

## IRS Takes Aim at Compensation

By Jeffrey Marshall

It's hard to find many fans of the Internal Revenue Service (IRS), and the agency is preparing to make itself even more unpopular with corporate America.

In recent months, the IRS has been moving to address "significant non-compliance by public companies with the tax law requirements applicable to executive compensation," according to attorneys at McDermott, Will & Emery (McDermott Will). The action stems from a 2003 IRS audit initiative that revealed a host of perceived compliance issues, the firm says, "ranging from non-reporting of compensation by executives to deficient corporate governance practices involving incentive payments, non-qualified deferred compensation, golden parachutes and executive perks."

The agency has been developing audit guidelines for its examiners, but has not released a timetable for publication, says Andrew C. Liazos, a Boston-based attorney with McDermott Will. The subject remains controversial, and the IRS isn't discussing it publicly, in part because of discussions about amending the IRS code to allow sharing of information with the Securities and Exchange Commission for possible enforcement actions, legal sources say.

"We'd all love to see IRS guidelines, but they don't have any requirement to release them to the public, though they would release them to the agents for audits," says David R. Fuller, a Washington-based attorney with McDermott Will.

While a few of the law firm's clients have been audited in the past on deferred compensation and golden parachutes, there has been "very little

history" of the IRS actively auditing these areas, Fuller adds, describing the situation as something akin to "benign neglect."

But awareness is building. Steven C. Price, president of TBG Consulting in Pittsburgh, a firm specializing in compensation and benefits, says that in recent months, "clients are becoming aware of this going on. They're asking things like, 'How do we get ourselves organized?' They want to build awareness of this situation into their [compensation] plans." He adds, "We've had one client contact us to start pulling together data because they were being audited. The [IRS] field people seemed to be asking the questions" arising from the audit initiative.

The list of areas getting attention is "very comprehensive," Liazos says. "You need to understand where there are the greatest potential for problems — especially where there are clear rules." Three areas that need special attention, he says, involve: Section 162(m) of the IRS code, which covers deductions for compensation in excess of \$1 million; loans to executives; and fringe benefits.

On the first, he says, problems could arise if, for instance, companies fail to comply with the performance-based requirements to deduct incentive compensation. That could result in millions of dollars in lost tax deductions, as well as raising questions about the Compensation Committee's report in the company proxy report.

Fuller says that fringe benefits coming under particular scrutiny include tax treatment of corporate aircraft for personal travel, including use by executive's spouses or other family members. "The IRS is challenging

these very aggressively," he says. "It's a very problematic area for taxpayers." He adds that the IRS doesn't see post-9/11 security concerns as justifying extensive use of corporate aircraft.

Other red flags involve loans to executives — like the multimillion-dollar loan to former WorldCom Inc. CEO Bernard Ebbers that turned up after his ouster. Such loans may not have been bona fide practices in the past, and now they are forbidden under The Sarbanes-Oxley Act for company officers or directors.

While the IRS may address technical rules that aren't followed, inadequate disclosure may be a far greater problem. "If the IRS sees a situation where there is taxable income and there has been no disclosure, that's a real issue," Liazos says.

While executive compensation is often a subjective area, it is effectively one of the control areas for CFOs under Sarbanes-Oxley, the McDermott Will attorneys maintain. CFOs need to warn other executives and their boards that private compensation information could be revealed — especially if lower-level personnel are routinely pressured by higher-ups to bend the rules and later elect to blow the whistle about those practices.

TBG's Price says that too often, various components of compensation are run out of different departments such as HR, benefits or the controller's office — and no one person "owns" the process. "You need to be able to respond [to an audit] on a unified basis," he says. "You should have a process clearly delineated so you have the right response from a tax standpoint. That could come through someone reporting up to the CFO." ❧

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