



NYLEX News

Premier Executive Benefits Plan Services

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To our clients and friends

This issue of NYLEX News discusses the recently released Internal Revenue Service Audit Technique Guides. These publications include instructions to IRS Agents for the examination of nonqualified deferred compensation plans, executive fringe benefits and split-dollar arrangements. The guides are intended to give agents basic information about these topics and practical advice on how to conduct an examination. The guides also provide valuable insight to companies, executives and their advisors as to issues the IRS may address. Please send comments about this article, as well as suggestions for future issues, to our Stamford, CT office.

IRS Audit Technique Guides

- Executive benefits are the focus of IRS examinations
- Understanding the rules and IRS' approach may help avoid IRS challenge

INTRODUCTION

The Internal Revenue Service recently published several Audit Technique Guides (ATGs) that IRS agents will use in conducting examinations of corporations and executives. These ATGs discuss income and employment tax issues for employers paying compensation and the executives being compensated.

The seven compensation-related areas for which there are now ATGs are: (1) split dollar life insurance; (2) nonqualified deferred compensation plans; (3) fringe benefits (including life insurance); (4) golden parachutes; (5) stock based compensation; (6)

transfers of compensatory stock options to related persons; and (7) Code section 162(m) salary deduction limits. The Guides describe the topic, discuss potential issues for the examiner to address and include practical suggestions as to how the examination could be conducted.

This issue of NYLEX News summarizes the ATGs that cover nonqualified deferred compensation plans, split dollar life insurance arrangements and fringe benefits.

NONQUALIFIED DEFERRED COMPENSATION PLANS

Nonqualified deferred compensation plans (NQDCs) are defined as any elective or nonelective plan, agreement, method or arrangement between an employer and employee to pay compensation some time in the future. NQDCs do not afford employers the tax benefits of qualified plans, because the

NQDCs do not meet the requirements of Section 401(a) of the Internal Revenue Code.

NQDC plans typically fall into four categories:

1. Salary reduction arrangements deferring the receipt of otherwise includible compensation.
2. Bonus deferral plans deferring the receipt of bonuses.
3. Supplemental Executive Retirement Plans (SERPs) primarily for a select group of management or highly compensated employees.
4. Excess benefit plans providing benefits for employees whose benefits are limited by Section 415.

NQDC plans by their nature are unfunded, although employers usually set aside assets to meet their future plan obligations. Employers often seek to acquire tax-favored investments such as corporate owned life insurance (COLI), in order to maximize the economic efficiency of these arrangements.

The ATG advises IRS agents to focus on the following:

- When are the deferred amounts includible in the employee's gross income? Agents should consider the issues of constructive receipt and economic benefit and look to see whether:

- The employee has control over the receipt of the deferred amounts without being subject to substantial restrictions.
- Amounts have been set aside for the exclusive benefit of plan participants or a preference is provided to participants over other general creditors.

- When are deferred amounts deductible by the employer? Generally amounts are deductible when the amounts are includible in income by the employee.
- When are deferred amounts taken into income for employment tax purposes? Recognition generally is required at the later of when the services are performed or when there is no substantial risk of forfeiture as to the deferred amounts.

GENERAL AUDIT STEPS

In addition to interviewing company personnel who are most knowledgeable about executive compensation practices, agents are advised to:

- Review deferral election forms.
- Review disclosures in SEC filings and in the notes to the company's financial statements.
- Determine whether the company engaged a consulting firm to assist the executive in wealth management.
- Review any distributions to covered executives other than those for death, disability or termination of employment.
- Review tax return Schedule M-1 for amounts that are expensed on the company's books but not deductible on the tax return.

SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENTS

Agents are advised that split-dollar life insurance arrangements can be a key feature of executive compensation

packages. Although the IRS for many years provided little guidance regarding the use of these arrangements, beginning in 2001 transitional guidance was issued in the form of notices and proposed regulations. Final regulations were issued and apply to split-dollar life insurance arrangements entered into or materially modified after September 17, 2003.

In order to identify the existence of split-dollar arrangements, agents are advised to review:

- Annual 10-K filing.
- Board of Director and Compensation Committee minutes.
- Executive employment contracts.
- Schedule M-1 for adjustments to taxable income for the payment of life insurance on executives.
- General ledger and accounts payable journal for life insurance payments.

INTERIM VALUATION RULES

Where the interim valuation rules apply, Agents should determine whether the taxpayer can use alternate valuation rates furnished by the insurance provider, or whether Table 2001 rates should be used. If the insurer's rates are being used, are these published rates available to all persons who apply for insurance coverage from the insurer?

The Agent should check the insurer's rate sheet for items such as "not for publication" or "internal use only". The insurer's Web site may indicate that they do not sell individual term insurance but only corporate policies. Any of these factors could indicate that the economic value of the term coverage should be recomputed using Table 2001.

SAFE HARBOR RULES

Notice 2002-8 includes special provisions for split-dollar life insurance arrangements that were entered into before January 28, 2002. Some of the safe harbors in Notice 2002-8 also apply to split-dollar arrangements entered into after January 28, 2002 but before the effective date of the final regulations.

FINAL REGULATIONS

Under the final regulations issued September 17, 2003, it is critical for the Agent to determine who owns the split-dollar policy. According to guidance offered in the ATG, if the executive owns the policy, the loan regime applies. The agent should make sure the rate of interest being charged on the loan is at least the applicable AFR rate; otherwise, the executive will be taxed on the difference between the AFR rate and the actual interest rate being charged.

If the employer is the owner of the split-dollar policy, the employer's premium payments are treated as providing an economic benefit to the executive. The agent should determine that if alternate valuation rates are being used to value the economic benefit, they meet the applicable requirements, including covering standard risks and that the policy is for a one year period.

The final split-dollar regulations apply to any split-dollar arrangement entered into after September 17, 2003, which includes an arrangement that is materially modified after that date. The Agent should request information about any modifications or amendments made to the arrangement after September 17, 2003.

EXECUTIVE FRINGE BENEFITS

The Audit Technique Guide defines executive fringe benefits as any property or service an executive receives in lieu of or in addition to regular taxable wages. Regardless of its form, a fringe benefit provided in connection with the performance of services must be treated as taxable compensation unless there is a specific statutory exclusion that applies to the benefit.

Because the tax treatment of fringe benefits can vary, agents are advised to follow a three-step analysis in examining this area:

- Identify the fringe benefit and start with the assumption that it is taxable compensation to the employee.
- Check to see if there are any statutory provisions that exclude the fringe benefit from taxable income.
- Value any portion of the benefit that is not excludible for inclusion in the executive's gross income.

The ATG identifies various fringe benefits that are most commonly encountered, including:

- **Awards and bonuses** — All compensation in whatever form is taxable. Agents are advised to review invoices for "ship to" addresses for large items that appear to be personal in nature.
- **Club memberships** — Club dues are nondeductible by the employer unless they are included in the employee's taxable compensation. Agents are advised that club dues and fees often are disguised by employers seeking a deduction. Also, club memberships have been distributed to departing executives and they should be reported as wages.

- **Loans** — Loans to executives have been made under terms that indicate the loans are really disguised compensation. Agents should look for (a) the existence of a promissory note, (b) cash payments according to a specified schedule, (c) interest being charged and (d) security for the loan. Loans should be reviewed to make sure the terms are being followed. Agents are instructed to examine the underlying intent of the arrangement.

Loans should be analyzed to determine if they have below market interest rates or no interest. Either situation would result in imputed income to the executive, who then is treated as having paid interest back to the employer. Different rules apply depending on whether the loan is a demand loan or a term loan. Also, de minimis exceptions apply in some situations.

The Sarbanes-Oxley Act of 2002 prohibited personal loans to officers and directors of public companies.

- **Spousal/dependent life insurance** — Group term life insurance premiums to insure the life of a spouse or dependent of an executive are includible in the executive's taxable income. Employers sometimes attempt to classify these payments as a de minimis fringe benefit, but agents are advised that the IRS takes a very narrow view of this provision. Also, split-dollar life insurance provided for an executive's spouse should be examined.
- **Wealth management** — Many executives are provided either a sum of money for financial planning or the services of an outside

professional. Agents are instructed that the use of financial planning services is a benefit received in lieu of compensation and is a taxable fringe benefit.

- **Qualified retirement planning** — Retirement planning services also represent taxable compensation unless the expenses are "qualified retirement planning services". These qualifying services are defined as retirement planning advice or information provided to an employee and his or her spouse under a qualified plan, which cannot discriminate in favor of highly compensated employees. Such services must be provided on substantially the same terms to each member of the group of employees normally provided education and information concerning the employer's qualified plan.

Agents are advised to identify this issue by seeking information about services provided to executives for income tax preparation, financial planning or other accounting services. A review of executive employment agreements and benefits also helps in identifying this issue, as will a review of outside accounting expense.

SUMMARY

These Audit Technique Guides are intended to give practical suggestions to the IRS Agent conducting a corporate or executive tax examination. Understanding the IRS' approach in examining and analyzing these issues can help taxpayers and their advisors avoid arrangements that will be challenged by an examining Agent and possibly result in additional income and employment tax assessments.

ABOUT NYLEX BENEFITS

NYL Executive Benefits LLC (NYLEX Benefits) provides supplemental executive benefit programs to a wide range of commercial clients. We focus on developing cost effective executive benefit solutions that are designed to attract, reward and retain key employees.

Our services are designed to assist clients at all stages in the adoption and operation of executive benefit programs, and include:

- Initial assessment
- Plan design
- Funding
- Plan implementation
- Ongoing administration

NYLEX Benefits' professional staff includes the following professional disciplines, all dedicated to supporting our clients' programs, processes, systems and services:

- Accountants
- Actuaries
- Attorneys
- Benefit specialists
- Insurance specialists

We take great care to assure that client programs are practical and cost effective and that they are designed to achieve our clients' strategic and operational goals.

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