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IRS EXPECTED TO INCREASE FOCUS ON EXECUTIVE COMPENSATION

By

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Attention tax directors! A recent compliance audit initiative (the "Initiative") indicates that the IRS intends to pay increased attention to executive compensation issues. Although there have not been any new rules or regulations issued in this area, the negative publicity generated by abuses of executive compensation plans has put pressure on the IRS to ensure that these plans are properly administrated and comply with all applicable tax rules.

In general, the key tax issues in executive compensation plans are whether the executive includes the proper amount in income at the proper time, and that the company's deduction is taken in the proper year. The Initiative addressed these issues by requiring the review of the returns of the top 15 highest paid employees and the directors of a corporation. The IRS is concerned not with the size of the compensation packages, but the construction of the compensation packages. The IRS intends to match the executive's W-2 income to the corporation's return. If the IRS finds any discrepancies, it intends to expand the scope of the review beyond the 15 highest-paid employees. In order to handle the additional work created by the Initiative, the IRS has trained agents in the eight areas discussed below.

You can expect executive compensation reviews to become a regular part of all corporate audits. In order to avoid IRS scrutiny and any resultant negative publicity, tax directors should consider performing a compliance check-up to identify any executive compensation noncompliance issues.

The Initiative indicates that the IRS will focus on eight areas:

- (1) non-qualified deferred compensation;
- (2) stock-based compensation;
- (3) the \$1 million cap on deductible compensation;
- (4) golden parachutes;
- (5) split-dollar life insurance;
- (6) transfers of compensatory options to related parties;
- (7) offshore deferred compensation arrangements; and
- (8) executive perks.

Of particular interest to most companies are the first two areas, non-qualified deferred compensation and stock-based compensation. This article discusses the issues raised in those areas.

Non-qualified deferred compensation.

In the area of non-qualified deferred compensation, the IRS intends to focus on the timing of executive income recognition and employer deductions. With respect to the executive, the IRS is concerned about proper application of the constructive receipt and economic benefit doctrines, especially when an offshore trust or rabbi trust is employed. With respect to the employer, the IRS can also be expected to look carefully at whether the employer is

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properly delaying deductions until the employee includes the amount in income. In addition, the IRS will check to ensure that FICA taxes are withheld and paid in the year the services are performed.

The IRS will also closely review whether an executive has the ability to control the timing of the receipt of the deferred compensation. Thus, even though a deferred compensation plan is well-written, if a participant is in a position of influence and authority over a plan administrator, that participant may be required to report the income prior to receipt. The IRS also plans to scrutinize the funding of deferred compensation obligations with offshore rabbi trusts. Although the assets in these trusts are subject to creditors' claims, creditors generally have difficulty locating and accessing the funds.

Stock-Based Compensation

The IRS intends to carefully scrutinize stock-based compensation plans to ensure that the executives are properly reporting income on vesting and any disqualified dispositions. For all stock option plans, and for employee stock purchase plans in particular, the IRS intends to determine whether (1) all employees were able to participate; (2) procedures were properly followed; and (3) statutory limits were not exceeded.

The IRS believes that there is potentially hundreds of millions of recoverable tax dollars. Companies with deferred compensation or stock-based compensation plans should perform a compliance examination to identify any non-compliance issues. An ounce of prevention.....

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Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, contact:

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