Executive Compensation in the Audit Spotlight

This issue of Tax Controversy Trends discusses the IRS’ increased focus on executive compensation issues on audit. Many of these issues were part of a recent IRS pilot program and now have become a routine part of mid-size and large business audits. Businesses already are seeing the IRS’ increased scrutiny of executive compensation, often starting with an IDR requesting the executives’ personal income tax returns.

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Those interested in the issues discussed in this newsletter should contact a member of the Tax Controversy Practice Group or the Benefits and Compensation Practice Group. The Benefits and Compensation Practice Group is chaired by Jim Barrall in the firm’s Los Angeles office and has over 40 attorneys worldwide. The group provides a full range of transactional services as well as ongoing counsel on benefits and compensation matters to employers in the United States and on a worldwide basis. Members of the group follow, and often participate in, the latest developments in the area. The group, for example, is active in the development of guidance for new section 409A, a sweeping provision that affects a broad range of deferred compensation. Additional information on the Benefits and Compensation Practice Group can be found at: www.lw.com/practice/department.

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IRS Audits Now Focusing On Executive Compensation

What began as an IRS pilot program to identify potential executive compensation issues now has become a routine part of IRS audits of large and mid-size business (LMSB) taxpayers. Although it is the company that is being audited, these issues directly implicate the amount of taxable income reported by the company’s executives. In some cases, the IRS is requesting copies of the executives’ personal tax returns as part of the company’s audit. LMSB taxpayers and their executives need to be prepared to handle these issues on audit. As one IRS official recently stated, companies need to “get their house in order” on executive compensation.

Issues Being Examined

The year-long IRS pilot program, which began in the second half of 2003, examined the executive compensation practices of two dozen large companies. The IRS reported that it found several instances of noncompliance and announced in late 2004 that seven issues would become a routine part of LMSB audits (e.g., corporations with at least $10 million in total assets). As part of this effort, the IRS recently issued audit technique guides for these issues that agents can use when examining the returns filed by companies and their executive employees.

The areas being targeted by the IRS are listed below, along with some of the specific items that the IRS may examine:

Nonqualified deferred compensation - Including the matching of employer deductions with the inclusion of income by executives, timing of employment tax liability, compliance with newly enacted legislation on deferred compensation (Internal Revenue Code section 409A), and the impact of certain nonqualified plan provisions on the qualified status of the employer’s 401(k) plan. The IRS has recently said that section 409A could affect examinations starting with the 2004 audit cycle. The Treasury Department
Stock-based compensation - Including whether equity grant recipients are recognizing income at the proper time and whether tax-favored plans - i.e., employee stock purchase plans (ESPPs) or plans allowing grants of incentive stock options (ISOs) - meet the applicable Internal Revenue Code requirements. As stock options and other types of equity compensation have increased as a component of executive compensation packages, the IRS can be expected to focus on whether employers are reporting income recognition by their executives upon the exercise of nonqualified stock options and the lapse of restrictions on restricted stock, as well as whether payroll taxes have been properly withheld. The audit technique guide suggests that, for public companies, IRS agents start by looking at the stock-based compensation of all persons subject to section 16(b) of the Securities Exchange Act of 1934, who can be identified from SEC filings. If the equity compensation of those persons has not been properly recognized, the audit technique guide suggests that “the audit scope may need to be expanded to other executives accordingly.”

$1 million cap on employer deductions for certain public company executives’ compensation - Involving compliance with the cap and with the rules allowing certain exemptions from the cap, such as for “qualified performance-based compensation.” The IRS is expected to focus on whether the complex requirements for exemption from the cap have been satisfied in both form and operation.

Executive fringe benefits - Including whether certain perquisites (e.g., the use of company aircraft or cars, payment of relocation expenses, and security arrangements) should be treated as taxable salary and wages. The IRS audit technique guide identifies more than 20 common executive fringe benefits, and IRS agents have sample information document requests (IDRs) for examining fringe benefit issues. If fringe benefits of high enough value have been excluded improperly from an executive’s gross income, that problem could potentially cause the executive’s income to exceed the $1 million deductibility cap.

Golden parachute payments - Including whether executives are paying the 20% excise tax on change-in-control payments exceeding three times the person’s average annual compensation during the preceding 5 years, and whether employers are improperly taking deductions for such “excess parachute payments.”

Split-dollar life insurance - Including whether executives are recognizing the proper amount of income with respect to these arrangements. The Treasury Department and the IRS have addressed split-dollar life insurance in recent final regulations applicable to any split-dollar life insurance arrangement entered into or materially modified after September 17, 2003, and in other guidance applicable to earlier arrangements.

Transfers of compensatory stock options to family limited partnerships - Including whether executives are attempting to defer gain recognition with respect to nonqualified stock options by, for example, transferring nonqualified stock options to a related party (such as a family limited partnership) in exchange for a long-term unsecured note. The IRS considers these so-called “FLP” arrangements abusive tax shelters (see IRS Notice 2003-47). The IRS recently announced a limited-time settlement initiative (see IRS Announcement 2005-19) for executives who entered into these transactions before July 2, 2003. Under the initiative, the executive must concede 100% of the tax that the IRS claims should have been paid and also must agree to pay a 10% penalty.

The pilot program also covered offshore employee leasing arrangements and asset protection plans. These include arrangements where executives of domestic companies have sought tax advantages by becoming employees of foreign companies that lease the executives’ services back to the domestic company. The IRS regards such arrangements as abusive tax shelters that seek to avoid income and employment taxes (see IRS Notice 2003-22). The IRS recently stated that this area is less of a priority for its LMSB Division, but that the Small Business/Self-Employed (SB/SE) Division is still pursuing a large number of these transactions.
A New World

The IRS' stated objective in making executive compensation a routine part of LMSB audits is "to ensure compliance with income and employment tax requirements by employers who pay the compensation and executive level employees who receive it." The IRS believes that the executive compensation rules are not being universally followed and views this area as ripe for enforcement.

The stakes could get high. For some of the issues that will be examined, the failure to comply can result in significant additional tax liability for companies and executives alike. For example, a failure to comply with the rules governing the $1 million deductibility cap discussed above could result in a sizeable deficiency due to lost tax deductions, and could lead to questions about the compensation committee report that appears in the company's proxy statement. The reclassification of benefits as taxable salary and wages could significantly increase the tax liability of the executives involved. The stakes will be even higher for executives who participate in nonqualified deferred compensation arrangements that do not satisfy the requirements of new section 409A, thereby exposing the executives to income taxation on vesting of the compensation, subject to ordinary income tax rates plus an additional 20% penalty tax.

In addition, the procedures used to examine these issues can be intrusive. During the pilot program, the IRS requested copies of the personal income tax returns of the company's executives as part of the audit of the company. Executive returns are still being requested in some cases as these issues have become a routine part of LMSB audits. The IRS has stated, however, that companies are resisting asking their executives for personal tax returns. Consequently, the IRS now is generally approaching the executives directly for their personal returns or is accessing them through its own administrative system.

Although the IRS is focusing on executive compensation in its LMSB audits, all companies need to review their executive compensation practices to ensure that they comply with all applicable rules. As the IRS gains experience in this area, its agents likely will become increasingly effective in identifying executive compensation issues and challenging taxpayer positions.


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