

EXECUTIVE COMPENSATION ALERT

JULY 2004

IRS INITIATIVES TARGET EXECUTIVE COMPENSATION AND LARGE RETIREMENT PLANS

The Internal Revenue Service is taking an increasingly closer look at the retirement plan practices of large employers. Recently enacted initiatives by the IRS include the Executive Compensation Plan Audit Program ("ECPA Program") and the Employee Plan Team Audit Program ("EPTA Program"). ECPAs will examine eight different aspects of executive compensation issues as part of a company's tax audit. The EPTA Program is focused on large retirement plans which have been defined by the IRS as plans with at least 2,500 participants.

Executive Compensation Plan Audit Program

As part of its increasing scrutiny of executive compensation practices, the IRS recently launched the ECPA Program. The new executive compensation compliance initiative will be a part of corporate tax audits and will involve two main parts: reviewing the individual tax returns of top executives as part of a corporate audit, and focus, as part of the IRS's review of corporate and executive returns, on certain specific executive compensation items.

Review of Corporate Executives' Tax Returns

As part of a corporate audit, IRS agents may be asking to see the tax returns of the company's top officers and highly compensated employees to see that the executives are properly reporting company compensation. The IRS has indicated that they will pursue any noncompliance issues they may uncover including other tax shelters. In any case where an executive refuses to turn over his/her return, the IRS may simply proceed directly against the executive to obtain the return.

Focus on Executive Compensation Items

The IRS will be reviewing eight principal areas. The areas are:

1. Nonqualified deferred compensation

The IRS agents will be focusing on basic

compliance items, whether companies are deferring the deduction of deferred compensation until the executive takes the amount into income. Agents will also be determining compliance with constructive receipt rules and checking to see whether employment taxes have been properly withheld on executive compensation. Finally, they will be specifically looking for the use of offshore rabbi trusts and other offshore funding arrangements.

2. Stock-based compensation

Qualified employee stock option and stock purchase plans will be examined to determine compliance with the basic statutory requirements, including such things as shareholder approval. Agents will also be looking at income inclusion with respect to equity based compensation including restricted stock, stock option and phantom stock plans under this category.

3. Section 162(m) deduction limit

IRS agents will be focusing on making sure that the \$1 million cap on the deductibility of top executive compensation under Code section 162(m) has been complied with, and if not, whether any of the exceptions to the cap apply. The IRS believes that there may be instances in which companies are deducting more than \$1 million with respect to an executive even where there is no applicable exception.

4. Section 280G excess parachute payments

Agents will be looking to make sure that the Code section 280G test has been correctly applied and that excess parachute payments have been properly handled.

5. Split-dollar life insurance

Agents will be determining whether proper amounts have been included in

the executive's income with respect to split-dollar life insurance arrangements.

6. Transfers of options to family limited partnerships

The IRS will challenge the tax deferral purportedly provided in arrangements where an executive has transferred stock options to a related party, such as a family limited partnership or trust, in exchange for a deferred payment obligation.

7. Employee leasing/asset protection plans

Agents will be looking for offshore employee leasing transactions that are used to avoid income and employment taxes.

8. Fringe benefits

Agents will be verifying that fringe benefits are being treated properly as wages for income and employment tax purposes, with a focus on common fringe benefits for executives such as corporate-owned aircraft and automobiles, and relocation expenses.

Recommended Course of Action

Tax compliance officers and human resource directors and others that are responsible for executive compensation should take steps to prepare for such audits. Actions should include the following:

- Alert management to this initiative and work out a plan for how they will deal with requests for executive tax returns. A plan should be developed to address issues that arise out of the IRS's review of the executives' returns that implicate the company's tax return.
- Take steps to assure the company that top executives are filing their individual tax returns on a timely basis, and that such returns are being professionally prepared.

- Make sure that executive compensation is properly handled on the company's tax return and that executive compensation income items are being properly reported on an executive's W-2.

Most importantly, the company should take inventory of their executive compensation plans to make sure that they are properly complying with the basic IRS rules governing such plans. At a minimum, this should include determining what deferred compensation plans are in effect, whether the documentation for such plans is up-to-date, whether the plans have had the required approval, and whether the terms and conditions of such plans raise issues under current IRS rules, such as the constructive receipt and economic benefit rules.

Employee Plan Team Audit Program

The audit selection process for EPTAs includes assigning points for characteristics such as the number of plan participants, plan assets, and plan contributions. Points are then "weighted" on a basis that considers audit history, type of plan, and effect on plan participants. The EPA process is also marked by its thoroughness. A plan selected for an EPA audit will be audited by a team of IRS agents, each of whom has a particular area of expertise. According to IRS statements, the examination can last for up to two years. The amount of IRS resources brought on EPA audits, combined with the complexity of the rules implicated by larger plans means there is a high likelihood that the IRS will find compliance issues.

Recommended Course of Action

We strongly urge employers whose plans fit

the target criteria for an EPA to review their plans as soon as possible to ascertain any qualification issues. If such issues are found, we further urge that the employer submit those issues under the Voluntary Correction Program, described in Rev. Proc. 2003-44, as soon as possible.

Under VCP employers can voluntarily disclose qualification failures to the IRS and propose specific correction measures. The employer ultimately receives a compliance statement that provides specific assurances that the IRS considers the problems identified permanently resolved. Costs to the plan sponsor are limited to a specified filing fee based on the size of the plan and paid with the initial application, plus the cost of correction, if any.

An important advantage of VCP is that the IRS indicates that they will not examine the plan while a VCP request is pending. Thus, filing a VCP request allows the employer to avoid the significant, long-term disruption that would likely result from being subject to an EPA.

If the IRS audits a plan and discovers compliance issues, they will allow the plan to avoid disqualification by entering a program known as Audit CAP. However, because Audit CAP results from an IRS examination and not from voluntarily identifying failures, the process may take much longer, require many more of the employer's resources, and ultimately result in significantly higher sanctions on the employer sponsoring the plan.

The EPA Program is in addition to the limited audit program for selected industries.

The limited audit program focuses on problems believed to be prevalent in many qualified retirement plans sponsored by employers in a specific industry. The audit is designed to target defined benefit, 401(k), and money purchase plans in selected industries. It is believed that the program will provide important information about common areas of noncompliance and will also uncover instances of abuse in certain areas which will be used for audits in other geographies and industries.

For information on one of the specific audit initiatives and how our employee benefits practitioners can help you, please contact members of the McAfee & Taft Employee Benefits Practice Group at the numbers listed below. Both the IRS and Department of Labor have established programs that can enable plan sponsors to mitigate and sometimes eliminate the imposition of sanctions on employers for retirement plan failures. However, there is growing concern among regulators that very little if anything is being done to correct qualification failures despite these programs. We strongly encourage you to conduct a review of your retirement plan programs to determine compliance with ERISA and Internal Revenue Code.

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