Morgan Lewis

webinar

IRS Audit Focus on Executive Compensation

June 11, 2013

Presenters:
Mary B. Hevener
David B. Zelikoff
Leslie E. DuPuy

Overview of Presentation Topics

- Compliance with Code section 162(m)
- Accrual of annual bonus payments
- Current tax issues with respect to executive air travel and other fringe benefits
- Tax withholding challenges created by the 2013 Medicare tax increase (0.9% and 3.8%)
- FICA refund claims and exceptions for severance/layoffs/SUB-Pay

COMPLIANCE WITH CODE SECTION 162(m)

Background

- Internal Revenue Code (Code) section 162(m) limits deductible compensation paid to a "covered employee" of a publicly held company to $1M.
  - Covered employees are the CEO and the 3 highest-compensated officers (other than the CFO) in such status on the last day of the taxable year.
- Code section 162(m) does not apply to certain "qualified performance-based compensation."

Performance-Based Compensation

- Performance Goal Requirement
  - Paid solely on account of attainment of 1 or more pre-established objective performance goals, pursuant to an objective formula
- Outside Director Requirement
  - Performance goals must be established by a compensation committee that consists solely of 2 or more “outside directors”
- Shareholder Approval Requirement
  - Material terms governing payment of the compensation must be disclosed to, and approved by, shareholders prior to payment
- Certification Requirement
  - The compensation committee must certify, in writing, prior to payment, that the performance goals and any other material terms were satisfied

Performance Goal Requirement

- The compensation must be paid solely on account of the attainment of pre-established, objective performance goals.
  - Established in writing
  - By the compensation committee
  - No later than 90 days after the beginning of the service period to which the performance goal relates, and within the first 25% of such service period
- The outcome must be substantially uncertain at the time the goals are established.

Performance Goal Requirement

- Objective
  - A third party having knowledge of the relevant facts could determine if the goal is met.
- The goal must state, in terms of an objective formula or standard, the method for computing the amount of compensation if the goal is attained.
  - No discretion to increase the amount of compensation; negative discretion is permitted.
  - Adjustments for certain objective subsequent events are permitted (e.g., reorganization or restructuring programs, executive termination costs, the sale or acquisition of a business unit, other one-time expenditures).

Performance Goal Requirement

- Payment must be contingent on attainment of the performance goal.
  - Cannot receive all or part of the compensation regardless of whether the performance goal is attained.
- Limited exception for compensation payable on account of death, disability, or a change in control.

Performance Goal Requirement

- If compensation is payable upon termination (without cause, for good reason, retirement), it will not constitute qualified performance-based compensation.
  - Revenue Ruling 2008-13:
    - *Performance periods beginning after January 1, 2009*
    - *Employment contracts entered into after February 21, 2008*
    - *Amendments to or renewals or extensions of employment contracts in effect on February 21, 2008*
  - Avoid amendments to grandfathered agreements.
  - Limit payment to the pro rata amount that would otherwise be payable on achievement of performance goals.
    - *Payment delayed until end of performance period.*

Outside Director Requirement

- The performance goals must be established by a compensation committee consisting of 2 or more "outside directors." A director is an outside director if:
  - Is not a current employee of the company;
  - Is not a former employee of the company who is receiving compensation for prior services (other than under a qualified retirement plan);
  - Has not been an officer (or interim officer) of the company (*see* Revenue Ruling 2008-32); and
  - Does not receive remuneration from the company, directly or indirectly, in any capacity other than as a director.
    - *Exception for certain* de minimis *remuneration*

Shareholder Approval Requirement

- The material terms governing payment of the compensation must be disclosed to, and approved by, shareholders prior to payment. The "material terms" include:
  - Class of eligible employees;
  - Business criteria on which the performance goal is based; and
  - Maximum amount of compensation that could be paid to any employee or the formula used to calculate the amount of compensation.

Shareholder Approval Requirement

- Shareholder reapproval required if:
  - Material terms are changed; or
  - The compensation committee has the authority to change the targets under a performance goal after shareholder approval of the goal.
    - *Every 5 years*

Certification Requirement

- The compensation committee must certify, in writing, prior to payment, that the performance goals and any other material terms were satisfied.
  - Approved minutes of the compensation committee in which certification was made qualify as written certification for these purposes.

Stock Options and Stock Appreciation Rights

- Grants of stock options and stock appreciation rights qualify as performance-based compensation if they meet the following requirements:
  - The grants are made by the compensation committee;
  - The plan under which the options and rights are granted states the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee; and
  - The exercise prices of the options or the base amounts for the stock appreciation rights are no less than the fair market value of the underlying shares on the date of grant.

Stock Options and Stock Appreciation Rights

- The IRS issued proposed regulations on June 24, 2011, that provide clarification to the shareholder approval requirement under the regulations. *See* 76 Fed. Reg. 37,034.
  - The requirement to disclose the maximum amount of option or SAR compensation that could be paid is satisfied where the maximum number of shares for which grants may be made to any *individual* employee *during a specified period* and the exercise price of those awards are disclosed to the shareholders.
  - The $1M deduction limit does not apply to options, SARs, and restricted property (but not RSUs and phantom shares) granted before the 1st shareholder meeting following the end of the 3rd calendar year after the IPO or, in the case of a privately held company that becomes publicly held without an IPO, the 1st calendar year after the calendar year in which the corporation becomes publicly held.

Section 162(m) – Deduction of Dividends or Dividend Equivalents

- IRS issued Revenue Ruling 2012-19 dealing with the deductibility of dividends or dividend equivalents on performance-restricted stock or RSUs.
- The ruling clarifies that payment of dividends or dividend equivalents must be conditioned on meeting performance goals to be deductible as qualified performance-based compensation under Code section 162(m).

What Do Employers Need to Do?

- Employers should carefully examine their existing plans and agreements to ensure compliance with Code section 162(m) requirements in order to avoid any loss of a deduction in the event of an audit.
  - Satisfy the performance-goal requirement by setting the performance goals within 90 days of the commencement of the performance period.
  - Satisfy the certification requirement by having the compensation committee certify the performance goals and other material terms in writing prior to the payment of performance-based compensation.
  - If the compensation committee has the authority to select different performance criteria and to change the performance targets, the material terms of the plan must be approved by shareholders every 5 years.

ACCRUAL OF ANNUAL BONUS PAYMENTS

Accrual of Annual Bonus Payments

- Background
  - Under the accrual method of accounting, a liability can be taken into account in the taxable year in which:
    1. *The fact of the liability is established;*
    2. *The amount of the liability can be determined; and*
    3. *Economic performance has occurred.*
  - The only additional limitation is that the amounts accrued for tax purposes must be paid within 2.5 months after the year end.

Accrual of Annual Bonus Payments

- Under the case law, so long as employees *collectively* have a right to receive the bonus, the bonus is accruable.
- Thus, if there is a pre-established bonus formula, and a commitment to pay the employees in the aggregate, that is communicated to employees, the bonus should be accruable.
- On audit, the IRS is looking for the existence of *any* possible way by which an employer might have reduced bonuses, collectively or individually.

Accrual of Annual Bonus Payments

- Rev. Rul. 61-127, concluding that bonuses were accruable where an employer advised its employees that it would pay bonuses in the aggregate amount of "not less than 2% of profits."
- Uncertainties as to which employee might receive a particular bonus do not affect the accruability of the aggregate bonus (per *Washington Post v. United States*; *United States v. Hughes Properties*; *Massachusetts Mutual Life Insurance v. United States*; and *Burnham v. United States*).
- See also Rev. Rul. 2011-29, revoking Rev. Rul. 76-345 and concluding that the "fact of the liability" to pay bonuses can be established even if an individual employee's bonuses are payable only if the employee works until the bonus pay date.
- However, the IRS has recently contended in audits that it "never intended to reverse" its opposition to work-to-paydate requirements. CCA 200949040; *see also* CCA 201246029.

Accrual of Annual Bonus Payments

- The IRS contends, in most audits, that the employer had no legal obligation to pay the bonus amounts as of the bonus year end because the employer had the right to reduce bonuses or employees could lose the bonuses if they terminated service.
- Yet many employers have communicated their bonus plans since the establishment of this bonus program, and many also made commitments to pay total amounts (to be allocated among employees).
- Where a commitment has been made by an employer to pay annual bonuses in an aggregate amount, employees could sue to enforce such payment. *See Thomson v. Saatchi & Saatchi Holdings*, *Central Texas Micrographics v. Leal*, *Vaughan v. Rehab One,* and similar cases on "reasonable expectancy" of compensation and promissory estoppel.

Accrual of Annual Bonus Payments

- Surprisingly, in some audits the IRS is even proposing "intentional disregard" penalties, which makes no sense at all.
- In many instances, the proposed assessments are unsupportable due to disregard of the employers' established bonus plans, which in many of the audits have satisfied all the required elements supporting accrual of bonus deductions.
- The proposed penalties are also unsupportable, and in any event should be abated for reasonable cause.

CURRENT TAX ISSUES: EXECUTIVE AIR TRAVEL

Executive Air Travel

- Whether a flight is for a business or personal purpose must be evaluated individually, and because each executive's facts are different, there is no black-and-white test that can be applied.
- If a flight (including one by a spouse, family member, or guest) is challenged by the IRS as undervalued, the IRS typically argues that:

  (1) the flight must be valued at CHARTER (not SIFL) rates; and

  (2) the employer's deduction for the flight must be disallowed.
- The first point can be challenged in appeals if the employer had made a "good faith" mistake.
- The second point can be challenged if the flight was a "business entertainment" flight, a "commuting" flight, or some other flight not covered by the "entertainment flight" rules of Treas. Reg. § 1.274-9 and -10 (as finalized August 1, 2012).

Executive Air Travel

- Shareholders also have brought derivative litigation alleging overuse of corporate aircraft.
- Concerns about revealing very high incremental costs of corporate plane travel in the proxy have led many companies to charge executives for many personal flights.
- However, those charges must be carefully structured under special lease agreements charging only incremental costs (and two times the gas); otherwise, charges could trigger FAA fines for incorrect licenses for the plane and its pilots and also trigger significant increases in excise taxes for the amounts charged.

CURRENT TAX ISSUES: DATA COLLECTION AND FRINGE BENEFIT AUDITS

Data Collection and Fringe Benefit Audits

- Since 2009, the IRS has been auditing more than 2,000 employers (under a program announced in late 2009, with initial optimistic intentions to examine 6,000 taxpayers from 2009 to 2011). Most of these audits were of small companies, with an intention to extrapolate the audit results to measure "business's compliance" with worker classification, fringe benefit, and payroll tax laws.
- The IRS's first extrapolation report in May 2011 was deemed by the Treasury Inspector General for Tax Administration to be "too small of a sample to provide meaningful compliance estimates," so the IRS was required to restart the audits for big companies in 2012.

Data Collection and Fringe Benefit Audits

- The initial IDRs in any of these audits cover hundreds of issues and can take over a year to complete.
- We can provide a sample of an initial IDR.
- There are typically 5 basic areas identified for attention during these audits (each covered below and in the following slides).

Data Collection and Fringe Benefit Audits

1. Fringe benefits (likely to include use of company cars, planes, and home computers; spousal travel; corporate apartments; prizes and awards; tax return preparation; meals; life insurance; and various *de minimis* items).
2. Reimbursed expenses (Code § 62(c) compliance).
3. Executive compensation (including deferred compensation and stock-based awards, such as qualified and nonqualified stock options, restricted stock, and various phantom stock programs, and for larger companies, Code sections 162(m) and 280G issues).

Data Collection and Fringe Benefit Audits

4. Payroll tax compliance overview. These questions will focus on W-4/W-9 collections (including investigations of employees who have claimed "exempt status" or too many exemptions), information return compliance (including specific questions about individuals who have received both Forms W-2 and 1099-MISC), and timing of payroll tax deposits.
5. Worker classification/independent contractors (the focus of these audits will be, ultimately, to collect solid revenue estimates for an expected Obama administration proposal to repeal § 530 of the 1978 Revenue Act).

Data Collection and Fringe Benefit Audits

- *Possible state referrals*
- Not only are these IRS audits painful processes, but, given increased coordination between the IRS and state tax agencies, it is possible that audit results will be coordinated with state tax authorities.
- Many states have longer statutes of limitations – some extending 2 or 3 years after the employer pays taxes to the IRS at the conclusion of the IRS audit.
- If the employer does not “confess” to the state its payment of taxes to the IRS, the state statute of limitations may never run out (e.g., in California).

2010 Increase in Information Reporting Penalties

- The Code not only includes penalties on individual taxpayers for underreporting income and underpaying taxes or paying taxes late, but also imposes penalties on employers for making the same types of errors.
- These penalties were dramatically increased in late 2010, effective for information returns filed in January 2011 (although there is a typo in the IRM, indicating that for “small employers” the increased penalties may be delayed until 2011).
- Also, an employer’s liability for underwithholding on executives increased in 2013 because the withholding rate on supplemental wages of more than $1M jumped from 35% to 39.6%.

2010 Increase in Information Reporting Penalties

- The post-2010 penalties (imposed under *each* of Code sections 6721 and 6722) are:
  - $100 per W-2, up to maximum of $1.5M for all such failures in the aggregate for the year;
  - $30 per W-2, with $250K annual cap if corrected within 30 days of January 31;
  - $60 per W-2 with $500K annual cap if corrected on or before August 1);
  - in cases of intentional disregard, greater of 10% of underreported amount or $250 per W-2 (with no annual cap).
- (Lower annual caps apply to small employers with gross receipts under $5M.)

2010 Increase in Information Reporting Penalties

- For errors on any single W-2 (or 1099), this law change has effectively doubled the penalties – from $100 to $200 per return (since penalties are imposed on errors in both the employee and employer copies of the forms).
- For errors by large employers that affect 15,000 or more employees, the penalties have increased six-fold, from $500K to $3M.
- Lower caps apply to small employers with gross receipts under $5M.
- For “intentional disregard” errors, the penalty is 20% of the underreported income.

2010 Increase in Information Reporting Penalties

- Have these changes increased the accuracy of information returns?
  - Perhaps information returns are more accurate, but certainly these higher penalties (and higher withholding rates for executives' compensation) have increased the "worry factor" for return filers.
- Will these changes increase the frequency of audits?
  - Maybe – and they certainly will increase costs for those audited and have led to more "computer-notice" assessments.

TAX WITHHOLDING CHALLENGES CREATED BY THE 2013 MEDICARE TAX INCREASE

Withholding Complications Resulting from Increases in 2013 Medicare & Income Taxes

- The 0.9% “Additional Medicare Tax” (AdMedTax) in 2013 requires withholding for any employee earning FICA-taxable wages of more than $200K (a withholding trigger slightly different from the actual trigger for liability, which is $200K for single filers and $250K for joint filers).
- The separate new 3.8% Medicare tax on *unearned income* must be paid through extra FITW withholding or estimated tax deposits.
- The top 2013 income tax bracket of 39.6% means a greater shortfall in withholding on bonuses and equity compensation, since only 25% is withheld up to $1M of supplemental wages.

Dealing with 2013 Medicare Tax Increases: Withholding & Deposit Complications

- Employers are required to withhold the 0.9% tax on any employee's FICA-taxable wages in excess of $200K in any year, *starting with the pay period when FICA-taxable wages exceed $200K*.
- This withholding is required even if the employer knows the employee is married with joint income under $250K.
- An employer is *not* allowed to withhold the 0.9% tax on any employee's FICA-taxable wages under $200K, even if the employer knows that the employee and spouse *jointly* earn wages of more than $250K, or if the employer knows the employee is married but filing separately.

Dealing with 2013 Medicare Tax Increases: Withholding & Deposit Complications

- Two married workers, each earning $200K, would owe the new 0.9% Medicare tax on $150K, but would have to pay this through quarterly tax deposits or increases in wage withholding.
- Still larger potential shortfalls in 2013 payroll tax withholding are created because supplemental wages under $1M are withheld at only 25% (i.e., 14.6% under the 2013 top tax rate of 39.6%).
- Finally, the new 3.8% Medicare tax on unearned income must be *either* paid through quarterly tax deposits or covered through increases in wage withholding.

Dealing with 2013 Medicare Tax Increases: Withholding & Deposit Complications

- Wage withholding is generally preferred, compared to quarterly tax deposits, because wage withholding is deemed to apply ratably over the calendar year, so late-year deposits of withholdings can eliminate any prior missed deposits of quarterly estimated taxes.
- *But watch out!!* – Year-end increases in income tax withholding may be blocked or complicated because:
  - Supplemental wages of more than $1M have a 39.6% withholding rate – no more, no less.
  - Changes in Form W-4 at year end are problematic.

Dealing with 2013 Medicare Tax Increases: Employee Requests for Withholding Adjustments

- Importantly, an employee *cannot* simply *ask* his/her employer to increase his/her FITW withholding to a higher percentage rate (e.g., “please withhold at 40%”).
- Instead, a Form W-4 *must* be filed to request additional withholding in a specific amount.
- *See* IRS Info Letter 2012-0063 (September 28, 2012) (and a similar 1997 letter) explaining the complicated procedure for increasing FITW on any wages (including supplemental wages subject to 25% flat rate withholding) by adjusting the Form W-4 governing regular wage withholding.

Dealing with 2013 Medicare Tax Increases: Employee Requests for Withholding Adjustments

- Too many changes in Forms W-4 (requesting low withholding early in the year, and dramatic year-end increases in wage withholding) can attract IRS scrutiny.
- In 2007, the IRS dropped its rule requiring employers to file early any Forms W-4 claiming more than 10 exemptions (or "exempt status"). See the pre-2007 version of Treas. Reg. § 31.3402(f)(2)-1(g)(1) and (3).
- But in some payroll audits the IRS has brought in criminal investigators to review Forms W-4.
- The penalties on employees can be significant. *See* §§ 6652 ($500 penalty) and 7205 ($1,000, or year in jail).

Dealing with 2013 Medicare Tax Increases: Employee Requests for Withholding Adjustments

- Note, too, that if any employee has total wages of more than $1M, the income tax withholding rate on any "supplemental wages" is locked in at *39.6%*, and the employee cannot increase or decrease the amount of wage withholding (per Treas. Reg. § 31.3402(g)-1(a)(2)).
- In such a case, an employee could not correct underwithholding, except with respect to basic (nonsupplemental) wages. Estimated tax deposits may be required to correct underwithholding – and if this is discovered at year end, the shortfall cannot be fixed.

FICA REFUND CLAIMS AND EXCEPTIONS FOR SEVERANCE/LAYOFFS/SUB-PAY

Payroll Tax Refund Claims

- Overview of Legal Arguments
  - FICA taxes are imposed on “wages” for “services performed”
  - SUB-Pay is exempt from FICA taxes
  - Statutory vs. IRS administrative definition of “SUB-Pay”
  - *Quality Stores* decision and Morgan Lewis’s role in filing amicus brief for the American Payroll Association (APA), arguing case before the Sixth Circuit, and filing second APA amicus brief opposing rehearing en banc

Payroll Tax Refund Claims

- Importance of 1968 final Treas. Reg. § 1.6041-2(b), requiring Form 1099-MISC reporting of SUB payments of "benefits because of [an employee's] involuntary separation from employment (whether or not such separation is temporary) resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions."
- This was the regulation Congress addressed in enacting Code § 3402(o)(2).

Payroll Tax Refund Claims
The Legal Arguments

- What Are Taxable "Wages"?
  - FICA "wages" are broadly defined as "all remuneration *for services performed*"
  - SUB-Pay benefits (as defined in a complex series of IRS rulings) are not considered "wages" by the IRS, but most companies don't pay severance from an IRS-approved SUB-Pay plan
  - Downsizing payments arguably do not constitute wages because they are not paid for the "performance of services"
  - Instead, downsizing payments are made because an employee has been prevented from performing services for a downsizing employer due to a reduction in force, plant shutdown, discontinuance of an operation, etc.

Payroll Tax Refund Claims: Statutory Definition of Involuntary Severance/Downsizing Pay

- Code § 3402(o)(2) (and other sections defining SUB-Pay):
  1. Amounts paid to former employees
  2. Pursuant to the employer's plan or arrangement
  3. On account of an involuntary separation
  4. The involuntary separation must arise from:
     - *a reduction in force,*
     - *discontinuance of a plant/operation, or*
     - *other similar conditions*
  5. The amounts are included in the employee's gross income

  Note: No requirement that the employee *stay* unemployed to receive benefits

Payroll Tax Refund Claims: *Quality Stores* Applies the Statutory Definition

- Sixth Circuit Upholds Taxpayer's Refund (September 7, 2012)
  - Applies the statutory definition of SUB-Pay in Code § 3402(o).
  - Statutory SUB-Pay is not paid for services performed.
  - Recognizes that the FICA and FITW definitions of "wages" for SUB-Pay purposes should be identical since the IRS has not issued regulations under the 1983 "decoupling amendment" overriding *Rowan v. United States*
  - Refused to apply the IRS's most recent ruling in a series of inconsistent Revenue Rulings.

Petition for Rehearing

- The DOJ argued, in its petition for rehearing of *Quality Stores* (filed October 18, 2012), that the 3-judge panel misread the law. However, all the cases cited by the DOJ were carefully considered by the panel. Also, the DOJ's brief once again does not mention the 1968 final regulation (effectively approved by Congress) that treated all SUB-Pay as "not wages."

Response to Petition for Rehearing

- *Quality Stores*, through its counsel, responded that the original 3-judge panel correctly applied the law and that no rehearing was necessary.
- APA filed a second amicus brief, attaching IRS instructions from 1971 Forms W-2 and 941E (for the first full year of effectiveness of Code § 3402(o)(2)), explaining to taxpayers that the law change required severance/downsizing benefits to be subjected to FITW, *but not to FICA/FUTA taxes.*
- Contemporaneous explanations are important tools of statutory interpretation.

Response to Petition for Rehearing

- The government's petition for rehearing en banc was denied by the Sixth Circuit on January 4, 2013.
- The government had an original deadline of April 4, 2013 to file a petition for writ of certiorari to the United States Supreme Court.
- On March 25, 2013, the Solicitor General's office requested and received an extension of the filing deadline until May 31, 2013.
- The DOJ's cert petition was filed on May 31, 2013. Quality Stores is expected to file a brief opposing the grant of a cert petition.

Payroll Tax Refund Claims
Next Steps

- File refunds for open years (generally, 2010-2012) in anticipation of Supreme Court action, IRS regulations, and/or possible legislation.
- File soon to avoid potential legislation "clarifying" law and blocking claims after the introduction of such a bill.
- Carefully monitor IRS denials of outstanding claims and apply for extension of the deadline for filing suit in court (2 years after claim denial) by obtaining signed "Form 907."

Payroll Tax Refund Claims
Next Steps

- Most claims are “frozen” in appeals, or have been “returned to campus,” pending an IRS decision on how to handle the claims.
- Steps to follow if IRS pays the refund (either per agreement at appeals, like that reached by one Morgan Lewis client, or per inadvertent refunds).
- Do *not* pay severance free from FICA/FUTA until this matter is resolved.
- Consider obtaining “consents” from employees at the point of severance to simplify collection processes.
- Possible issuance of explanatory employee letters to employees requesting FICA exemptions.

Presenters

Mary B. Hevener
Partner, Washington, D.C.
202.739.5982
mhevener@morganlewis.com

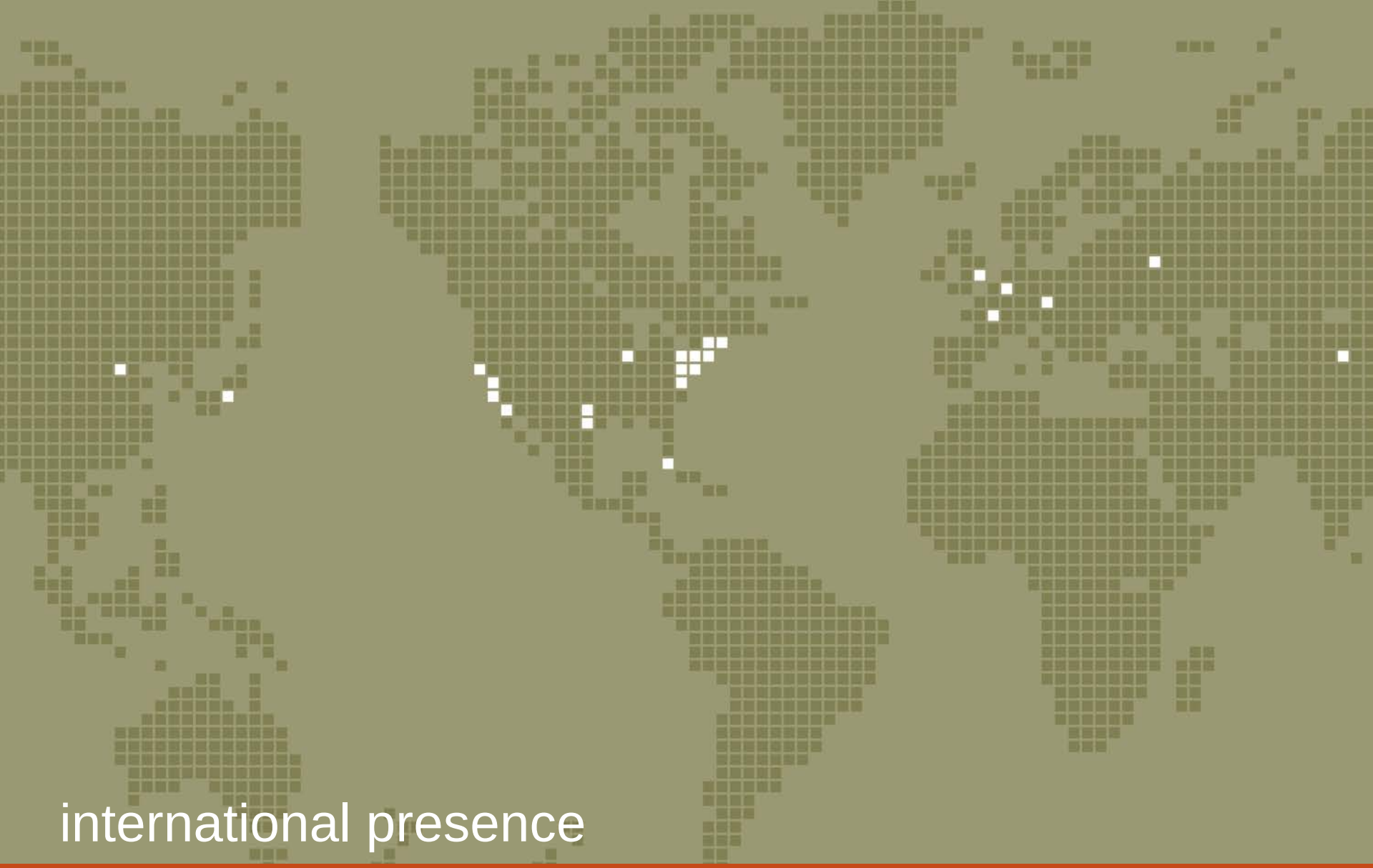
Leslie E. DuPuy
Associate, San Francisco
415.442.1247
ldupuy@morganlewis.com

David B. Zelikoff
Partner, Philadelphia
215.963.5360
dzelikoff@morganlewis.com

DISCLAIMER

- This material is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. These materials may be considered Attorney Advertising in some states. Please note that the prior results discussed in the material do not guarantee similar outcomes. Links provided from outside sources are subject to expiration or change.

- **IRS Circular 230 Disclosure**
  To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein. For information about why we are required to include this legend, please see http://www.morganlewis.com/circular230.



international presence

Almaty Beijing Boston Brussels Chicago Dallas Frankfurt Harrisburg Houston Irvine London Los Angeles Miami Moscow New York Palo Alto Paris Philadelphia Pittsburgh Princeton San Francisco Tokyo Washington Wilmington