Best Practices in Travel, Entertainment, and Codes of Ethical Conduct

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A Recent Real Paradigm Shift

- 2002: SARBOX
  - **Public Company Accounting Reform and Investor Protection Act of 2002**
- 2008: Financial Crisis/Madoff
- 2009:
  - Northern Trust 2/09
  - Letter to President from Medical Industry-5/10/09
  - Medicare bankrupt two years sooner (2017) due to recession-5/12/09

Northern Trust Open

- **Northern Trust, a bank that has received $1.6 billion in bailout money just spent a fortune in L.A. hosting a series of lavish parties and concerts with celebrity entertainers.**
- Congressman Brad Sherman said, "Wall Street is laughing at us saying, 'we got to keep your money and our lifestyle is unchanged.'"

Definition of Code of Ethics (Sarbanes-Oxley)

- Standards as are reasonably necessary to promote:
  - (1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
  - (2) full, fair, accurate, timely, and understandable disclosure in the period reports required to be filed by the issuer;
  - (3) compliance with applicable governmental rules and regulations.

IRS Publication 463: Travel, Entertainment, Gift, and Car Expenses

- You cannot deduct expenses for entertainment that are lavish or extravagant. An expense is not considered lavish or extravagant if it is reasonable considering the facts and circumstances. Expenses will not be disallowed just because they are more than a fixed dollar amount or take place at deluxe restaurants, hotels, nightclubs, or resorts.

University of Denver

- Changed rules on spending last month for two reasons:
  - Cut expenses to be more financially sustainable for institution's stakeholders
  - Avoid the appearance of lavish or extravagant spending (who cares?)
- Rule Changes Examples
  - Ban on retreats
  - No meals provided to employees at restaurants or school unless a "bona fide university function"

Advanced Medical Technology Association—Code of Ethics

- Member-Sponsored Product Training and Education
  - Modest meals and receptions
  - Reasonable travel and modest lodging costs
  - Can't pay for "any other person who does not have a bona fide professional interest in the information"
  - FAQ 8: Terms "modest" and "occasional"
    - The Code seeks to balance an interest in civility with the desire to avoid even the appearance that hospitality may be used as an inducement to purchase

Sample Code of Ethics Provision

- Payments. The Company and its employees and directors will not make any improper payments to government or non-government officials, employees, customers, persons, or entities, nor will the Company or its employees and directors request or accept any improper payment from suppliers, customers, or anyone seeking to do business with the Company.

Sample Code of Ethics Provision

- Fair Dealing. Each employee and director will deal fairly with the Company's customers, suppliers, competitors, independent auditors, and other employees and will not take unfair advantage of anyone through manipulation, concealment, abuse of privileged information, misrepresentation of material facts, or any other unfair dealing or practice.

WB Sample Code of Conduct Provision

- *Any violation of these policies and procedures should be reported immediately* to the President or executive in charge of the applicable division, subsidiary, or operating unit, or to the Chief Executive Officer, Chief Financial Officer, General Counsel, or Chief Compliance Officer of the Company. In the alternative, a violation may be reported in the manner outlined in the Company's Ethics Hotline Policy. confidential except on a "need to know" basis. Reporting may be anonymous. The President or executive in charge of a division, subsidiary, or operating unit, the Chief Financial Officer, the General Counsel, and the Chief Compliance Officer will notify the Chief Executive Officer of any reports that they receive.
- Officers, directors, executives in charge of each division, subsidiary or operating unit, and other appropriate employees will be required periodically to confirm in writing that they understand and are complying with these policies and that they are not aware of any violations of these policies or have properly reported all violations.

2004 Organizational Amendments

- Under the guidelines, a corporation convicted of a federal offense may seek leniency if it has maintained an effective program to prevent and detect violations of the criminal laws.
- New ethical and corporate culture obligations beyond legal compliance by Board and senior management

Culture of Fear

- "Top Qwest management, including former chief executive Joe Nacchio and general counsel Drake Tempest, "set goals and targets that are impossible to obtain without engaging in unethical or illegal acts," an unnamed Qwest employee wrote in a memo sent to the board of directors in April 2002."
- Denver Post 9/25/02

Internal Revenue Service
United States Department of the Treasury

Executive Compensation - Fringe Benefits Audit Techniques Guide (02-2005)

NOTE: This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.

Issue Description

Corporate executives often receive extraordinary fringe benefits that are not provided to other corporate employees. Any property or service that an executive receives in lieu of or in addition to regular taxable wages is a fringe benefit that may be subject to taxation. In 1984, the Internal Revenue Code ("Code") was amended to include the term "fringe benefits" in the definition of gross income found in §61. A fringe benefit provided in connection with the performance of services, regardless of its form, must be treated as compensation includible in income under §61.

Whether a particular fringe benefit is taxable depends on whether there is a specific statutory exclusion that applies to the benefit. For example, when §61 was amended to include the term "fringe benefits", §132 was added to provide exclusions for certain commonly provided fringe benefits that had previously not been addressed in the Code. Section 132 provides exclusions for working condition fringes, deminimis fringes, noadditional cost services, qualified employee discounts, qualified moving expenses, qualified transportation fringes, and qualified retirement planning services.

Although it is clear that fringe benefits are taxable, employers may not treat them as wages for income and employment tax purposes. Employers may classify a taxable fringe benefit under expense accounts other than compensation, resulting in a failure to subject the fringe benefit to income and employment taxes.

Because the tax treatment of fringe benefits can vary depending on the facts and circumstances under which they are provided, it may be helpful to follow a 3-Step analysis when examining a particular item an employer gives or makes available to an executive.

- First, identify the particular fringe benefit and start with the assumption that its value will be taxable as compensation to the employee.
- Second, check to see if there are any statutory provisions that exclude the fringe benefit from the executive's gross income.
- Third, value any portion of the benefit that is not excludable for inclusion in the executive's gross income. Fringe benefits are generally valued at the amount the employee would have to pay for the benefit in an arm's length transaction.

Potential Issues

There are several potential issues regarding fringe benefits; however, this paper is designed to outline those more commonly provided to executives. There are both income and employment tax issues related to fringe benefits.

- Is the expense deductible by the corporation?
- Is the amount excludible from gross income of the executive?
- Is the executive receiving personal benefit from the corporation?
- Does the benefit exceed the §162(m) limitation?

The following discusses some of the most common fringes provided to executives.

Athletic Skyboxes/Cultural Entertainment Suites - In the case of a skybox or other private luxury box leased for more than one event, the amount allowable as a deduction under Code §274(l)(2) with respect to such events shall not exceed the sum of the face value of a non-luxury box seat ticket(s) for the number of seats in the luxury box. Luxury boxes rented by related parties or individuals are treated as a single lease in determining whether a luxury box is leased for more than one event. See Notice 87-23, 1987-1 C.B. 467, 469. The remaining amount for attendance at the event is limited to ordinary and necessary business expenditures that also satisfy all the requirements under §274(a), (d), and (n) for deducting entertainment expenses. Similarly, a purchase of a skybox is the purchase of a facility subject to §274(a). Catered events may need examination to verify the deduction limitations of IRC §274(n) have been correctly applied. If the purchased or leased skybox is used personally by the top executives of the corporation, the value of the benefit may be taxable income to the executives.

Awards/Bonuses - A Company may utilize a number of methods to provide compensation for services rendered by the executives. Additional attention must be given to executive payment arrangements and plans used to determine bonuses and or awards. Generally, all payments in whatever form, are payments in the nature of compensation if they arise out of an employment relationship or are associated with the performance of services. Payments in the nature of compensation include (but are not limited to) wages, salary, bonuses, severance pay, fringe benefits, pension benefits and other deferred compensation. Awards and /or bonuses paid to key executives should be carefully reviewed to determine if they should be included as remuneration under §162 (m). Corporations have begun providing non-cash awards and bonuses to executives. Attention should be given to payments made on behalf of executives. It may be necessary to review invoices for the "ship to" address for large ticket items that appear to be personal in nature.

Club Memberships – Effective since calendar year 1994, § 274(a)(3) provides that no deduction is permitted for club dues. This includes all types of clubs, including social, athletic, sporting, luncheon clubs, airline and hotel clubs and "business" clubs for all amounts paid or incurred after 1993. Regulations § 1.274-2(a)(2)(iii) and (e)(3) (ii)(b) clarifies that the purposes and activities of a club, and not its name, determine whether it is covered under the disallowance provision. The employer has the choice of either including the value of the club membership in the employee's income or forgoeing any deduction for the club dues. IRC § 274(e)(2). Put another way, the company can deduct the cost if it treats the club dues as compensation includable in gross income and wages. However, if the employer's deduction for club dues is disallowed by § 274(a)(3), Regulations § 1.132-5(s) provides that the amount, if any, of an employee's working condition fringe benefit relating to the emplo yer provided membership in the club is determined without regard to the application of § 274(a) to the employee. To be excludible as a working condition fringe, however, the amount must otherwise qualify for deduction by the employee under § 162(a). Note that the requirements of § 274(d) must still be met (i.e., time, place and business purpose must be established. See Regulations § 1.132-5(s)(3) for examples applying these rules.

Although many corporations are aware of the law regarding the deductibility of club dues and membership fees, they will often make such e xpenditures and disguise the deduction. Club memberships have been distributed to departing executives through severance agreements. The value of a club membership distributed to executives upon departure is wages. Close scrutiny should be afforded employment contracts and severance agreements for executives.

Corporate Credit Card - Many companies provide corporate credit cards to executives and other employees. The difference between the rank and file credit card accounts and those maintained for executives is generally the method of reimbursement. Top level executives are permitted to use the card at will. A monthly statement may be mailed directly to the corporation and the account may be paid in full without the submission of a business expense report. Lower level executives are generally required to submit an expense report and are reimbursed for business related expenses. Personal expenses paid on behalf of executives are taxable fringe benefits that should be included in wages.

The determination of whether the corporation has an accountable plan within the meaning of §62(c) and the regulations thereunder should be made at the beginning of the examination. If executives are not required to substantiate that the expenses charged to the corporate credit card were for business expenses, the reimbursement is considered to have been made under a non-accountable plan and the entire reimbursement is taxable to the executive, and wages for employment tax purposes. See Regulations § 1.62-2.

Executive Dining Room – Meals furnished on the employer's business premises and for the convenience of the employer are excludable from income under IRC §119. In the case of an employer-operated eating facility, the rules of IRC §132(e)(2) must be met in order for the income to be excludable as a de minimis fringe. The four tests outlined in Treasury Regulation §1.132-7(a)(2) must be met in order for the value of the meals to be excluded from an employee's gross income. This income exclusion is available to highly compensated employees only if the "direct operating cost" test of Regulations §1.132-7(a)(1)(i) is satisfied. The nondiscrimination rules under § 1.132-8 must also be met. The fringe benefit rules incorporate the § 410(b) standards in determining whether the benefit is provided on a nondiscriminatory basis. See Regulations § 1.132-8(d). For purposes of applying these nondiscrimination rules, a highly compensated employee ("HCE") for 2003 is an employee who meets either of the following tests:

1. The employee was a 5% owner at any time during the year or the preceding year.
2. The employee received more than $ 90,000 in pay for the preceding year. (See Notice 2002-71, 2002-45 I.R.B. 830. This amount is unchanged from 2002. See Notice 2001-84, 2001-53 I.R.B. 642.).

The employer can choose to ignore test (2) if the employee was not also in the top 20% of employees when ranked by pay for the preceding year. The definition of HCEs for fringe benefit purposes incorporates the standard under § 414(q).

Loans - No Cost/Low Cost/ Disguised Compensation - A number of companies have made loans or extended credit to their executives. These loans have either been at no cost or low cost. In some instances, the terms have been such that the loan is really disguised compensation. Factors that are indicative of a bona fide loan are 1) existence of a promissory note, 2) cash payments according to a specified repayment schedule, 3) interest is charged, and 4) there is security for the loan.

Loans to executives should be reviewed to determine if they are bona fide and to determine if the terms are being followed. Is there a written document detailing the terms of the loan, payment over a certain number of years or is payment on demand; is the interest rate at market or at a below market rate of interest; is the loan listed on the company's balance sheet as a receivable? Are the terms of the loan being followed – payments are to be made monthly and the executive is not making payments, etc. The loan terms could include forgiveness of part or the entire loan if the executive remains with the company for a certain number of years, etc.

I.R.C. §7872 deals with the treatment of loans with below market interest rates; it specifically applies to what it terms compensation-related loans, which include belowmarket loans directly or indirectly between an employer and an employee. In general, § 7872 operates to impute interest on below market loans. In the case of employer/employee loans, the employer is treated as transferring the foregone interest to the employee as additional compensation and the employee is treated as paying interest back to the employer. Different rules apply depending on whether a loan is a demand loan (7827(a)) or a term loan (7872(b)). A demand loan is a below market loan if it does not provide for an interest rate at least equal to the applicable federal rate. A term loan is a below-market loan if the present value of all amounts due on the loan is less than the amount of the loan (i.e., the yield to maturity is lower than the applicable federal rate). With respect to demand loans, the imputed interest payments and deemed transfer of additional compensation are treated as being made annually. With respect to term loans, the lender is treated at the time of the loans as transferring the difference between the loan amount and the present value of all the future payments under the loan as additional compensation. The term loan is then treated as having original issue discount equal to the amount of the deemed transfer of additional compensation and, thus, subject to the original issue discount provisions of § 1272 et. Seq. There is a de minimis exception from the application of the § 7872 imputation rules if loans between the parties in aggregate do not exceed $10,000. (7872(d)(3)). The de minimis exception does not apply if one of the principal purposes of the loan is tax avoidance.

Personal loans to officers and directors of public companies are banned by the enactment of the Sarbanes-Oxley Act of 2002, which became effective on July 30, 2002. Personal loans outstanding on the date of enactment are not prohibited, provided there is no material modification or renewal of the loan on or after the date of enactment. Neither loans nor an extension of credit can be renewed after the date of enactment of Sarbanes-Oxley. This law does not apply to private companies.
Some loans to executives are essentially disguised compensation based on the terms of the loan. Sections 61(a)(1) and 61(a)(12) define gross income to include compensation for services and income from discharge of indebtedness. Reg. §1.61-12(a) provides that if an individual performs services for a creditor, who in consideration for the services, cancels the debt, the debtor realizes income in the amount of the debt as compensation for services. Discharge of indebtedness income by an employee from an employer under these circumstances is payment in the nature of compensation, and thus is includible in gross income and wages for employment tax purposes.

Issues have been raised regarding loan forgiveness (remain in the employ of the corporation for a period of four years), unusual repayment methods (stock in lieu of

cash), and extreme repayment dates (repayment by the executive's trust upon the death of the executive and his spouse). Loans are often used to disguise compensation; therefore, the underlying intent must be examined and addressed.

Outplacement Services – Outplacement services provided solely for executives are not excludable from gross income. The service must be provided to all classes of employees; however, the le vel of service afforded the executives can differ greatly from that provided to lower level employees (Revenue Ruling 92-69, 1992-2 C.B. 51). The services must also meet the requirements of a working condition fringe benefit outlined in IRC §132.

Qualified Employee Discounts – This exclusion applies to a price reduction an employer gives an executive on qualified property, §132(c)(4), or services offered to customers in the ordinary course of the line of business in which the employee performs substantial service. It does not apply to discounts on real property or discounts on personal property of a kind commonly held for investment (such as stocks and bonds) §132(c). There are specific rules that must be followed if the employee is highly compensated (see Notice 2002-71, 2002-45 I.R.B. 830). Treasury Regulation §1.132-1(b)(1) does not allow company discounts for directors and independent contractors. It has become quite common for former officers to be retained on a contractual basis by the corporation upon retirement and continue to receive discounts. Qualified employee discounts must be provided on a nondiscriminatory basis. See generally Regulations § 1.132-8. This regulation incorporates § 410(b) nondiscrimination standards, and the § 414(q) definition of HCE. See Regulations § 1.132-8(d) and (f).

Security-related Transportation - Regulations § 1.132-5(m)(1) provides that if a bonafide business-oriented security concern exists, and an overall security program exists, then the employee may exclude the excess of the value of the transportation provided by the employer over the amount that the employee would have paid for the same mode of transportation absent the bona fide security concern. With respect to air transportation, the phrase "same mode of transportation" means comparable air transportation.

A bona fide business-oriented security concern exists only if the facts and circumstances establish a specific basis for concern regarding the safety of the executive (§1.132-5(m)(2)(i)). A generalized concern for the executive's safety will not trigger application of the security exclusion (§1.132-5(m)(2)(i)). Under § 1.132-5(m)(2)(i), the employer must demonstrate the existence of a bona fide security concern. A bona fide security concern exists if the facts and circumstances demonstrate a specific basis for concern regarding the safety of the employee. Examples of specific bases for a bona fide security concern include a specific threat to harm the employee or a recent history of violent terrorist activity in the geographic area in which the transportation is provided.

Section 1.132-5(m)(2)(ii) provides that an overall security program must be established. In order to establish the existence of an overall security program, the employer must generally establish that security is provided to the employee on a 24-hour basis.

However, under §1.132-5(m)(2)(iv), an overall security program is deemed to exist if the following conditions are satisfied:

- A security study is performed with respect to the employer and the employee (or a similarly situated employee of the employer) by an independent security consultant;
- The security study is based on an objective assessment of all facts and circumstances;
- The recommendation of the security study is that an overall security program (as defined in paragraph (m)(2)(iii) of this section) is not necessary and the recommendation is reasonable under the circumstances; and
- The employer applies the specific security recommendations contained in the security study to the employee on a consistent basis.

An independent security study could conclude, for example, that security during air travel is necessary, but security on a 24-hour basis is unnecessary.

The expenses incurred for security services will normally be deducted under "Other Deductions". A review of the W-2/1099 forms and employment agreements may provide information related to security services.

Upon examination it has been found that homes of executives have been fortified with special rooms or other security devises. It is important to evaluate the level of security afforded top executives and their families to determine that security studies are being followed.

Spousal/Dependent Life Insurance – 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 deminimis 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. For further guidance, refer to the ATG titled "Split Dollar Life Insurance".

Transportation - If an employer provides a car or other road vehicle for an executive's use, the amount excludable as a working condition fringe benefit is the amount that would be allowable as a deductible business expense if the executive paid for its use (§1.132-5(b)). The executive's personal use of the vehicle is taxable. The value is generally determined by reference to fair market value unless one of the special valuation methods is used (§1.61-21(b)(4)). The three special valuation rules for automobiles are:

1. Automobile lease valuation rule – §1.61-21(d)(2);
2. Vehicle cents-per-miles rule – §1.61-21(e); and
3. Commuting valuation rule – §1.61-21(f).

There are specific requirements that must be met in order to use these special valuation rules. For example, the employer must provide the employee with a vehicle for commuting for bona fide noncompensatory business reasons in order to use the commuting valuation rule.

Chauffeurs - The taxable benefit with respect to a chauffeur is determined separately from the taxable benefit of the use of a vehicle. In order to determine the taxable benefit, the business use percentage must be determined. See §1.61-21(b)(5). If the chauffeur's services are obtained for security reasons refer to § 1.132-5(m).

Employer-paid parking - The term "qualified transportation fringe" (§132(f)) includes: 1) transportation in a commuter highway vehicle between the executive's residence and place of employment; 2) any transit pass; and 3) qualified parking. The value of parking provided to an executive on or near the business premises of the employer is excludable

from gross income if the statutory monthly limit is not exceeded (§132(f), 1.132-9, and Notice 94-3 (providing valuation rules)).

Transportation expenses may be deducted under Other Deductions and Depreciation on the tax return. A review of benefit packages, employment contracts, and W-2/1099 forms may indicate potential issues in this area.

Transfer of Property - Income provided or granted to employees or executives includes all remuneration granted for the exchange of services. Remuneration may also take the form of property. Property may include real and personal property other than money or an unfunded and unsecured promise to pay money in the future. Property may also include a beneficial interest in assets (including mone y) which can be transferred or set aside from the claims of the creditors of the transferor, such as in a trust or escrow account. See Regulation §1.83-(3)(e).

Property other than cash may be represented in a number of forms. It may include stock or personal property including real estate, furniture, equipment, personal computers and or cellular phones.

Employee Use of Listed Property - Special recordkeeping rules apply to computers except for those used exclusively at the business establishment and owned or leased by the person operating the business. Detailed records are required to establish business use of computers that can be taken home or are kept at home by the executives. There are no record keeping exceptions like "no personal use" available for computers. See Code §280F(d)(4)(B) and §274(d)(4), and cf. Reg. §1.274-6T(a)(2) and§ 1.280F-6T(b)(3)(ii).

Similar recordkeeping problems arise for cellular and car phones placed in service after 1989. Code §280F(d)(4)(A)(v) as adopted under OBRA '89 identifies these items as listed property. This requires documentation of business usage in order for the purchase and operational cost to be an allowable deduction and not included as income to the executive.

In addition, the taxable income in connection with the transfer of tangible property must be determined utilizing one of the prescribed methods listed in Regulation §1.482-3. It has become common place for corporations to purchase homes for relocating executives or to provide low or no interest loans for the purchase of homes. Executives generally maintain a home office that may be furnished by the corporation. Sometimes upon termination of employment the furnishings and equipment are transferred to the executive as part of their severance package.

Relocation Exepenses – The value of relocation benefits may be includable in gross income. Section 82 provides that there shall be included in gross income (as compensation for services) any amounts received as payment for or reimbursement of expenses of moving from one residence to another which is attributable to employment. However, § 132(g) provides an exclusion for qualified moving expense reimbursements. Under § 132(g), an employee may exclude the amount paid or reimbursed by the employer that would be deductible under § 217. Under § 217, only the costs of moving personal belongings and traveling to the new location are deductible. Costs such as meals and lodging in temporary quarters are not deductible under § 217. In addition, other costs paid by the employer, such as brokerage fees, property taxes, insurance, fix-up expenses, and reimbursement for losses with respect to the sale of the prior home are includable in gross income.

Non-commercial Air Travel - If an executive (or family member) uses the employer's aircraft for personal reasons, the use must be valued and included in taxable wages (§1.61-21(g)). The valuation will depend on whether the flight is primarily business or personal and whether o r not the executive is a "control employee" (§1.61-21(g)(8)). The value of the flight is determined by reference to fair market value unless the special valuation rules known as the Standard Industry Fare Level formula ("SIFL") are elected (§ 1.61-21(g)(5)). There is a lower SIFL inclusion amount if the air travel is a security related benefit meeting the requirements of §1.132.5(m)(2)(iii).

Even though the amounts attributable to the personal use of the aircraft exceed the amounts treated as compensation to the executive, the employer's deduction is not limited, unless deduction is limited by the recently enacted amendment to § 274(e)(2), discussed below. The courts have consistently held that the taxpayer's deductions for operation of the aircraft were in no way limited by the value reportable as compensation for personal use of the aircraft. **Midland Financial Co. v. Commissioner**, T.C. Memo 2001-203; **National Bancorp of Alaska, Inc. v. Commissioner**, T.C. Memo 2001-202; **Sutherland Lumber-Southwest, Inc. v. Commissioner**, 114 T.C. 197, aff'd 255 F.3d 495 (8th Cir. 2001). The Service acquiesced to **Sutherland** (AOD 2002-02).

Section 274(e)(2) was recently added by the Jobs Act of 2004 to provide that the employer's deduction is limited to the amount included i n the executive's income. The amendment was expressly intended to reverse Sutherland Lumber. It applies with respect to individuals who are subject to the reporting requirements under § 16(a) of the Securities Act of 1934 (the president, principal financial officer, principal accounting officer, any vice president in charge of a principal business unit, or any other officer who performs a policy making function). Under § 274(e)(2), with respect to covered executives, a corporation may not deduct the expense of operating aircraft in excess of the amount included in the executive's income, which is generally based on the SIFL valuation methodology. New § 274(e)(2) applies to expenses incurred after October 22, 2004.

The deduction on the return for this expense will normally be found under "Travel and Entertainment" or "Officer Compensation". A review of the flight log, flight schedules, W-2/1099 forms, Compensation Committee Minutes, and employment contracts will usually provide the information needed to compute the amount to be included in taxable wages. Corporations will normally include a portion of the imputed amount in wages; however, these amounts are often computed incorrectly. It has been found that departing executives may enter into consulting contracts that contain provisions "allowing the worker the same travel status and privileges as other senior company executives". This has been interpreted to mean that such workers are allowed to utilize the service of the corporate aircraft rather than travel by commercial means.

Employer-paid vacations – The value of employer-provided vacations generally is includable in gross income and wages. The value of a vacation is generally not excludable as a working condition fringe benefit because vacation expenses are personal expenses. A working condition fringe is any property or service provided to an employee of an employer to the extent that, if the employee paid for the property or service, the amount paid would be allowable as a deduction under §§ 162 or 167 (§1.132-5(a)). In general no deduction shall be allowed under § 162 for personal, living, and family expenses. An example of personal expenses would include expenses incurred in traveling away from home (which include transportation expenses, meals, and lodging) and any other transportation expenses not deductible under §162 (§1.262-1(a) and 1.262-1(b)(5)).

However, special rules exist for air travel provided in connection with trips that are part business and part personal. See Regulations § 1.61-21(b)(6)(iii). In addition, a portion of the cost of air travel may be e xcludable if there is a security related concern within the meaning of § 1.132-5(m).

This expense may be deducted under Other Deductions, Travel and Entertainment, or Employee Benefits. A review of the flight logs for the corporate jet may reveal vacation trips taken by executives and

their families.

Spousal or Dependent Travel – No deduction under §274(m)(3) shall be allowed for travel expenses paid or incurred for a spouse, dependent, or other individual accompanying the executive on business travel unless –

- the spouse, dependent, or other individual is an employee of the taxpayer,
- the travel of the spouse, dependent, or other individual is for a bona fide business purpose, and
- such expenses would otherwise be deductible by the spouse, dependent, or other individual.

If the employer elects to treat the travel of the spouse as compensation and tax the executive accordingly, the employer can deduct the travel expenses. IRC § 274(e)(2). The amounts must be reported in the executive's W-2 as originally filed. The employer must also withhold taxes with respect to the amounts included in gross income. (§1.132-5(t); 1.274-2(f)(2)(iii)). The limitations set out in §162(m) must be considered when spousal travel is included in executive compensation.

If an employer's deduction under § 162(a) is disallowed by § 274(m)(3), the amount of the employee's working condition fringe benefit relating to the employer-provided travel is determined without regard to § 274(m)(3). However, to be excludable as a working condition fringe, the amount must otherwise be deductible under § 162 by the employee if incurred by the employee. The amount will be excludable as a working condition fringe if it can be shown that spouse's presence has a bona fide business purpose and if the employee satisfies the substantiation requirements under § 274(d). If the spouse's travel is not excludable as a working condition fringe, then the employee must include the value of the spouse's travel in gross income. See Regulations §§ 1.132-5(t); 1.61-21(a)(4).

A deduction for this expense would normally be found under Travel and Entertainment or Employee Benefits. A review of the flight logs and schedules may indicate when spouses or other related parties accompany the employee on trips or vacations. It may also be necessary to issue an IDR asking for specific information related to travel.

Wealth Management – As part of their employment agreement or as a separate written or oral agreement, many executives are provided either a sum of money for financial planning or the services of the accounti ng firm used by the company. The use of financial planning services is a service that an executive receives in lieu of compensation and is a taxable fringe benefit, receiving a sum of money for financial planning is also compensation unless the requirements of § 132(m) are met.

Qualified Retirement Planning - Beginning with the year 2002, §132(a)(7) excludes from gross income qualified retirement planning services. The services are defined in §132(m) as any retirement planning advice or information provided to an employee and his spouse by an employer maintaining a qualified employer plan. The employer may not discriminate in favor of highly compensated executives. The nondiscrimination rule states that the exclusion is allowable for highly compensated employees only if the retirement planning services are available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's qualified employer plan (which is defined as a plan, contract, pension or account described in §219(g)(5)). For the purposes of CIC taxpayers, this would be stock bonus, pension or profit sharing plans with a qualified trust, not the executive's nonqualified deferred compensation.

You can identify this issue by requesting information about services provided by the company to the executives for income tax preparation, financial planning, or other accounting services. A review of the executive's employment agreements and benefits will also assist in identifying this issue. A cursory review of the corporation's outside accounting expense account(s) may lead to identification of this issue.

An Employer May Pay the Employee's Share of FICA Taxes

An employer may pay the employee FICA tax imposed by §3101 owed with respect to a fringe benefit. The payment of the employee's FICA tax constitutes a payment of additional wages for FICA and income tax withholding purposes. (§31.3401(a)-1(b)(6)).

Rev. Proc. 81-48, 1981-2 CB 623, and Revenue Ruling 86-14, 1986-1 CB 304, provide a formula for purposes of calculating an employee's FICA wages when the employer pays the FICA tax without deducting the amount of the tax from the employee's pay. For example: In 2004, an employer pays an employee $300 weekly and arranges to pay the employee FICA tax without deducting the amount of the tax from the $300. The rate of FICA tax is 7.65%. The amount of wages, social security wages, and Medicare wages is $324.85 as computed using the formula shown below.

W = S/1-R

W = The employee's total FICA wages after the increase reflecting the pyramiding effect referred to in § 2.04 of the revenue procedure.
S = Stated pay (the pay before taking into account the increase in wages).
R = Rate employee FICA tax.

W = 300/1-.0765

W = $324.85

How to Identify

SEC Items such as Form 10-K (Items 10, 11, and 12) and Form 4 can be used to identify executive compensation issues. The Form 4, Statement of Changes in Beneficial Ownership, may indicate whether stock was used for loan repayments. (Sarbanes-Oxley Act restricts the use of loans after July 30, 2002).

The following line items on the income tax return frequently contain taxable fringe benefits; the list is not all inclusive :

- Other Deductions
- Cost of Goods Sold
- Depreciation
- Employee Benefits
- Schedule M-1
- Travel and Entertainment
- Rent

Request a listing of the executives and officers from the taxpayer to identify the highly compensated executives. A representative group of executives may be selected for an in-depth examination. At a minimum the selection should include the SEC §16b executives (CEO and the other four highest compensated officers) for publicly traded companies.

The following steps should aide in the examination of Executive Fringe Benefits:

- Determine the department responsible for approving and processing payments to executives and officers.
- Review the Executive Compensation Committee Minutes, reports, etc.
- Review loan agreements between the corporation and executives/officers.
- Identify all payments to, or on behalf of, the executives/officers.
- Inspect the employment contracts and/or severance agreements to identify salaries and benefits paid to the executives.
- Sample monthly expense reports submitted by executives. Determine if there is an Accountable Plan and if the plan meets the requirements of IRC 62(c).
- Search for the executive's name, SSN, or title in Accounts Payable. This search may identify payments to executives that were not included on a Form W-2 or Form 1099.
- Request a listing of the specific Payroll Codes or other accounting codes that relate to expenses/expenditures for executives. These codes can be used to identify payments to the executives/officers that may be taxable as compensation.

Attachments

Information Document Request Forms – The attached IDRs are samples containing items that should be considered when examining executive fringe benefits. The requirements of the Team Coordinator, Team Manager, or Taxpayer will dictate the format and manner in which these items should be requested.

Articles – A list of articles that may be of use when examining executive fringe benefits. The articles have been selected because they provide insight into the world of executive pay. The listing will be updated periodically as new information is reported.

Executive Compensation Articles

Oink, CEO Pay is Still Out of Control, Here's Why, Fortune, April 14, 2003 By Jerry Useem

- Have They No Shame
- 12 Piggy Offenders
- Salary Is The Least of It

A Rigged Market for CEOs, Washington Post April 30, 2003 by Steven Pearlstein

Big Kozlowski, Fortune, December 6, 2002, by Nicholas Varchaver

CEO Perks That Will Drive You Berserk, Fortune, July 21, 2002 by Andy Serwer and Grainger David

Getting Paid In Planes, Perks, and Automobiles, Fortune, July 9, 2002 by Jeremy Kahn

The Great CEO Pay Heist, Fortune, June 11, 2001 by Geoffrey Colvin

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