1,500
Tranche 2 - Vests 1/1/2006	2,000	\$10,000	\$24.20	\$16,940		\$3,100			\$1,500
Tranche 3 - Vests 1/1/2007	2,000	\$10,000	\$26.62	\$18,634		\$2,700			\$1,500
Tranche 4 - Vests 1/1/2008	2,000	\$10,000	\$29.28	\$20,497		\$2,300			\$1,500
Tranche 5 - Vests 1/1/2009	2,000	\$10,000	\$32.21	\$22,547		\$1,900			\$1,500
Sale at 1/1/2009			\$32.21		\$10,696			\$24,420	
Subtotals				\$94,019	\$10,696	\$13,500	\$70,000	\$24,420	\$7,500
Total Taxes						\$118,214			\$101,920

- *Internationally Based Employees—Compensatory Stock Options.* Organizations in the United States are becoming increasingly more global. Equities granted to executives living outside of the United States may need to follow the tax code of the country in which the executive resides. Historically, however, equity grants to executives abroad were *de minimis* and their tax ramifications frequently ignored. Many times, however, the corporate tax deductions were taken by U.S. employers based upon the exercise of nonqualified stock options by all employees — both U.S. and foreign. In view of the complexity of the cross-border tax rules, coupled with anticipated IRS scrutiny in this area, it is critical that employer organizations closely examine the tax treatment accorded cross-border equity grants and the compensation implications related to vesting and exercises by executives.

Family Limited Partnerships and Offshore Leasing Arrangements

The transfer of compensatory options to family limited partnerships as well as offshore leasing arrangements have been identified by the IRS as listed transactions, the tax benefits of which may not be allowable under federal income tax laws. The IRS issued Notice 2003-47 (regarding the transfer of compensatory stock options to related persons) and Notice 2003-22 (regarding abusive employee leasing arrangements) to address these two situations and other arrangements that have come to the IRS's attention.⁵⁰ In view of these developments, it is important for employers to make certain that they identify any such ar-

⁵⁰ Notice 2003-47, 2003-30 I.R.B. 132; Notice 2003-22, 2003-18 I.R.B. 851.

rangements that may exist within the corporate enterprise and evaluate their business purpose in light of the IRS's view of such arrangements.

- *Offshore Leasing Arrangements.* The issue of offshore leasing has become more prominent of late and may have several variations or permutations. The IRS will be scrutinizing these types of arrangements as potentially abusive tax shelters that attempt to evade employment and unemployment taxes. Under the typical leasing arrangement, an individual taxpayer supposedly resigns from the current employer or professional corporation and signs an employment contract with an offshore employee leasing company. The offshore company indirectly leases the individual's services back to the original employer using one or more intermediaries. The individual performs the same services before and after entering into the leasing arrangement. These arrangements appear to result in an attempt to evade corporate income and employment taxes. The IRS is challenging the supposed tax benefits claimed for these arrangements and, if appropriate, intends to assess appropriate interest and penalties.
- *Family Limited Partnerships.* Under this practice, an executive receives NQSOs that are transferable to family members. The executive sells the fair market value of an option (as determined by the Black-Scholes value on the date of the sale) to family members. In return, the executive receives a long-term interest-only note providing for a balloon payment. As a result, the sale of the transferable options would be, in theory, governed under §83, and tax would be deferred for the executive until receipt of the note payment. The family limited partner-

ships claim that any gains are taxed at capital gain rates and are offset by the fair market value that the family limited partnerships paid for the option. Thus, the employer loses the ability to deduct the exercise value, which it normally would have been able to deduct. The family limited partnerships and the executive appear to believe that this arrangement works because fair market value is paid for the options, and thus, it may be argued that the sale was at "arms-length." The IRS contends that these arrangements are not at arms-length and thus should be taxable.

EXECUTIVE COMPLIANCE REVIEWS

In light of the IRS's planned initiative in this area, employers would be prudent to consider inventorying the various formal and informal executive compensation programs and perquisites that apply to current and former executives (both domestic and international). Once these arrangements have been identified, employers should undertake a coordinated effort to track the operation and administration of such arrangements, including determining the basis for corporate deductions and income recognition by executives. The purpose of these compliance reviews is to assess the corporation's potential income tax and deduction posture and corresponding employment tax liability associated with the issues covered by the IRS executive audit initiative. Failure to comply with the provisions concerning the reporting and payment of employment and withholding taxes can result in sig-

nificant civil penalties under the Code, including penalties related to the failure to deposit employment taxes, tax underpayments due to negligence or intentional disregard of rules and regulations, substantial understatement of income tax, substantial valuation misstatement penalties, penalties due to underpayment by reason of fraud, willful failure to collect and pay over withholding taxes, and aiding and abetting the understatement of tax liability.⁵¹ The willful failure to pay any tax or file a return in the proper manner and at the time required may also subject a person to criminal penalties.

A focused review of existing programs can help an employer assess potential liability and minimize exposure for the company, its directors, officers and executives. Some relief may be available to employers that can demonstrate that they had a good faith reason to believe that the benefit was excludible from the executive's gross income or, upon learning of any discrepancy, took immediate action to address the situation. In this regard, substantiation and required recordkeeping will be a critical component of any such demonstration.

The prospect of an IRS examination should underscore the importance of employers fully understanding how their executive compensation programs are being administered and reported. Following completion of a careful review of the applicable deduction, reporting and withholding rules, employers will be in a much better position to withstand IRS scrutiny in this area.

⁵¹ §§6656, 6663, 6672, 6701.

Sample of Executive Compensation Topics that May Be Reviewed by IRS

Deferred Compensation	Equity-Based Compensation	Split-Dollar Life Insurance	\$1 Million Deduction	Golden Parachutes	Fringe Benefits	Offshore Leasing	Family Limited Partnerships
Constructive receipt	Timing of deductions	Tax treatment under new regulations	Determine performance-based compensation	Identify disqualified individuals	Working condition fringe benefits	Use of professional service corporations	Transfer of stock options to FLP
FICA	Income recognition	Payments not declared as income	Review of income exceptions	Payments in excess of "safe harbor"	Favoring HCEs	Tax avoidance	Review of income deferrals
Economic benefit	Treatment of vesting	Taxation at "rollout"	Loans as compensation	Base amount determination	Tax preparation	Business purpose	Purpose of transaction
Offshore & rabbi trusts	Disqualifying dispositions	Grandfathered contracts	Applicable remuneration	Timing of employment agreements	Personal computers & cell phones		
Election periods	§83(b) elections	Economic benefit	Timing of shareholder approval	Noncompete agreements	Outplacement		
Bonus payments	Employment taxes	Loan treatment	Composition of compensation committee	Valuation of accelerated stock options	Relocation expenses		
Substantial restrictions on receipt	Treatment as wages		Approval process	Determine parachute payments	Business and spousal travel		
	Grants of awards to foreign employees				Post-employment fringe benefits		