Employee Relations

LAW JOURNAL

Reprinted from *Employee Relations Law Journal*, Volume 30, No. 2 Autumn 2004,
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Employee Benefits

IRS Audits of Executive Compensation Suggest the Need to Review Executive Pay Practices and Procedures

Anne E. Moran

The Internal Revenue Service has announced that it is undertaking extensive audits of executive compensation. This follows on the heels of a pilot program in which the IRS scrutinized carefully the executive compensation practices of 24 chosen companies. As discussed in more detail below, as part of its expanded review, not only will IRS corporate auditors ask specific questions about executive pay and practices, but executives may be required to provide copies of their personal tax returns for review. These activities go hand in hand with other activities of the IRS in policing what it considers aggressive executive compensation practices, such as the issuance of notices making certain of these practices "listed transactions" subject to increased disclosure requirements and potential penalties.

Although cynics might argue that the IRS is merely joining the bandwagon of state attorneys general, shareholder advocates, and Congress attacking executive compensation, such activities should prompt any officials responsible for executive pay—including human resource and tax officials—to take a look at their current executive compensation policies and to warn executives in advance that their own personal returns may be subject to increased scrutiny. They should also be aware that unlike the past, a confluence of events—in particular, the publicity about the corporate pay practices at Enron and other companies—has created an atmosphere in which the IRS may be able to attack certain executive compensation practices without fear of extensive interference by Congress. This same dangerous atmosphere, however, might also provide an opportunity for human resource managers and other

Anne E. Moran is a partner at Steptoe & Johnson LLP in Washington, DC. She advises clients on benefits issues arising under retirement, health and other benefit plans. She has represented clients during Internal Revenue Service audits, particularly those involving the funding of welfare plans and VEBAs, and in the Voluntary Compliance Resolution and CAP Programs for pension plans. Over the course of her career, she has served as Tax Counsel for the Senate Finance Committe, on the ERISA Advisory Council for the Department of Labor, and as the Chair of the Joint Committee on Employee Benefits for the American Bar Association. Ms. Moran may be reached at *amoran@steptoe.com*.

advisers to convince corporate executives that enhanced record keeping and approval processes for their compensation is important and appropriate.

A Bit of Background: "Traditional" Practices Prevail

Executives are often engaged in a tug-of-war with their corporate employers and the IRS because they want to maintain control over the amount and timing of their pay and benefits, but they do not want to be taxed on those benefits. For over three decades, the IRS has sparred with taxpayers over the extent to which an employee could change or secure the deferred compensation promise made to him by the employer. Both Congress and the courts have made it difficult for the IRS to enforce its views of the "proper" treatment of executive compensation, particularly deferred compensation and executive fringe benefits. In some cases, the IRS's position appears to have been more conservative than the courts have required. Pressure from Congress has often caused the IRS to soften proposed regulations that would govern the tax treatment of employee fringe benefits.

Modification of Deferred Compensation

Common practices allowing employees to modify their deferred compensation arrangements without income inclusion are based on court cases (which the IRS has unsuccessfully contested) holding that modifications of compensation arrangements could occur without causing income recognition at the time of change as long as such modifications occur before the deferred compensation is scheduled to be paid. For example, in ***Oates v. Commissioner***,[1] the court allowed a modification of a payment schedule for the taxpayer three days before payments would begin. In ***Veit v. Commissioner***,[2] deferrals of profit sharing payments from one year to a later year were permitted without current income taxation.

The IRS attempted in the 1970s to issue proposed regulation 1.61-16 that would have altered the practices arising from these cases. That regulation would have currently taxed compensation that could be deferred pursuant to an employee's election. In response, Congress enacted section 132 of the Revenue Act of 1978, which prohibits any changes to the deferred compensation rules as they existed in 1978. After the passage of the 1986 Tax Reform Act (which reduced rates prospectively), the IRS issued Announcement 87-3 stating that it would closely scrutinize agreements designed to defer income until later, lower-rate, tax years. The IRS warned that if such short-term deferrals lacked substance, the taxpayer could be treated as "in constrictive

receipt" of the deferred amount.

The courts have continued to rebut the IRS's position that employees who elect to change the timing of their deferred compensation promises have "constructively received" such compensation by virtue of that election and thus should be currently taxed. In ***Martin v. Commissioner***,[3] the IRS unsuccessfully challenged modification of deferred compensation agreements where the amount due was not yet payable. An IRS-generated internal technical advice memorandum leading up to ***Martin***[4] had argued that a modification of a deferred compensation plan resulted in constructive receipt of the amounts under the plan and attempted to distinguish ***Oates***, ***Veit I***, and ***Veit II***. In distinguishing ***Oates***, the internal memo stated that since the payments were contingent on renewal commissions, nothing had been earned at the time of the election. The IRS tried to distinguish ***Veit I*** and ***Veit II*** by noting that in both cases the change in payment date was the result of "bilateral negotiations," although the courts did not emphasize these factors.

The IRS has maintained its unsupported position at the ruling level and will not issue an advance ruling concerning the application of the constructive receipt doctrine to an unfunded deferred compensation arrangement unless the election to defer payment of compensation is made before the beginning of the "period of service for which the compensation is payable. . . "[5] Nonetheless, many companies have relied on ***Veit***, ***Oates***, and ***Martin*** to permit modification of deferred compensation promises in a variety of circumstances[6] and the IRS has not appeared to be able to challenge successfully modifications made sufficiently in advance of the initially established date of receipt.

Securing the Deferred Compensation Promise

The deficit reduction legislation enacted in 1982 and 1984 severely limited the amounts that could be set aside in tax-qualified retirement plans available to all employees. As a result, many executives saw a greater proportion of their retirement savings set aside in "nonqualified" deferred compensation arrangements that enjoyed neither tax deferral until retirement nor the bankruptcy protections of qualified plans. As a larger proportion of executives' compensation became nonqualified, executives and their employers sought for ways to have such promises "funded" to some extent in trusts established for that purpose. This created a tension between the executives' desire for security and the tax principle, discussed below, that in order to avoid current taxation of those deferred compensation promises, such promises had to be subject to the claims of the employer's creditors.

Section 83 of the Internal Revenue Code ("Code") codifies the so-

called "economic benefit doctrine" that taxes service providers who have received the "economic benefit" of a promise of payment. Section 83(c) of the Code provides that a service provider is taxed when any transferred property first becomes either not subject to a substantial risk of forfeiture or freely transferable. The IRS's regulations under section 83, however, provide that an ***unfunded*** promise to pay does not result in a transfer of property. Treasury Regulations Section 1.83-3(e) defines "property" subject to taxation as:

> real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. The term also includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account.

In the context of considering non-qualified, deferred compensation arrangements that are "funded" by irrevocable trusts established for the benefits of executives, the IRS has repeatedly ruled that if the assets of the trust remain subject to the general creditors of the employer-company in the event of insolvency or bankruptcy, and if employee-participants receive no beneficial ownership in or preferred claim to the assets of the trust, then participants receive no property interest upon creation or settlement of the trust and the contribution of assets to the trust.[7] Further, IRS Revenue Procedure 92-64, 1992-2 C.B. 442, provided a model rabbi trust that the IRS stated would not be considered "funded" and thus, if adopted essentially verbatim, could be relied upon to defer income. This "model" rabbi trust contains language specifically providing that all assets would be subject to claims of creditors and that trust payments would cease if the company became insolvent.

The courts have agreed that arrangements like rabbi trusts do not create an economic benefit. In ***Minor v. United States***,[8] the taxpayer entered into a nonqualified deferred compensation arrangement with his employer, a prepaid medical plan. The arrangement was funded by a trust that remained subject to the claims of the employer's general creditors. Consistent with the rulings of the IRS, the court held that:

> the deferred compensation plan is unsecured from Snohomish Physicians' creditors and therefore incapable of valuation. Thus, Minor's benefits do not constitute property under 26 U.S.C. § 83 (1982) and 26 C.F.R. § 1.83-3 (1982).

Based on these guidelines, it has generally been agreed that where assets are transferred to a trust that remains subject to the claims of the company's creditors, no economic benefit is conferred upon the beneficiaries. But companies hoping to satisfy executives who want to "eat their cake and have it too" have attempted to minimize the trusts' expo-

sure to creditors as much as possible. One way was to create "financial health trigger clauses" in the deferred compensation plan or trust that become operative if the employer-company suffers stipulated level of economic losses. For example, a plan might provide that distributions would occur automatically if the employer's net worth declined by a specified percentage. A relatively common feature of such arrangements that became notorious in the ***Enron*** case was a provision allowing trust participants to take a withdrawal from the trust with the imposition of a penalty (***i.e.***, a "haircut" of generally between five to 15 percent). The theory here is that the haircut creates a substantial risk of forfeiture and so the trust is not funded. Another popular feature involves accelerated vesting or the triggering of payouts in the event of a change of control (a "takeover trigger"). The IRS has expressed concerns that certain of these triggers might, in practice, prevent the assets of the plan from being considered the employer's assets, since it was possible in such cases that the assets would not in fact be available to the employer's creditors. But the IRS never took a formal position on these matters.

Fights Over Fringe Benefits

Corporations and their executives were also successful in loosening up the strict rules governing fringe benefits that were enacted in 1984. These rules have been carefully monitored by Congress over the years. In 1975, Treasury issued a discussion draft of proposed IRS regulations containing rules for determining when various types of fringe benefits constituted taxable compensation.[9] In general, the draft took the controversial position that employer-provided goods or property that was not otherwise available to the public on a free or discounted basis would be income to the employees receiving such goods or services. In response to pressure from taxpayers feeling threatened by possible IRS regulations on the issue, Congress enacted a moratorium on fringe benefit regulations in 1978 (Public Law 95-427) instructing the Treasury Department not to change its "historical" treatment of fringe benefits. When the moratorium was due to expire in 1983, Treasury agreed not to issue any regulations or rulings on fringe benefits before 1985.

This moratorium gave Congress time to enact a comprehensive set of rules governing the tax treatment of fringe benefits in the Tax Reform Act of 1984. These comprehensive rules were codified in section 132 of the Internal Revenue Code (not to be confused with section 132 of the Revenue Act of 1978 discussed above). As amended in 1992 and 1993, section 132 of the Code provides that the following employer-provided items are excluded from an employee's income:

1. No additional cost services;

2. Qualified employee discounts;

3. Working condition fringe benefits;

4. De minimis fringes;

5. On-premises athletic facilities;

6. Qualified transportation fringes; and

7. Qualified moving expense reimbursements.

As a condition of qualifying for certain of these exclusions, Congress required either that the cost or benefit be minimal (***e.g.,*** de minimis fringes) or nondiscriminatory (***e.g.***, for no additional cost services, discounts, cafeterias, and qualified transportation fringes). These conditions meant that the statutory exclusions were not always available to eliminate the value of common executive prerequisites from income. However, Congressional Committee reports made it clear that that Congress had definite ideas regarding the scope of any IRS regulations that would interpret new section 132. For example, the Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1984 at page 864 (the "1984 Blue Book") contains an admonition that an ordinary student of the legislative process (but not necessarily of the ***tax*** legislative process) would consider unnecessary: "Any example of a fringe benefit which [the House Ways and Means Committee's legislative history] explicitly states is excluded under the Act from income and wages is to be so treated in any regulations."

Thus, the IRS regulations interpreting new section 132 were carefully scrutinized. For example, in 1985, the IRS issued special valuation rules for company aircraft that calculated the taxable value of the flight based on the amount of business purpose. These created a great deal of controversy and in May of 1985, Treasury officials promised to lower the values significantly and to provide clearer rules. The current regulations provide a variety of methods to calculate personal and business use of employer-provided transportation. Personal airplane use can be calculated using one of three methods designed to be easier to administer and generally imposing less imputed income to the executives on personal and non-business travel than a "fact and circumstances" valuation might create.[10]

Similarly, the 1984 Blue Book's legislative history of section 132 makes it clear that commuting to one's home is not business use of a company vehicle, even when work in performed during a trip.[11] Nonetheless, the regulations provide ways to reduce the income tax and recordkeeping burden for companies that provide executives with chauffeurs and other transportation services. Special valuation rules can apply to ease the

recordkeeping burden associated with tracking employer-provided transportation. In many cases, a company may be able to demonstrate that the chauffeur or airline services must be provided by the company for security reasons. The regulations require that private sector employers demonstrate this need with an independent security study. If the study documents the need for 24-hour security protection, the executive (and the spouse and family on the same flight or car) can travel in secure company owned vehicles and the cost of any extra security features (including the cost of a chauffeur, if it can be shown there would be no chauffeur but for security concerns) would not be included in income.[12]

Crackdowns on Executive Compensation

In contrast to the Congress and the court's rejection of the IRS view of the deferred compensation rules and the increased flexibility in fringe benefit regulations that was driven in part by Congress' intervention, Congress has felt obligated to react to public distaste for taxpayer-subsidized "business expenses" by imposing legislation that it believed would stop executive compensation "abuses." It increased the deduction disallowance for business meals from 20 percent to 50 percent in 1993, limited the deductible cost of skybox rentals under Code Section 274(u)(1), and disallowed deductions for meals that are "lavish and extravagant under the circumstances."[13] Similarly, in 1993, although stating that it was not opining on current law, Congress enacted Section 274(m)(3) of the Code to codify the rule that deductions are not allowed for travel expenses of an employee's spouse, dependent or guest except in the limited circumstances allowed by the statute.[14]

Two major pieces of legislation attempted to restrict deductions for executive pay at the corporate level. First, as a reaction to some widely publicized severance payments in connection with corporate takeovers, in 1984, Congress enacted section 280G at the Code dealing with so-called "golden parachute" payments. These payments are defined as payments in excess of three times an employee's average compensation over the past five years that are made upon a "change of control" in the corporation. Under section 280G, they are nondeductible to the corporation paying them and subject to a 20 percent excise tax paid by the executive. However, the IRS only issued final regulations under section 280G in 2003 (generally effective January 1, 2004), although audits of such payments based on the proposed regulations have occurred. Another Congressional clampdown on executive benefits was enacted in 1986. Section 162(m) of the Code limits the deduction for compensation of a company's top five employees to $1,000,000. Significant exceptions apply, however, including exceptions for "performance-based compensation" and for stock options issued at fair market value on the theory that such options were inherently performance based.[15]

Enron Changes the Landscape

Although some of the rules discussed above did in fact restrict executive pay practices and require detailed recordkeeping, executive pay continued under a relatively calm state of affairs until the early 2000, when events transpired to cause more scrutiny of executive compensation. This scrutiny began with the Enron-type corporate scandals, but was exacerbated by the downturn in the economy and news stories describing high executive pay at a time when workers were asked to reduce their pay and benefits "for the good of the company." The public outcry centered primarily on the ***amount*** of the executive pay and benefits, which, it should be noted, was in large part attributed to stock option gains whose tax treatment was well regulated under the tax law and which were the result of grants that were generally approved by shareholders and the compensation committees of the companies' boards. Although the IRS complained about certain abuses, due in part to the limits of section 132 of the Revenue Act of 1978 and in part to bureaucratic inertia, the IRS issued very little official guidance to stop any of these practices.

The collapse of Enron and revelations about its pay practices created an opportunity for the IRS to join Congress in the blame game. Congress belatedly conducted hearings on the Enron scandal and in 2003 the Joint Committee on Taxation issued a 700-page Report of the Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues and Policy Recommendations (the "Enron Report"). While admitting that "there are no clear rules governing many aspects of deferred compensation arrangements" and acknowledging a wide variety of common practices, the Report stated (without authority or specific examples) that some taxpayers "may" push the limits of current law.[16]

The IRS Audit Program Enters the Fray

Armed with the shield of Enron and the Enron Report, the IRS announced in 2003 that it had undertaken a pilot program to review 24 companies' deferred compensation practices. According to remarks made by IRS personnel, this pilot program revealed a number of disturbing trends. The IRS determined that certain companies' executives were not following the valuation and other rules relating to taxation of corporate fringe benefits and that some executives were not even reporting their income on their personal tax returns. The IRS has even asserted that some executives had not filed returns, although actual examples of executives who have failed to file returns have yet to be made public.

As a result of this pilot project, the IRS stated that it would expand its review of executive compensation. The IRS's large and mid-size business division (LMSB), which audits entities with assets over $10 million

(about 200,000 companies), has undertaken this review. The IRS has publicized this initiative heavily, emphasizing that the era of "benign neglect" is over. Revenue agents are being trained in these areas, and it appears that checklists and other procedures will or have been adopted. The IRS has publicly mentioned a number of specific areas for review. These are discussed below.

Stock Options and Stock-Based Compensation

There does not appear to be any particular abuse targeted here and the rules governing stock options and stock awards are relatively clear. The IRS's focus on options and stock-based compensation is likely due to the fact that such compensation constitutes a significant and very public portion of the executive's pay. Issues that the agents may examine are timing of income inclusion and corporate deductions, section 83(b) elections to treat restricted stock grants as taxable earlier than required, and adherence to any formal plan documents and election procedures. In addition, the IRS is likely to track whether the employee's reporting of gains is consistent with the employer's deductions. Finally, as discussed below, the IRS has released guidance stating its belief that certain programs to defer the recognition of stock option gains may be considered "listed transactions" subject to additional scrutiny and disclosure requirements.

Deferral of Option Gains

The IRS has identified the transfer or sale of stock options to family limited partnerships or to related parties as a tax shelter and thus this planning technique will be challenged. Any sale or disposition of an option to a related person will be considered a "listed transaction" subject to increased disclosure requirements.[17]

Non-Qualified Deferred Compensation

The IRS states that it is focusing on the correlation of employer deductions with the employee's recognition of income. The IRS agents will likely request any deferred compensation plans and review such plans to make sure proper procedures for deferrals, withdrawals, and calculating benefits were followed. Clearly, it is expected that the IRS will review rabbi trusts. It is not clear yet how the IRS will treat features such as the "net worth trigger" or "haircut withdrawals" that were criticized in the Enron Report and that are the subject of current legislative proposals, discussed below.

Offshore Trusts

Some promoters had suggested that companies establish trusts for their executives outside of the United States as a vehicle for holding assets that will ultimately be used to fund deferred compensation promises. Issues that could be considered here are whether such trusts remain subject to the claims of creditors (if they are intended to be rabbi trusts).

"Irish Leasing" or "Offshore Leasing"

The IRS has deemed as "listed transactions" arrangements under which certain corporate executives were "discharged" from one company and then rehired by an offshore leasing company to provide services to the discharging company (thus arguably permitting the payment and possibly deferrals to be accounted for offshore). Such transactions will be challenged by the IRS on audit and are subject to enhanced disclosure requirements.[18]

Split-Dollar Life Insurance

Split-dollar life insurance arrangements are programs under which the employer generally funds all or part of the cost of an executive's life insurance premiums, and upon the executive's death, receives repayment of those premium payments from the insurance proceeds. This is an interesting choice for the IRS to review since the Treasury Department and the IRS have dramatically changed positions on the proper timing and amount of income inclusion of split-dollar arrangements at least four times over the past 30 years. The IRS initially treated such arrangements as loans, then as the provision of life insurance benefits, and recently switched back to a loan analysis for certain products.[19] The IRS will also likely examine whether taxpayers properly determined the value of insurance coverage under its existing guidance, as it believes that some taxpayers might have been using improper tables that understated income.

Fringe Benefits

Inspired perhaps by news reports of company-provided vacation homes and lavish personal fetes, the IRS has announced it will also review items such as housing allowances, use of corporate jets and automobiles, and club dues. In most cases personal use of these items is generally taxable under the law and acknowledged as such; the question is whether the corporations and executives are applying the regulations

properly and whether the valuation methods used taxes the executives sufficiently. Issues such as the application of the special rules for security-related travel are sure to come into play as a number of companies have taken additional precautions (and in some cases refuse to allow executives to travel on commercial flights) after September 11. Recordkeeping, documentation, and substantiation issues are key here.

Corporate loans to executives are also the subject of additional scrutiny. The IRS will be reviewing loan documents to ensure that the loans are bona fide and that employers and executives are properly reporting such loans under the "no interest" loan rules of section 7872 of the Code.

"Golden Parachutes"

The IRS has issued explicit guidance on the tax treatment of payments made upon a change of control that can be subject to the golden parachute rules of section 280G, and it will be reviewing severance and other arrangements to ensure that they meet the requirements of these regulations. If such arrangements are not compliant, the employer would be denied a deduction for such payments under section 280G of the Code and a 20 percent nondeductible excise tax would be imposed on the executive under Code section 4999.

$1 Million Cap on Executive Compensation

Under section 162(m) of the Code, the tax deduction for payments to a publicly held company's top executives (generally the CEO and the next top four) is $1 million. The regulations permit an exception for "performance-based compensation" and certain other types of compensation, and it is likely the IRS will review those exceptions to ensure that they meet the regulatory requirements. In addition, companies that did not intend to do so may find that they have inadvertently exceeded the $1 million limit if the IRS is successful in challenging arrangements that the company believed had deferred the executive's income into another tax year.

Audit Procedures

The IRS corporate audit procedures generally appear to require review of the "hot buttons" described above. Large corporations have been asked to provide an analysis of ***all*** taxable and non-taxable payments to listed executives for the years under review. Employment, severance, consulting and "any other" agreements or contracts are requested. The IRS also asks about loans and insurance arrangements.

Once the IRS reviews the employment agreements, it can identify certain fringe benefit promised therein (like the company car or chauffeur) as well as the specific compensation promised. This author has also seen followup questions on the use of corporate offices for retired executives and other executive "perks."

Finally, it appears to be standard procedure for the IRS to issue a letter to the corporate employer being audited asking if the company or its officers engaged in any "listed transactions" which are identified in IRS notices and other published guidelines. For each transaction the taxpayer must describe the facts of the transaction, provide an analysis of the law giving rise to the claimed tax benefit, provide copies of all relevant documents and materials received from promoters and/or presented to the company or its management for approval, give the IRS a list of all memoranda and opinions secured on behalf of the company with respect to the transaction and the names of promoters who received fees from the taxpayer in connection with the transaction, and provide a privilege log describing documents in the taxpayer's possession but withheld due to attorney-client privilege.

Many of these listed transactions deal with corporate transactions and deductions, but a number of them relate to executive compensation arrangements, including the "Irish Leasing" arrangement described above. In cases in which an issue of concern to the IRS is uncovered in the audit of the company, the IRS is likely to audit the executive as well. And even if the executive audit appears to be intended to be limited to the compensation issues uncovered at the corporate level (which has occurred in some cases) it is nonetheless disconcerting to tell a top executive that he must release his personal returns and take the time to defend an individual audit. Further, in some cases the executive might have entered into another tax shelter arrangement unrelated to his employment with the corporate employer, and that arrangement also stands a good chance of being scrutinized as a result of the corporate audit and followup review of the executive's personal returns.

Application to Small Employers

While most of these examinations will be directed at and primarily affect larger companies and some issues only apply to publicly held companies (*e.g.*, the $1 million cap on compensation), the IRS has not limited its audits of executive compensation to employees of those organizations. In particular, the strict review of rabbi trusts, split-dollar life insurance and deferred compensation techniques can affect executives at all levels.

Legislative Activity

It is curious (or perhaps just coincidental) that the IRS's increased audit activity is occurring at the same time that Congress has proposed legislation to reduce certain perceived abuses in executive compensation practices. In H.R. 2896, the American Jobs Creation Act of 2003, and in S. 1687, Jumpstart Our Business Strength Act (the JOBS Act), both houses of Congress have recommended proposals that would change the taxation of executive compensation. One proposal that was initially floated but that was not contained in the most current version of the JOBS Act was to repeal section 132 of the Revenue Act of 1978, giving the IRS greater flexibility to issue regulatory guidance on what it considers proper deferred compensation techniques.

Other proposals do appear to adopt, at least prospectively, the IRS's view on proper deferral techniques and attempt to eliminate certain practices criticized in the Enron Report. These proposals would require that any election to defer compensation be made during the prior calendar year (except for newly eligible taxpayers) in order for the deferred compensation to escape current taxation. The legislation would generally require at least a year's waiting period for any subsequent deferral election, and a delay of payout for at least five years after the subsequent deferral election (except for death, disability, or emergency). This avoids the "rolling elections" that some executive have used to defer receipt of compensation for relatively short periods of time. Acceleration of payments that were previously deferred would be prohibited except in limited circumstances set forth by the Treasury Department. Distributions from rabbi trusts would be prohibited except in certain instances—pursuant to a schedule set on the date compensation is deferred, or due to death, disability, separation from service (in certain cases), after a change of ownership or control, or in the event of a described hardship. The use of financial health funding "triggers" would result in current taxation of amounts set aside in trusts with such triggers.

The Senate versions of these proposals would also prohibit key employees from receiving payouts sooner than six months after the separation from service (to avoid the ability of key executives to "resign, take the money, and run" just before a company collapses). The Senate bill also limits a rabbi trust's investment options to those comparable to the employer's qualified plan. Under certain proposals, arrangements to defer gains attributable to the exercise of stock options or vesting of restricted stock will be currently taxed and any amounts set aside in an offshore rabbi trust would be deemed current compensation, with possible limited exceptions for payment made abroad for services performed there. Another provision would require that deferred compensation be listed on an employee's W-2 and subject to withholding—thus making it less likely for an executive to take aggressive reporting positions on his return.

Conclusion

The IRS seems to believe it has a unique opportunity to audit executive compensation without fear of reprisal from Congress, and it is taking advantage of this opportunity. Although clearly companies and executives who fail to follow the rules should deal with the adverse consequences of that failure, it is unfortunate that the Service had to resort to the audit technique of enforcement, particularly in light of the dearth of regulatory guidance and lack of clear rules, and particularly in cases where the Service has known about various practices but failed to act in the past. Moreover, legislation pending in Congress may end—hopefully on a prospective basis—some of the practices the Service dislikes. Nonetheless, this changed climate may give companies and their advisers a rare opportunity to review executive compensation practices and let corporate decisionmakers recognize the benefits of understanding and documenting their reporting positions, as well as the need to "play by the rules."

Notes

1. 18 T.C. 570, (1952) *nonacq.*, 1952-2 C.B. 5, *aff'd*, 207 F.2d 711 (7th Cir. 1953), *decision acquiesced by the IRS,* 1960-1 C.B. 5.

2. 8 T.C. 809 (1947) *acq.*, 1947-2 C.B. 4, and 8 T.C.M. (CCH) 919 ("Veit I" and "Veit II").

3. 96 T.C. 891 (1991).

4. *See* T.A.M. 8632003 (Apr. 18, 1986).

5. Rev. Proc. 71-19, 1971-1 C.B. 698, 698, *amplified*, Rev. Proc. 92-65, 1992-2 C.B. 48.

6. *See, e.g.*, Joint Committee on Taxation, Report of the Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues and Policy Recommendations, at page 597 (2003).

7. *See*, *e.g*., PLR 8113107 (December 31, 1980), which was the first ruling allowing such a trust to be established by a synagogue for its rabbi, thus establishing the term "rabbi trust" as a description of these arrangements.

8. 772 F.2d 1472 (9th Cir. 1985).

9. *See* 40 Fed. Reg. 4118 (September 5, 1975).

10. *See* Treas. Reg. § 1.61-21(j).

11. *See* Joint Committee on Taxation, General Explanation of the Deficit Reduction Act of 1984 ("Blue Book") at 566–567.

12. *See* Treas. Reg. § 1.132-5(m)(3) (*e.g.,* (2)).

13. *See, e.g.,* IRC § 162(a)(2) and Treas. Reg. § 1.132-6T(f)(2).

14. *See* H. Conf. Rep. 213, 103 Cong., 1st Sess. (1993).

15. *See* Treas. Reg. § 1.162-27 (e).

16. *See* Joint Committee on Taxation, Report of the Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues and Policy Recommendations (the "Enron Report") at 627.

17. *See* IRS Notice 2003-47, 2003-30, I.R.B. 132, and Treas. Reg. § 1.83-7 and 1.83-7T.

18. *See* IRS Notice 2003-22, 2003-1 C.B. 851.

19. *See* A. Moran, "Split-Dollar Life Insurance: Significant Changes in Store," 28 *Emp. Rel. L.J.* 129 (Summer 2002) and T.D. 9092, 68 Fed Reg. 54336–54361 (final split-dollar regulations).