

IRS Issues Executive Compensation Audit Guidelines: What Employers Need To Do Now

The IRS recently posted on its website new "Audit Technique Guidelines" ("ATGs") which provide IRS agents auditing corporate tax returns (Form 1120) a road map for reviewing a company's executive compensation practices. Specifically they assist the agent in determining whether various common items of compensation are being properly reported to the company's executives as taxable income, and whether the company is taking related tax deductions for officer compensation during the appropriate tax year.

In light of the complexity of the areas covered by the ATGs, it is incumbent on companies providing any compensation or benefits included on the IRS audit list to review, in advance of an IRS audit, the state of its records and procedures, with respect to income tax reporting and deduction of such benefits, to be provided in response to IRS information requests.

How It All Began

The IRS's executive compensation audit initiative is not new. The Service began these examinations two years ago, fostered by the public's perception that executive compensation and perquisites were "out of control," and the IRS's concern that the increased dollar amount and complexity of executive compensation arrangements resulted in pervasive noncompliance with the tax rules.


The initiative began by selecting for a pilot program 24 companies in various industries with open corporate tax return audits. From these experiences, the IRS honed the guidelines into seven primary focus areas, and has indicated that some or all of these areas will be routinely examined as part of corporate tax return audits.

The Seven Deadly Sins and Where They May be Hiding

The ATGs outline the tax rules and common noncompliance areas with respect to the following common compensation items:

- **Transfers of Compensatory Options to Related Persons**
- **Non-Qualified Deferred Compensation Plans**
- **Stock Based Compensation**
- **Code Section 162(m) Salary Deduction Limit**
- **Fringe Benefits**
- **Golden Parachutes**
- **Split Dollar Life Insurance** (no ATG has been posted yet)

In order to examine these practices, the IRS will review numerous documents requested from the company and its executives, and retrieved from public sources. These include SEC filings, employment and consulting agreements, Board of Directors and Compensation Committee minutes (including proposals, exhibits, attachments and resolutions), company payroll records, tax return work papers, employment tax returns, executives' Forms 1040, merger and acquisition agreements, plan documents, agreements, and arrangements, employee communication materials, stock option grant reports, life insurance policies, accounts payable records, employee expense reports, loan agreements and severance agreements.



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What Issues Have Been Found?

A number of common errors have been reported by the IRS as surfacing during its audits. Companies are also discovering errors and weaknesses in their plans and practices as they self-audit their executive compensation programs. Among these are the following:

- **Company Tax Deductions in Wrong Year.** Companies have been found to be deducting nonqualified deferred compensation, stock option and restricted stock expenses in the year earned or granted rather than in the year in which the employee has includible income. In addition, the ATGs direct IRS agents to begin reviewing nonqualified deferred compensation plans' compliance with new Code Section 409A with the 2004 audit cycle.
- **Misreporting of Post-Employment Stock Option Exercises.** The IRS has found companies reporting post-employment stock option exercise income on Form 1099 rather than Form W-2, thereby failing to withhold and pay appropriate employment taxes.
- **Executives' Failure to File Form 1040.** The IRS has reported that some company executives had not filed Form 1040 to report their compensation income.
- **FICA Taxes on Nonqualified Deferred Compensation.** Companies have reportedly failed to subject deferred compensation to FICA taxation when the amounts were no longer subject to a substantial risk of forfeiture, which generally requires FICA tax withholding at the time of deferral in most plans.
- **Deductions in Excess of Code Section 162(m) Limitation.** Companies have been found deducting annual compensation in excess of \$1 million paid to the top 5 officers in reliance on the "performance-based compensation" exception provided in Code Section 162(m)(4)(C) without being able to adequately demonstrate compliance with the exception's requirements. This includes advance shareholder disclosure and approval, establishing objective performance goals within the first 90 days of the performance year, and having a compensation committee comprised only of outside directors.
- **Executive Perquisites.** Companies have reportedly failed to report perqs and fringe benefits in executives' includible compensation, including the following:
 - Personal use of company aircraft and vehicles
 - Spousal travel
 - Loans with below market interest or that are forgiven
 - Spousal and dependent life insurance coverage
 - Financial counseling and tax preparation services
 - Reimbursed business expenses
 - Security-related transportation
 - Club memberships.

In addition, companies have been found to be reporting post-retirement consulting income on Form 1099 where the IRS takes the position that such executives are still common law employees subject to employment tax withholding.

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