

# Executive Compensation, Benefits and Employment Law Focus

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## Flurry of Cases Could Make Employers Decide to Select “Top Hat” Plans for Further Review

Over the last few months, a number of court cases have been decided that analyze whether or not certain arrangements meet the requirements for “top hat” status under the Employee Retirement Income Security Act of 1974, as amended (ERISA). These cases may provide additional guidance for employers in reviewing whether their own arrangements do, in both design and operation, satisfy the requirements for top hat status, and may provide relevant guidance for covered employees as well.

**Background**

ERISA generally imposes a myriad of participation, vesting, funding and fiduciary requirements on employer-sponsored employee benefit plans and arrangements that provide for retirement income or the deferral of income for periods extending to the termination of employment and beyond. ERISA includes an exception from many of these requirements for certain unfunded plans that are maintained “primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees.”<sup>1</sup> As a result of this so-called “top hat” exemption, employers are able to provide unfunded deferred

compensation plans and arrangements to certain executives that are exempt from certain ERISA requirements.

The legislative history may be an appropriate place to begin when reviewing the need for the top hat exemption. “Although the legislative history does not provide a definition of a ‘select group of highly compensated employees,’ it does provide some guidance in this area. In discussing the exemption from ERISA’s vesting requirements, the legislative history states that, because top hat plans are, ‘in effect, controlled by the employees for whose benefits they are established, there is no need to impose the vesting requirements of [ERISA].’”<sup>2</sup>

The determination of top hat plan status is often difficult as neither ERISA nor the regulations thereunder define or provide any guidance with respect to the meaning of the phrase “primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees.” While the legislative history provides insight into the purpose behind the top hat exemption, Department of Labor (DOL) advisory opinions<sup>3</sup> and case law are the primary tools for analyzing top hat



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1 See ERISA §§ 201(2), 301(a)(3), 401(a)(1).

2 See generally, “Has the Supreme Court Said “Yea-Tes” to § 414(q)?—Revisiting Top Hat Plans in Light of Yates,” Andrew L. Oringer, Esq. and Jason M. Rothschild, Esq., 33 Tax Mgmt. Compensation Plan. J. 9 (January 7, 2005).

3 Advisory opinions, while not binding on a court, may provide an indication of the DOL’s thinking regarding a particular issue.

plans. Early DOL advisory opinions addressing the meaning of a “select group of management or highly compensated employees” often compared (i) the number of employees eligible to participate in the top hat plan to the employer’s total workforce and (ii) the eligible employee’s average salary in relation to the average salary of the employer’s total workforce.<sup>4</sup> In Advisory Opinion 90-14A,<sup>5</sup> the DOL stated that “in providing relief for ‘top hat’ plans from the broad remedial provisions of ERISA, Congress recognized that certain individuals, by virtue of their position or compensation level, have the ability to affect or substantially influence, through negotiation or otherwise, the design and operation of their deferred compensation plan....” Since the release of Advisory Opinion 90-14A, many courts have looked to the DOL’s standards and have performed an analysis of both quantitative and qualitative factors.<sup>6</sup>

The consequences of failing to satisfy the top hat exemption requirements may be significant—not only are there requirements effecting the provisions of the plan applicable to participation and vesting, but there are also (could be) significant funding and other fiduciary effects. Four recent cases, described below, provide additional guidance as to what plans and arrangements may or may not qualify as top hat plans.

### Recent Cases

In *Alexander v. Brigham and Women’s Physicians Organization, Inc.*,<sup>7</sup> the US Court of Appeals for the First Circuit upheld the district court’s finding that two deferred compensation plans for surgeons whose earnings exceeded certain limits were top hat plans. In this case, the employer employed a number of surgeons who were also Harvard Medical School (Harvard) faculty members and, as a result, were subject to a Harvard-imposed salary cap. Due to the salary cap, the employer established the deferred compensation plans to which the surgeons’ earnings

(subject to certain limitations) in excess of the salary cap would be allocated. The plans did not allow surgeons to opt out of the plans.

Although all surgeons were potentially eligible to contribute to the plans, the court noted that “a plan is ‘maintained’ for a group of employees only if those employees realistically have the capacity to benefit from it” and therefore, in determining whether the plans covered a “select group,” only those surgeons who generated sufficient income to actually participate in the plans were relevant for purposes of determining whether such employees were a select group of highly compensated employees. In analyzing whether the participating surgeons were in fact a select group of highly compensated employees, the court stated that the “status analysis turns on both qualitative and quantitative dimensions.” The court determined that it was clear that the participants were, in fact, a select group of highly compensated employees since (i) they were “qualitatively select” because they were the highest-earnings surgeons (i.e., the average income of participants in one plan was more than five times the average income of the total workforce and the average income of participants in the second plan was even greater) and (ii) they were also “quantitatively select” because at no point did they make up more than 8.7 percent of the employer’s total workforce.

In rejecting the participant’s request to read an individual bargaining power requirement into the qualification requirements for top hat plans, the court explained “(i) that neither the text nor the legislative history of the statute contains the slightest hint that Congress contemplated that courts would consider employees’ ability to bargain over the terms of their deferred compensation plans and (ii) that the DOL opinion letter does not presume to interpret the statute-militate just as strongly against importing a requirement of collective bargaining power into the top-hat provision.” The court also stated that,

<sup>4</sup> See generally, “Key Rulings Help Determine Which Employees Qualify for ERISA’s “Top-Hat Plan” Exception,” *White & Case Executive Compensation, Benefits and Employment Law Focus* (September 2007).

<sup>5</sup> DOL Adv. Op. 90-14A (May 8, 1990).

<sup>6</sup> See note 4, above. See also *In re New Valley Corp.*, 89 F.3d. 143 (3rd Cir. 1996) addressing the “select group” requirement and noting that, “[i]n number, the plan must cover relatively few employees. In character, the plan must cover only high-level employees.”

<sup>7</sup> 2008 WL 186385 (1st Cir. 2008).

while “Congress’s rationale for fashioning the exemption was that the members of a ‘select group of management or highly compensated employees’ could fend for themselves, the statute by its terms does not purport to require proof of power of any sort.”

In *Daft v. Advest Inc.*,<sup>8</sup> the district court denied the employer’s motion to reconsider its earlier holding that the employer’s deferred compensation plan was not a top hat plan within the meaning of ERISA. In this case, the employer, a securities brokerage firm, established a nonqualified plan for a “select group of highly compensated account executives.” Participation in the plan was limited to account executives who satisfied certain gross commission thresholds which had originally been set, at the plan’s inception in 1992, at US\$200,000 and had increased over time to US\$275,000 in 2005. The court indicated that, in making its decision, it was, “in part, influenced by the fact that the defendants bore the burden to show that they qualified for the narrow top hat exemption....”

In presenting new evidence to the court that the average annual compensation of the plan participants ranged between two to four times the average compensation of all employees, the court stated that, in determining whether plan participants were “a select group of highly compensated employees,” the range of salaries, rather than the average salary was more useful. Specifically, the court noted that it would have been more relevant to provide a “comparison of the salary earned by employees minimally qualifying for participation against the average salary of all employees.” The court further stated that “[t]o consider averages and not the minimum salary would not protect the Congressional goal underlying the creation of top hat plan exemptions. Specifically, an average can mask wide divergence in compensation and show little regarding whether participation is restricted to highly compensated individuals.”

The court noted that participation by 12.78 percent of the workforce was a significant number of employees which would not change its earlier analysis. In particular, the court declined to conclude that 12.78 percent of the population was so small as to automatically count as a select group. The court reasoned that, based on the information in the record that more than half of the employer’s account managers participated in the plan, the gross commission threshold for plan participation was too low.

In *Deal v. Kegler Brown Hill & Ritter Co. L.P.A.*,<sup>9</sup> the court found that an oral deferred compensation plan for an “of-counsel” attorney in a law firm, which the parties agreed was an unfunded “employee pension benefit plan” within the meaning of ERISA intended to provide deferred compensation, was not a top hat plan. In this case, from 1988 until 2000, the firm used the same formula to compensate its directors and certain of-counsel attorneys, which included the use of “bookkeeping accounts” to record certain allocations and reductions. In 1992, following the firm’s adoption of a plan for directors of the firm, the “bookkeeping accounts” were referred to as “retirement accounts.” The firm reported the director plan to the DOL as a top hat plan. No separate written deferred compensation plan was created for of-counsel attorneys.

The court noted that a top hat plan not only must “be unfunded, it must exhibit the required purpose and it must also cover a ‘select group’ of employees.” Accordingly, the court stated that the “select group” limitation has both quantitative and qualitative restrictions such that “[i]n number, the plan must cover relatively few employees” and in “character, the plan must cover only high-level employees.” Recognizing that the burden is on the employer to show that a plan is a top hat plan, the court applied four “qualitative and quantitative factors including (1) the percentage of the total workforce invited to join the plan (quantitative), (2) the nature of their

<sup>8</sup> N.D. Ohio, No. 5:06-cv-01876 (January 18, 2008).

<sup>9</sup> S.D. Ohio, No. 06-cv-901, (January 29, 2008).

employment duties (qualitative), (3) the compensation disparity between top hat plan members and non-members (qualitative) and (4) the actual language of the plan agreement (qualitative)."<sup>10</sup>

According to the court, the employer failed to meet its burden of showing that these factors weighed in favor of finding the plan to be a top hat plan. In addressing the nature of the of-counsel's employment duties, the court rejected the employer's claim that his duties were more similar to those of directors than associate attorneys, explaining that the "[t]op hat plan exemptions from the majority of ERISA's requirements is Congress' recognition that certain individuals do not need the protections afforded by ERISA's substantive rights because, due to their position or level of compensation, they have the ability to substantially influence the design and operation of their deferred compensation." The court held that, on balance, the plan was not a top hat plan where the firm failed to establish that three of the four factors of the select group test weighed in favor of finding that the plan was a top hat plan.

In *Roberts v. Fearless Farris Service Stations, Inc.*,<sup>11</sup> the court found that a deferred compensation plan which provided benefits to certain employees, including administrative staff, payroll clerks, truck drivers and maintenance personnel who generally lacked negotiating power within the company and whose annual salaries ranged between US\$22,000 and US\$85,000, was not a top hat plan. In making its determination, the court noted that employees participating in a top hat plan must "have sufficient influence within the company to negotiate compensation agreements that will protect their own interests where ERISA provisions do not apply." Although most of the participants were long-term employees who earned various amounts,

the court found that they were not a "select group of management or highly compensated employees" because most, if not all, were not highly compensated, they were not all or mostly management and they did not have the ability to negotiate an agreement that protected their own interests. In addition, the court rejected the argument that the participants were "key" due to their role in the company; noting that employees who are not highly compensated or management do not meet the top hat standard.

## Conclusion

In light of the fact that employers may be required to establish affirmatively that their unfunded deferred compensation arrangements satisfy ERISA's requirements for the top hat exemption, employers may wish to review this recent spate of cases to determine if they continue to have adequate comfort that their plans intended to be limited to a "select group of management or highly compensated employees" are in fact so limited. If an employer's deferred compensation arrangement fails to meet this standard, the arrangement will be subject not only to ERISA's participation and vesting, but also to its funding and fiduciary requirements. Many plans not intended to satisfy ERISA would be unlikely to do so and, sometimes as importantly, the potential breach of funding and fiduciary rules could result in unprotected (and possibly even personal) liabilities and responsibilities. The cases may also be helpful to employees who wish to understand their rights and possible claims. Thus, the recent litigation could shed new light on the relevant issues for all affected parties.

As always, White & Case would be happy to assist or advise you with respect to developing and reviewing your top hat plans and arrangements.

<sup>10</sup> Quoting *Bakri v. Venture Mfg. Co.*, 473 F.3d 677 (6th Cir. 2007).

<sup>11</sup> D. Idaho, No. CIV 05-472-S-WFN (February 6, 2008).

## DOL Issues Guidance on Fiduciary Responsibility for the Collection of Delinquent Plan Contributions

The US Department of Labor (the “DOL”) recently issued guidance in response to the prevalence of trust agreements that purport to relieve financial institutions serving as plan trustees of any responsibility to monitor and collect delinquent employer and employee contributions. In [Field Assistance Bulletin \(“FAB”\) 2008-01](#), issued February 1, 2008, the DOL addresses the duties of named fiduciaries and trustees with respect to the collection of delinquent employer and employee contributions to plans subject to the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), even if such duties are not stated or clearly specified in the plan and trust documents.

According to the DOL, although employer contributions are considered delinquent when they are due under the plan but have not been timely transmitted to the plan, these contributions do not become an asset of the plan until the contribution has been made. However, if an employer fails to make such contributions, the plan has a claim against the employer for the contribution, and that claim is an asset of the plan. Under the DOL’s plan asset regulation, employee contributions are delinquent, and considered assets of the plan, if they remain in the hands of the employer beyond the earliest date that such amounts reasonably could have been segregated from the employer’s general assets, which, with respect to retirement plans, may not be later than the 15th business day of the month following the month in which such amounts were withheld or paid to the employer. Recently, the DOL has proposed an amendment to the plan asset regulation, which would provide a safe harbor contribution period of seven business days for employee contributions to plans with 100 or fewer participants.

The DOL stated that, under common law, it is a well-settled premise that trustees have a duty to enforce valid claims held by a trust. In addition, based on ERISA’s statutory framework (described below), the DOL noted that authority over plan assets includes a plan’s legal claim for delinquent contributions. Such legal claim must be assigned to a discretionary trustee, a directed trustee subject to the proper direction of a named fiduciary or an investment manager.

ERISA requires fiduciaries to discharge their duties prudently and solely in the interests of participants and beneficiaries. In connection with this requirement, the DOL noted that the determination of the steps that must be taken by a fiduciary with respect to the collection of delinquent contributions depends on the facts of each case. Specifically, a fiduciary should weigh, among other factors, the value of the plan assets involved, the likelihood of a successful recovery, and the expenses expected to be incurred with respect to any collection action.

ERISA also requires that a plan be established and maintained pursuant to a written instrument which specifies one or more named fiduciaries who jointly or severally have authority to control and manage the plan. In addition, plan assets must also be held in trust by one or more trustees who are either named in the plan or trust instrument or appointed by a named fiduciary and, except for directed trustees and investment managers, have exclusive authority and discretion to manage and control plan assets. According to the DOL, a plan trustee, therefore, will, by definition, always be a “fiduciary” under ERISA and, accordingly, is required to discharge its trustee responsibilities prudently and solely in the interest of the plan’s participants and beneficiaries.

As noted above, questions have arisen as to whether, and to what extent, trust agreements and other written instruments may define or exclude the responsibilities of trustees with respect to monitoring and collecting delinquent contributions. If plan assets are held by two or more trustees, they will jointly and severally be liable for the management and control of the plan (including, presumably, management and control of collecting delinquent contributions) unless the trust document allows the trustees to agree to allocate specific responsibilities or duties among themselves. In this instance, a trustee to whom certain specific responsibilities or duties have not been allocated will not be held liable for any loss resulting from the failure of another trustee to perform the responsibilities or duties allocated to the other trustee. In addition, where assets are held in more than one trust, a trustee is only responsible for the trust for which it is a trustee.

Thus, as explained in FAB 2008-01, if a particular trustee—including a directed trustee—is not responsible for monitoring and collecting delinquent contributions, the trustee “nonetheless would have an obligation under sections 404 and 405(a) [of ERISA] to take appropriate steps to remedy a situation where the trustee knows that no party has assumed responsibility for the collecting and monitoring of contributions and that delinquent contributions are going uncollected. Moreover, with respect to co-fiduciary liability, ERISA imposes liability on a fiduciary for another fiduciary’s breach if the fiduciary knowingly participates in the breach, enables commission of the breach, or knows of the breach and fails to take reasonable efforts under the circumstances to remedy it. Such appropriate steps to remedy the breach may include, among other things, advising the named fiduciary or the DOL of the breach, directly taking actions to enforce the contribution obligation on behalf of the plan, or seeking amendment of the relevant plan and trust documents.

In short, FAB 2008-01 makes clear that plan documents and other instruments cannot excuse financial institutions and other trustees (even directed trustees) from their long-established fiduciary duties under ERISA. As noted by the DOL, “although a fiduciary may enter into a separate agreement relieving a trustee of the duty and responsibility to collect and monitor contributions, if no trustee or investment manager is assigned this responsibility, the fiduciary with the authority to hire the trustees may be liable for plan losses due to the failure to collect contributions because the fiduciary failed to allocate this responsibility.” In the DOL’s view, a named fiduciary with authority to appoint the plan’s trustees must, unless the plan provides that a trustee will be a directed trustee with respect to contributions, or the authority to collect contributions is delegated to an investment manager, ensure that the obligation to collect and monitor contributions is properly assigned to a trustee.

In situations where the trust instruments and plan documents are ambiguous as to the authority to delegate these responsibilities, the DOL observes that these instruments should be interpreted in accordance with ERISA’s requirements, instead of in a manner that would relieve the trustees and investment managers from responsibility for contributions. Similarly, where the plan and trust documents are at odds with the actions of the parties, such as where a directed trustee assumes discretionary responsibility, that trustee cannot limit its liability for exercising discretion by claiming that it is a directed trustee. A trustee cannot alter its status as a fiduciary through contractual provisions that define its trustee duties as non-fiduciary in nature.

In light of FAB 2008-01, it is unlikely that plan trustees or investment managers will agree to be assigned or allocated the responsibility of monitoring and collecting plan contributions under a trust agreement. Therefore, plan sponsors and other named fiduciaries of ERISA-covered plans should be aware that they may be held liable for plan losses arising from the failure to collect delinquent contributions.

## International Highlight

### Works Council Members in Germany May Claim for Stock Options

**Those companies with international stock options should be aware: Even though they have not been awarded stock options under an international stock option plan set up by the foreign parent company, members of the works councils in Germany may claim for stock option awards against their local employer. This has been decided by the German Federal Employment Tribunal (*Bundesarbeitsgericht*) in a recent ruling.**

(January 16, 2008, ref no. 7 AZR 887/06)

In Germany, there are not many jurisdictions in which the superior courts deal with the impacts of foreign stock option plans regarding employment relationships in Germany. The last decision that became well-known among German employment lawyers was the decision by the German Federal Employment Tribunal in 2003 concerning the Nokia stock option plan and its legal treatment under the TUPE regulations (Transfer of Undertakings and Protection of Employment). The court decided that the award agreement regarding the granting of stock options concluded between the individual employee and the foreign company must be qualified as an independent contractual arrangement and therefore stands independently alongside the local employment agreement with the German subsidiary. The obligations arising out of the award agreement do not become part of the local employment relationship and thus are not automatically transferred to the buyer of a business under TUPE.

In the case decided now, a member of the works council claimed stock options that his fellow colleagues, who were not members of the works council, had received. There is a basic principle in German law regarding works councils in which

members of the works council may not suffer economical or job-related disadvantages due to their membership. Especially regarding remuneration, section 37, paragraph four of the German Works Constitution Act regulates that the remuneration of the members of the works council must not be lower than the remuneration of a comparable employee. The defendant employer, however, brought forward the arguments from the Nokia case and argued that the stock options award relationship is independent from the German employment relationship and thus stock options do not count as remuneration. The lower German employment courts followed this reasoning and dismissed the case. From the point of view of the lower German employment courts, the award of stock options by the foreign parent company is not considered remuneration in the sense of section 37, paragraph four of the German Works Constitution Act. Any benefits from third parties do not fall under this provision. Even applying a broad interpretation of the term 'remuneration,' benefits from third parties do not fall under this provision.

The German Federal Employment Tribunal did not agree. The court stated that benefits from third parties can be well-regarded as remuneration. The crucial question is whether the local employer has promised these benefits. If this is the case, the members of the works council may also be entitled to claim stock options. The lower courts, so far, did not clarify if the local employer had promised these benefits, so the case was returned to them for clarification.

Should you have any questions regarding stock option plans and their implementation in Germany, you may contact Björn Theis, a lawyer in White & Case's Munich office at [btheis@whitecase.com](mailto:btheis@whitecase.com).

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