WRITTEN TESTIMONY OF THE COMMISSIONER OF INTERNAL REVENUE MARK EVERSON BEFORE THE SENATE COMMITTEE ON FINANCE ON BACKDATING OF STOCK OPTIONS AND OTHER EXECUTIVE COMPENSATION ISSUES

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Good morning Chairman Grassley, Ranking Member Baucus, and the Members of the Senate Finance Committee. It is good to appear before you again to discuss the issue of executive compensation and the Internal Revenue Service's efforts in administering and enforcing our nation's tax laws.

It is hard to pick up a newspaper or hear a financial report on the evening news without learning of some new or continued excess in executive compensation. When this excess violates the securities or tax laws, it undermines not only investor confidence and corporate governance, but also tax administration.

This morning, my focus will be on executive compensation issues for corporate executives. I want to discuss our efforts and procedures in this area, what we are finding, and impediments that lie in our way.

The IRS examines corporate returns in two of our business units. Our Large and Mid-Size Business (LMSB) division handles the examinations of corporations with assets greater than $10 million while other companies would fall into the Small Business and Self Employed (SB/SE) business unit.

The Service has, by design, increased the coverage rate of corporations and high income individuals that we audit over the last several years. In Fiscal Year (FY) 2005, we audited over 10,800 corporations with assets over $10 million as opposed to approximately 9500 in 2004. This is a coverage rate of 20 percent in FY 2005, compared to a coverage rate of 16.7 percent in FY 2004 and 12.1 percent coverage rate in FY 2003. Based on year to date data we anticipate we will maintain the same level of audits in FY 2006 and the same coverage rate.

Similarly, for corporations with assets under $10 million the coverage rate has increased as well. In FY 2005, we examined 17,858 small corporations, a coverage rate of 0.79 percent. This is more than double the audit rate in FY 2004 (0.32 percent). We expect our FY 2006 numbers to be similar to the 2005 rates.

We see a similar increase in audits of high income taxpayers, those with incomes in excess of $100,000. In FY 2004, we examined 166,221 high income taxpayers. That number rose to almost 220,000 in FY 2005. Similar increases can also be seen in the

coverage rates. The rate in FY 2004 was 1.25 percent, as opposed to 1.57 percent in FY 2005. The coverage rate for those with incomes over $1 million is 5 percent. Our plan in FY 2006 is to complete 234,000 high income individual audits. We are well ahead of that schedule currently and may reach as many as 240,000 or more.

While we are doing more, we are not where we want to be or need to be. Compliance by large businesses and high-wealth individuals remain two of the Service's strategic priorities.

Executive Compensation

When examination teams examine a large corporation, executive compensation issues are required to be considered. There are a variety of issues in the executive compensation arena confronting IRS examiners. These issues relate both to the company and to key executives within the company. Issues include such items as stock-based compensation, (including stock options), parachute payments made when control of the company changes, non-qualified deferred compensation, split dollar life insurance, and various fringe benefits. More recently, we have been confronting the issue of backdating of stock options.

From an overall corporate perspective we need to make sure that the company has complied with section 162(m) of the Internal Revenue Code (IRC), which potentially limits the amount of compensation that the company can deduct.

A Compliance Initiative Project was established for many of these issues and Audit Technique Guides (ATG) have been written and published for the use of our examiners and the public.

As I indicated, as part of our corporate examinations, the examiners not only look at the overall corporate return, but also inspect the returns of executives in the corporation. They then make a decision, or a risk assessment, as to whether they should engage in a full scale examination of any executive's individual return. This decision is based on a number of risk factors, such as the amount of tax paid by the executive in question, whether there has been proper reporting of all income and fringe benefits known to the examiner through audit of the corporation, the use of tax shelter activities, and the existence of reportable deferred compensation. In general, risk assessments are based on return information, audit history, and public information, including filings before the Securities and Exchange Commission (SEC).

The choice and number of executive returns we inspect in any particular company are determined by the examination team, but the inspected returns generally extend beyond those filed by the top five executives that are relevant to the corporation's section 162(m) issues. For example, in the largest corporations we would typically inspect 15-20 executive returns. If the inspection on an individual executive's return does not demonstrate the presence of risk factors, the return will not be subjected to a full examination.

In some cases, the risk factors seen on the individual returns of executives do indicate the need for further examination. In FY 2005, for example, LMSB conducted formal examinations of the individual returns of 90 executives, resulting in adjustments of just over $16 million. For FY 2006, through July, LMSB has examined 95 returns of corporate executives, leading to adjustments of over $84.5 million. It is important to remember these examinations were of *only* those returns identified by LMSB auditors through an assessment of risk factors they identified in the course of examining a corporate return and an inspection of personal income tax returns from executives of that corporation.

These audits are part of our overall program to increase the examinations of high income taxpayers that I mentioned earlier.

While the number of audits and the audit coverage rates are increasing, they are still too low. We plan to deploy additional resources to the area of high income taxpayer examinations. Some of those resources will likely come from the drawdown of resources now devoted to examining small estates under the estate and gift tax program. It is important to remember that this drawdown will not affect large estates (those in excess of $5 million), where our coverage rate will still be in the range of 28 percent.

For FY 2006, through July there have been approximately 25 corporate executive compensation fraud cases referred for criminal investigation. Of those, 20 were sourced from SB/SE. These referrals deal primarily with the diversion of corporate income to corporate executives, resulting in the underreporting of compensation on the executive's personal income tax return.

Tax Administration and Corporate Governance

It is important to distinguish between tax administration and the oversight of corporate governance. The IRS is, of course, responsible for the former, but does touch on issues of corporate governance with some regularity, while our colleagues at the SEC focus more directly and undoubtedly more often on the latter. It is critical that we work together to the extent possible under existing law.

I have stated publicly before that clearly Sarbanes/Oxley and the post-Enron environment have improved corporate governance, including in the tax arena. It has also increased and improved the contacts between the Service and the SEC, as well as with the Financial Accounting Standards Board. We have had useful and productive discussions on the recent significant changes to FASB Statement No. 109, *Accounting for Income Taxes,* on the implications for certain SEC reporting companies of their participation in real-time tax examinations through LMSB's Compliance Assurance Process, on the ways in which large corporate examiners, analysts and researchers can best access and understand data filed with the SEC and maintained and made available through the SEC's EDGAR database and non-SEC sources, and most recently, on the backdating of stock options.

The SEC's cooperation and willingness to share information about what it is finding from its investigations of options backdating, which is referenced below, are particularly significant for us. The SEC's authority, expertise and ability to access information on a real-time basis allow us to identify potential options backdating exam subjects more precisely and more quickly than we would be able to do on our own.

From a tax administration standpoint, we sometimes identify issues in the course of an audit of a corporation that surface problems from a corporate governance perspective. But for several reasons, including the relevant reporting periods for tax purposes and the lag time between return filing and return examination, we are unlikely, in many cases, to identify governance issues before they have become known through the media or identified by other organizations, such as institutional shareholders, research analysts, or the SEC. In any event, we are generally precluded from sharing that information with the SEC or other government agencies by section 6103 of the IRC.

In addition, tax provisions that might be expected to have an impact on corporate governance may, for a number of reasons, not always have the impact that had been anticipated when they were drafted. Take section 162(m) of the IRC for example. It is intended to limit the income tax deduction that may be taken by a publicly held corporation for certain compensation in excess of $1 million paid to its chief executive officer and the four other highest paid executive officers unless certain specific requirements are met. Only compensation that is considered "performance-based compensation" is deductible above the $1 million level. The limit applies only to publicly traded corporations.

Section 162(m) is a relatively straightforward section of the IRC that most companies understand and with which they are able to comply. They commonly structure compensation arrangements with their highly paid executives that allow the executives to earn compensation in excess of the $1 million limit in the form of performance-based bonuses, particularly in the form of stock options. As a result, corporations subject to section 162(m) are generally entitled to deduct these performance-based bonuses and we generally find this is not a significant area of noncompliance from a tax administration perspective.

This may be the case even if a company paying substantial or even unsettling amounts of deductible performance-based compensation is actually not doing well from an earnings per share or earnings growth standpoint. This development is partially a product of the latitude corporate law grants companies in compensating executives, and partially a product of the use of that latitude by corporate boards. The standards of section 162(m) are no more stringent than the corporate law standards upon which this corporate largesse is sustained.

Backdating of Stock Options

One of the issues this hearing is focused on is the backdating of stock options. Company after company is restating earnings upon discovery of proof or indications of backdating

of options for their executives. Such backdating not only raises corporate governance concerns if proper approval was not obtained from the corporation's shareholders and directors, but can indicate tax compliance issues as well.

In general, corporate stock options are granted to employees with an exercise price equal to the market price of the stock on the date of grant. An employee benefits from an option if the market price of the stock on the day the option is exercised exceeds this exercise price. The practice of backdating options allows the use of hindsight to pick a date for the exercise price on which the market price was low. Picking a date on which the stock price was low in comparison with the current price gives the employee the largest potential for gain on the option and makes it possible for the employee to benefit from corporate performance that occurred before the option was granted. While this practice does not guarantee income on the exercise date, it increases the value of the option and makes it more likely the employee will be able to exercise the option at a time when the market price exceeds the exercise price (i.e., at a time when the option is "in the money").

As this simplified description of the practice suggests, backdated options that are in the money do not measure the performance of the company from the date of grant, and as a consequence, may not be treated as performance-based compensation under section 162(m). Thus, for the company, the tax implications are that any deduction of compensation related to the backdated option would be subject to the $1 million IRC section 162(m) limitation and would be disallowed if paid to the chief executive officer or one of the four other highest paid executive officers.

In addition, if an Incentive Stock Option (ISO) is backdated, the option will no longer qualify for preferential ISO treatment and will be reclassified as a nonqualified stock option. The difference between the exercise price and the sales price would be additional wages to the executive and must be included on the employee's Form W-2 in the year of exercise. The executive will lose the deferral and rate benefits associated with ISO qualification, but the corporation may be eligible for an additional wage deduction if IRC section 162(m) limitations are not triggered.

Under new section 409A of the IRC, enacted as part of the American Jobs Creation Act of 2004, serious tax implications can now exist for the executive of a corporation that backdates options. He or she may now be responsible for the payment of tax on income previously deferred until the exercise of the options. In addition, there can be substantial additional taxes under section 409A. This provision applies to options granted after 2004 and options granted before 2005 that were not earned and vested as of December 31, 2004.

We are currently in a transition period with the rules relating to section 409A. During the transition, options that were in the money on the grant date can be amended to avoid violating section 409A in either of two ways. The parties can increase the exercise price to equal the fair market value on the original grant date and eliminate any other deferral feature, or the parties can amend the options to provide for a fixed exercise date after

which the option will be worthless. Alternatively, the grant of backdated options could be rescinded if the options have not been exercised.

In recent months, we have set aside and are reviewing cases identified as involving or potentially involving the backdating of stock options by the SEC, the Department of Justice, or companies announcing that they must restate earnings. We have met with SEC representatives and they agreed to share information regarding ongoing backdated stock options investigations.

This information sharing is critical to our efforts. I mentioned earlier that there are substantial tax implications *if* the backdating is discovered. The truth is we are not likely to discover something like backdating of options in the course of our ordinary examinations of taxpayers, either corporate or individuals, since backdating is not readily apparent from inspection of the tax return.

Within the IRS we have taken numerous steps to both increase awareness of the issue among our examiners and assist them when cases of backdating are identified. We have:

- approved a Compliance Initiative Project to allow for examination of cases with potential backdating;
- posted a Backdating Issue Alert on our internal web pages;
- issued and posted a proposed backdating Information Document Request Form (IDR); and
- provided Technical Advisor support to teams that have open examinations.

Executive Compensation in the Tax Exempt Arena

Tax exempt organizations also face their fair share of issues related to executive compensation. I know this is an issue of great concern to members of this Committee.

In late 2004, our Tax Exempt/Government Entities (TE/GE) group began the Exempt Organization Executive Compensation Project to explore the seemingly high compensation paid to executives and others who were controlling exempt organizations. We contacted over 1800 organizations. From that number we sent out 1225 compliance letters requesting information on how compensation was set and reported. Roughly 30 percent of those contacted by letter submitted amended returns or schedules as a result of the process and over 170 of the responses to these letters resulted in a full examination of the organization contacted. The balance of the 1800 organizations contacted, over 600, were contacted through an examination. The examinations we have closed to date and the other contacts we have made with exempt entities have shown compliance issues associated with reporting and with loans to executives or other controlling officials. Our examination work continues.

To help combat reporting problems, we have modified the Form 990 in an effort to better capture executive compensation data from the tax exempt community. Executive compensation will continue to be a prime area of focus for our TE/GE group in FY 2007.

For example, we currently have 532 non-profit hospital contacts on executive compensation issues outstanding.

Challenges Faced In the Area of Executive Compensation

Many of the challenges faced in the area of executive compensation are similar to those faced in other areas of tax administration – the lack of transparency and the inability to share information with other agencies.

Transparency

Despite the fact that we have ramped up efforts in this area in recent years, adjustments on executive and corporate returns as a result of executive compensation issues are relatively infrequent. Our examiners find relatively few indications of executive compensation non-compliance in return information they inspect and the returns they examine.

This is an area where, as we well know, corporations can comply with the law without inordinate risk or expense and still manage to pay their executives handsomely. While there may be non-compliance, we may well not find it reflected on the tax return.

When I testified before this committee on June 13, 2006, I spoke of book-tax differences and how they were growing for corporations. In the area of executive compensation, we estimate from Tax Year 2004 aggregate Schedules M-3 data that the book-tax difference is $47 billion. To a significant degree, this number is made up of the book-tax differences arising from non-qualified stock options. These options are popular with senior management in many public companies because they are a way for the company to offer performance-based pay that is deductible under section 162(m). We anticipate that the recent changes in the accounting standards by the Financial Accounting Standards Board (FASB) will reduce this difference considerably. Many Nonqualified Stock Options that were deductible by the corporation for tax purposes were not required to be expensed for book purposes prior to 2005.

The M-3 is the schedule that corporations with assets of over $10 million must file to reconcile differences between what they report on their books, consistent with generally accepted accounting principles, and what they report to the IRS for tax purposes. The M-3 is critical to our enforcement efforts in that it provides greater transparency over the specific bases for the differences between financial statement income and expense and tax income and expense.

We use the M-3 to guide examiners to potential areas of non-compliance. Our examiners are instructed to pay attention to items on corporate schedules M-3 that are large, unusual or questionable.

The M-3 does not necessarily identify non-compliance, but it does give us an indication of areas that merit further analysis. Together with other aspects of the M-3, however, this

information can be useful. For example, lines 2b and c ask the question: "Has the corporation's income statement been restated for the current year or any of the five income statement periods preceding?" If the corporation answers yes, it may prompt an examiner to raise additional questions and could lead potentially to the discovery that stock options have been backdated.

With respect to corporate executives, we have no tool similar to the M-3 that would help identify otherwise non-transparent issues on the tax return and in such cases enable us to identify where to ask the right questions with respect to an executive's compensation. A corporate executive's 1040 return elicits information with respect to the same line items that are required to be filled in by the assembly line worker or groundskeeper. Without more specific information, we are not well positioned to pick out problematic returns and not bother the compliant executive.

I might compare this dynamic to the situation we faced with respect to the creation and promotion of abusive tax shelters before the disclosure regime was created. Prior to the regime's establishment, we had no ready mechanism to identify abusive, or potentially abusive, transactions. Much of what we currently have the opportunity to look at was not ascertainable from the return, and consequently went undetected. Now, taxpayers and promoters are required to report, using Form 8886, certain tax shelters and potentially abusive transactions to our Office of Tax Shelter Analysis. This data has been invaluable to us both in terms of better understanding the nature of the potentially abusive transactions and in identifying specific taxpayers that are participating in the shelter and those that might promote them.

Information Sharing

I want to thank the Chairman, Senator Baucus and members of this committee for their efforts in allowing us to share data with State Charity Officials under the Pension Protection Act. This provision is an important step in our cooperative efforts with the states in the tax exempt arena. But, unfortunately, this type of information sharing initiative is the exception rather than the rule.

As I indicated earlier, our discussions with the SEC served to remind us of two recurring themes related to our efforts to coordinate compliance efforts with other Federal agencies. First, the IRS and other federal law enforcement agencies frequently gather and analyze information, independent of the other agencies, concerning the same parties and matters. Second, while the other agencies can provide considerable information to the IRS, we are precluded from providing any information from a tax return. We cannot even confirm the existence of many facts relevant to their investigations.

Section 6103 of the IRC broadly states that tax returns and return information are confidential and cannot be shared except for very specific purposes identified in the IRC. This is an important taxpayer protection that should only be modified after careful consideration. We are working with the SEC to determine whether there might be

limited areas in which broader information sharing would be helpful, and will work with this Committee on any proposals that may be developed.

Conclusions

Abuses in the areas of executive compensation are a concern from both a tax administration and a corporate governance perspective. The IRS will continue to prioritize its efforts in the entire area of executive compensation. As I indicated, this is an area where we, in many instances, are unlikely to identify significant noncompliance through our traditional corporate audits. To fortify our ability to identify such noncompliance, greater transparency concerning the details of each executive's total compensation might be considered. In the meanwhile, we will apply our resources to this area with full rigor.

We will also prioritize our coordination with the SEC and our use of both public and non-public information that may be available to us. We are heartened by the Commission's collaboration and the utility of the information they are willing to make available to us in the area of backdated stock options.

I appreciate the opportunity to appear before the Committee this morning and I would be happy to respond to any questions.