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Subject: **IRS Releases Executive Compensation Audit Guides, Including Split Dollar, Deferred Compensation and Fringe Benefits**

Major References: [\*IRS Corporate Executive Compliance Audit Technique Guidelines, Released April 28, 2005\*](#)

MDRT Information Retrieval Index Nos.: 2400.00; 6800.00

*The Internal Revenue Service recently published on its website seven audit technique guides (ATGs) that agents will use during the course of corporate and/or executive tax examinations. The ATGs discuss income and employment tax issues for the employers who pay the compensation and for the executives who receive it. The ATGs are the result of an IRS executive compensation audit pilot program involving two dozen large corporations that concluded several months ago. The ATGs will now be used in all IRS corporate and executive audits.*

The seven 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. Each ATG gives a short description of the topic, then describes potential issues for the auditor to focus on and gives practical suggestions on how the auditor might examine the issues involved. Those suggestions include interviewing company personnel and plan administrators, looking at the company website, conducting internet research about the company and its executives and requesting certain documents, like SEC filings, Board and/or Compensation Committee resolutions or minutes, employment, consulting, loan and severance agreements, plan documents and amendments, corporate and/or partnership federal income tax returns, W-2 forms, notes to financial statements, expense and accounts payable reports, contracts between the employer and financial planning firms who handle wealth management for the company's executives, ledger accounts or account statements for each executive and records maintenance and retention policies for executive compensation materials.

The following is a brief summary of the ATGs for split dollar arrangements, nonqualified deferred compensation and fringe benefits.

### *Split Dollar Arrangements*

The split dollar ATG instructs the IRS auditor to review the company's annual report (Form 10-K) filed with the SEC, paying particular attention to items 10, 11 and 12 to determine the "insiders" under Section 16(b) of the Securities Exchange Act of 1934. The auditor is also told to review (i) the company's proxy statement, paying particular attention to the detailed disclosure regarding director and officer compensation, and (ii) the minutes of the Board and Compensation Committee pertaining to the company's insurance arrangements with executives. The split dollar ATG states:

Inspect the employment contracts of executives and other highly paid individuals as frequently insurance arrangements are contractual. Inspect the Schedule M-1 for adjustments to taxable income for the payment of life insurance on employees. Inspect the general ledger and/or accounts payable journal for insurance expense payments.

Once the auditor has determined that there is a split dollar arrangement, it is "imperative", according to the ATG, that the auditor obtain a copy of the split dollar arrangement, the life insurance policy and any amendments, in order to determine whether grandfather rules, transition rules or the final regulations apply.

The key points to consider with respect to valuation issues, when a split dollar arrangement is in place prior to September 17, 2003, and not materially modified thereafter, are:

- If the taxpayer is using the lower published premium rates instead of the PS 58 Tables or Table 2001, is the rate being used a published rate available to all persons who apply for term insurance coverage from the insurer? (See section III(3) of Notice 2002-8 for additional rules if the arrangement is entered into after January 28, 2002.)
- Is the alternate rate for a one year standard term policy, all risks, or is the rate based on a policy with a renewal feature?
- Request a copy of the rate sheet, which will describe the terms of the policy (e.g., renewal factors), policy applicability (e.g., standard risks, non-smoking), dollar value of the policy, etc. Look on the rate sheet for items such as "not for publication" or "internal use only." Check the insurance company's website to determine if they sell individual policies or only corporate policies. Any of these factors could indicate that the economic value of the term coverage should be recomputed using Table 2001.

Under the heading, "Safe Harbor Rules," the ATG states that Notice 2002-8 contains special provisions for split dollar arrangements that were entered into prior to January 28, 2002 and informs the auditor that employers have several options with respect to such arrangements. The ATG states that the employer must have decided which option to apply to a particular split dollar arrangement in effect prior to December 31, 2003 and that the auditor should carefully review any split dollar arrangement in effect before January 28, 2002 to determine that the employer has selected one of the available options. In addition, the ATG states that some of the safe harbors in Notice 2002-8 also apply to split dollar arrangements entered into after January 28, 2002 and before the effective date of the final regulations.

With respect to the final split dollar regulations issued on September 17, 2003, which apply to any split dollar arrangement entered into after that date (including material modifications made after that date to existing arrangements), the auditor is told to determine who owns the split dollar policy, then apply the following rules:

- If the executive owns the policy, the employer's premium payments are treated as loans to the employee. Consequently, unless the executive is required to pay the employer interest on the loan at or above the applicable federal rate (AFR), the executive will be taxed on the difference between the AFR interest and the actual interest. Verify that the rate of interest being charged is at least the AFR. If the rate being charged is below market, impute taxable income to the employee using the rules under Treasury regulation section 1.7872-15.
- If the employer owns the split dollar policy, the employer's premium payments are treated as providing taxable economic benefits to the employee. The economic benefits include the employee's interest in the policy's accessible cash value and current life insurance protection. Be certain that if alternate valuation rates are being used to value the current life insurance protection, they meet the requirements discussed above (all standard risks, term of at least one year, etc.).

The ATG also directs the auditor to Treasury regulations section 1.61-22(j)(1)(ii) for the meaning of "entered into" after September 17, 2003 and directs the auditor to Treasury regulations section 1.61-22(j)(2) whereby an arrangement entered into on or before September 17, 2003 is "materially modified" after September 17, 2003 is treated as a new arrangement entered into on the date of the modification and is subject to the final regulations. The ATG states that Treasury regulations section 1.61-22(j)(2)(ii) sets forth a non-exclusive list of changes that are NOT considered to be material modifications.

### ***Nonqualified Deferred Compensation***

The nonqualified deferred compensation (NQDC) ATG focuses both on plan documents and on plan operation with respect to the proper timing of taxing income. Specifically, the ATG states that:

NQDC plans may be formal or informal and they need not be in writing. While many plans are set forth in extensive detail, some are referenced by nothing more than a few provisions contained in an employment contract. In either event, the form of a NQDC arrangement is just as important as the way the plan is operated. That is, while the parties may have a valid NQDC arrangement on paper, they may not operate the plan according to the plans' provisions. In such a circumstance, the efficacy of the arrangement is not dependent upon its form. A NQDC plan examination should focus on when the deferred amounts are includible in the employee's gross income and when those amounts are deductible by the employer. It should also address when deferred amounts must be taken into account for employment tax purposes.

The ATG discusses the doctrines of constructive receipt, economic benefit and cash equivalency and the auditor is instructed to request copies of any insurance policy or annuity plan purchased by the employer that is designed to provide retirement or severance benefits for executives, as well as copies of trusts, escrows, separate accounts and "any other communications" between the employer and employees that set forth the benefits, perks, nonqualified savings, severance plans or retirement arrangements. The agent is told

to examine whether the executive has control over the receipt of the deferred amounts including the ability to borrow against the asset, pledge the asset as collateral, or transfer the asset. The agent is told to confirm that the inclusion of income in the executive's Form W-2 matches the company's deduction for such compensation, both with respect to timing and amount. The NQDC ATG merely mentions new Code section 409A and IRS Notice 2005-1, but does not give any further guidance as to how auditors are to apply those rules. Presumably, the NQDC ATG will be updated when further guidance under Code section 409A is released later this year.

### ***Fringe Benefits***

The fringe benefit ATG discusses the most common fringes paid to executives that are improperly treated as not being taxable income to the executive, including spousal/dependent life insurance. The ATG states:

Group term life insurance premiums paid to insure the lives of a spouse or dependent of an executive are included in the gross income of the executive. (Treasury Regulation §1.61-21(b)(1)). The "cost" of dependent group term life insurance must be determined under Table I of §1.79-3(d)(2) of the regulations. Employers attempt to classify such payments as a de minimis fringe benefit; however, the Government takes a very narrow view of this provision (PLR 200033011). Split dollar life insurance provided for an executive's spouse should be examined.

The fringe benefit ATG also discusses wealth management services and qualified retirement planning services, where the employer's payment for financial planning services should be treated as taxable income to the executive, but certain retirement planning services provided to the executive and his or her spouse are a tax-free fringe benefit under Code §132(m), so long as the employer maintains a qualified retirement plan and does not discriminate in favor of highly compensated employees in provided such services to employees. The auditor is told to identify these issues by requesting information about services provided by the company to the executives for income tax preparation, financial planning or other accounting services, as well as reviewing employment agreements and the company's accounts payable records showing payments to outside experts.

Any AALU member who wishes to obtain a copy of the IRS's Executive Compensation Audit Guidelines may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at [www.aalu.org](http://www.aalu.org) and enter the *Member Portal* with your social security number and select *Current Washington Report* for linkage to source material or (3) email Jeff Lavine at [lavine@aalu.org](mailto:lavine@aalu.org) and include a reference to this *Washington Report*.



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