

## **TO MASLON CLIENTS AND OTHER FRIENDS**

### **DETAILED MEMO ON SECTION 409A - MARCH 2008**

#### **DEFERRED COMPENSATION PLANS MUST COMPLY WITH SECTION 409A - FINAL REGULATIONS & RECENT NOTICES CLARIFY HOW & WHEN**

*2008 Action Items to Comply with Section 409A.* Beginning in 2005, Section 409A of the Internal Revenue Code ("Section 409A") governs each non-qualified deferred compensation plan that is described in Section 409A and is not exempt (an "NDCP"). NDCPs include both plans and individual agreements; and are summarized on pages 4 and 5. As explained later in this memo, Section 409A restricts (or even prohibits) many common NDCP provisions, and imposes severe penalties on participants entitled to benefits under any NDCP that does not comply. Thus, employers should seek counsel before amending or adopting any NDCP, or making further payments under an NDCP. This memo also includes a list of action items for NDCP sponsors, to be completed in 2008. That list begins on page 2.

*Section 409A has Finally Been Clarified.* In April 2007, final Treasury Regulations (the "Final Regulations") were issued to clarify Section 409A. The Final Regulations also exempted some severance pay, and extended some transition rules until the end of 2007. In September and October 2007, IRS issued several Notices that extend some favorable transition rules until the end of 2008.

*Good Faith Compliance in 2008.* During 2008, the parties to an NDCP may comply in good faith with Section 409A by relying on Notice 2005-1 (the "2005 Notice") or the Final Regulations; and following the terms of the NDCP (to the extent they comply with any of those Section 409 documents. However, beginning January 1, 2009, the parties to an NDCP may no longer rely on the 2005 Notice, but instead must comply with the Final Regulations.

*Deadlines to Amend NDCP Documents.* In October 2007, IRS issued Notice 2007-86, which modifies the Final Regulations by requiring all NDCP amendments (or documentation of unwritten terms), that are required for compliance with Section 409A and the Final Regulations, to be completed by December 31, 2008. However, the time and form for any benefit payments otherwise due after 2008, can also be changed in 2008, by an NDCP amendment or written election. As a practical matter, the payment terms of some NDCPs should be redesigned now, and amended as necessary, to ensure that benefit payments due in 2008 and later years will comply in good faith (during 2008) with the 2005 Notice or the Final Regulations and, in later years, with the Final Regulations.

*Payment Transition Rules in 2008.* When the payment terms of an NDCP are re-designed and/or amended, parties to the NDCP should be aware that the following changes can be made in 2008, but will be restricted in later years:

- an NDCP may be amended during 2008, to include new payment terms and allow new payment elections (timing and/or method) to be made in 2008 for previously earned amounts, but only if those terms or elections (a) do not affect payments already due in 2008, (unless they would have violated Section 409A), and (b) do not trigger payments that were not due in 2008; and
- the same types of amendments and payment elections can be made or changed in 2008, again if the amendment or elections (a) do not affect payments already due in 2008, (unless they would have violated Section 409A), and (b) do not trigger payments that are not due in 2008;
- discounted stock options or stock appreciation rights can be canceled, and non-discounted options or rights can be re-issued in their place (but any compensation to a participant for the lost discount must be in the form of either (a) restricted stock or (b) deferred compensation that complies with Section 409A and is not payable in 2008); and
- certain errors made in NDCP administration may be corrected during 2008 and 2009, with limited tax consequences, if the conditions in IRS Notice 2007-100 are met.

*Compliance with Final Regulations in 2008 and Later.* By December 31, 2008, all NDCPs must be amended or documented to comply with the Final Regulations for years beginning after 2008. After 2008, all NDCPs must also comply in operation with the Final Regulations.

*2008 Action Items.* Because Section 409A is now in effect, and each NDCP must be amended before the end of 2008 to comply with the Final Regulations, employers should promptly:

- Identify each plan, agreement and other compensation arrangement that could be treated as an NDCP. A summary of the NDCP definition begins on page 4.
- Determine whether any unpaid benefits under a compensation arrangement were earned and vested as of the end of 2004. Those benefits would not be affected by Section 409A, unless their vesting was accelerated between October 3, 2004, and December 31, 2004, or the benefits (or related rights or features) have been materially enhanced after October 3, 2004. A summary of this exemption is on page 5.

- Obtain competent advice before amending any compensation arrangement that could be an NDCP, because some amendments might cause a Section 409A exemption to be lost. For example, benefits earned and vested in 2004 could become restricted rather than "grandfathered" under Section 409A, if they are enhanced after October 3, 2004.
- Maintain procedures to ensure that, even before required amendments are made, each NDCP is operated after 2004 (and before 2009) to comply with at least the 2005 Notice and/or the Final Regulations, even if all amendments required in 2008 are not yet done. Beginning January 1, 2009, both the operating procedures and documents for an NDCP must comply with the Final Regulations.
- Make sure that deferral elections, for compensation to be earned in 2009, are made by the end of 2008; and explain the new payment restrictions to participants in each NDCP, along with the likely effects on their current benefits and future deferred compensation. This explanation should emphasize how, beginning in 2009, the new rules will restrict changes of any time and method they choose before 2009 for benefit distributions. A summary of the deferral election rules is on page 6; and a summary of the payment restrictions begins on page 6.
- Between now and December 31, 2008, evaluate alternatives and develop a strategic plan for taking advantage of the remaining transition rules in 2008, complying with Section 409A and re-designing each NDCP to maximize alternatives that are still open. This strategic plan may include allowing participants to change payment elections before the end of 2008, segregating any vested benefits now "grandfathered" as exempt from Section 409A, and amending NDCPs or adopting new ones in 2008 to use the remaining flexibility under Section 409A.
- By December 31, 2008, designate in writing all NDCP terms for the timing and method of payments that will be made in 2009, in a way that will comply with the Final Regulations in 2009.
- Prepare to report to the IRS, on Form W-2 (or Form 1099 for non-employees), any vested tax-deferred compensation that becomes taxable before 2009, as a result of Section 409A violations discovered before 2009.
- Prepare to report to the IRS, on Form W-2 (or Form 1099 for non-employees), any tax-deferred compensation earned after 2004 by NDCP participants. However, the reporting deadline for compensation deferred in 2005, 2006, 2007 and 2008 has been extended until future IRS guidance is published.
- By December 31, 2008, make all required NDCP amendments (or document any remaining unwritten terms of the NDCP) in a way that is consistent with the Final Regulations, effective in 2009.

- We urge you to consult with us very soon, to discuss whether your business (or you personally) may have any NDCPs; and discuss the effects of Section 409A on any NDCPs that do exist. You may contact any member of our tax and executive compensation team for help with Section 409A. This team includes, among others, Mark Baumann (612-672-8339), Larry Koch (612-672-8322), Barry Gersick (612-672-8384) and, for stock-based compensation, Marty Rosenbaum (612-672-8326) and Alan Gilbert (612-672-8381).

*Updated Definition of NDCP.* The definition of an NDCP remains very broad, although the Final Regulations include some new exemptions. An NDCP includes every economic benefit that will be delivered to employees, directors, partners, LLC members and some independent contractors after the year in which it was earned, unless an exemption applies. Some examples are voluntary deferral of pay, short-term and long-term incentives, supplemental executive retirement plans (or SERPs), so-called "rabbi" trusts, deferred directors' fees, severance pay commitments, change in control payments, stock options, stock appreciation rights (SARs), "phantom stock," any restricted stock or stock option that is convertible into deferred pay, deferred payments made for not competing, "split-dollar" insurance agreements not treated as loans, and taxable "executive perks" such as personal expense reimbursements payable in future years. Essentially, an NDCP is any plan or arrangement that provides for any deferral of earned compensation, either for a group or by individual contract, except for:

- compensation paid within 2½ months after the year in which it was earned and vested (this is called a "short-term deferral");
- compensation that is fully discretionary until paid;
- tax-qualified retirement plans listed in Section 409A;
- plans that provide only disability benefits, death benefits or paid vacation or sick leave;
- a limited amount of separation pay (currently \$460,000 or, if less, two times annual pay) paid by the end of the second tax year after the employee is discharged or leaves for "good reason" (as defined in the Final Regulations);
- employee stock purchase plans under Code Section 423;
- incentive stock options under Code Section 422;
- grants of restricted stock or other property taxable under Code Section 83; or
- other stock options or stock appreciation rights granted with respect to common stock of the participant's corporate employer (or its corporate parent), if (a) the exercise price is never less than the stock's fair market value on the grant date, and (b) the option term is not extended after the grant date beyond its maximum original exercise period (The Final Regulations include detailed rules for this exemption, such as stock valuation standards for both private and publicly held companies, and restrictions on using stock of subsidiaries.). Until future guidance is issued, options to purchase equity interests in limited liability companies (or other entities taxed as partnerships) can be treated in the same way as corporate stock options.

For Section 409A, a deferred benefit is "earned" only when the participant is legally entitled to it. However, this entitlement is determined by assuming that all later vesting conditions will be met and no benefits will be forfeited.

For Section 409A, "vesting" means the end of any substantial risk of forfeiture. However, a risk of forfeiture for competition with the employer does not delay vesting of covered benefits, except for the following exemption of benefits that were vested in 2004.

*Effective Date and "Grandfathered" 2004 Exempt Benefits.* Generally, Section 409A applies to amounts that are first deferred (or first become vested) under an NDCP after 2004. However, deferred compensation that was earned and fully vested before 2005, is exempt from Section 409A unless the arrangement is improperly amended as described in the next paragraph. Section 409A does apply to amounts deferred under an NDCP before 2005 (and related investment earnings) if they were not vested (in other words, were subject to a substantial risk of forfeiture) at the end of 2004. Section 409A applies to investment earnings after 2004 only if Section 409A applies to the deferred amounts that are credited with those earnings. Any amounts that could be forfeited after 2004, for competition with the employer, are not treated as vested for this 2004 exemption, so they are not exempt from Section 409A.

*Avoid Material Modification of "Grandfathered" Plans.* The Section 409A exemption described in the preceding paragraph does not apply to deferred benefits otherwise exempt from Code Section 409A, if the benefit arrangement is materially modified after October 3, 2004. With some exceptions allowed by the Final Regulations, a "material modification" includes an improvement or addition of any benefit, right or feature, but does not include any exercise or reduction of an existing benefit, right or feature. A material modification includes any acceleration of vesting under the benefit arrangement between October 3, 2004, and the end of 2004.

*Penalties for Non-compliance.* If an NDCP (or a participant) does not satisfy the requirements of Section 409A for any tax year after 2004:

- All compensation deferred for that year (and all non-exempt amounts from prior tax years) under that NDCP, and all similar NDCPs with the same employer, must be included in the participant's taxable income for that year (or, if later, when it first becomes vested).
- The participant must pay interest to the Internal Revenue Service (at the rate for tax underpayments, plus one percentage point) on the income tax that would have been due if the deferred amounts had been taxable when first earned or, if later, when they first became vested. This interest accrues from then until the year when the income is taxed under Code Section 409A.
- The participant must pay an extra 20% penalty tax on all deferred amounts included in his or her taxable income under Section 409A.

### *Summary of Key Restrictions of Section 409A*

*Restrictions on Timing of Compensation Deferrals.* A participant may elect to defer (or an NDCP may require deferral of) compensation for services performed during a taxable year, only if the election (or requirement) is made before that year (except as allowed by the Final Regulations). The election (or requirement) can also be made before the employer's fiscal year, but a fiscal year election (or requirement) may apply only to bonuses for the fiscal year. A participant who becomes eligible during a year can make a deferral election within 30 days after becoming eligible, but the election can affect only compensation for services performed after the election is made. As a result, only a pro-rated portion of an annual bonus can be deferred by the new participant. If performance-based compensation will be based on services performed during a period of 12-months or longer, a deferral election can be made up to six months before the end of the period (unless the compensation amount is then substantially certain). Commissions that are not earned until the customer pays can be deferred by an election made before the year in which the customer pays. However, if compensation will not be vested for 12 months (or more) in the future, an NDCP participant may elect to defer the compensation at any time at least 12 months before vesting could occur.

*Restrictions on Benefit Payments and Changes.* Generally, the time and form of future benefit payments must be stated at the time of initial compensation deferral, either in the NDCP or a participant's election. Later on, a participant (or the employer) may elect to delay, but not accelerate, the scheduled time for a payment, or change the method for payment, only if:

- the change is made at least one year before it can affect any payment; and
- each affected payment is also delayed at least five years from its scheduled date. However, this five-year delay rule does not apply if the revised payment time or method applies only upon the participant's death, disability or unforeseeable emergency. For applying the five-year delay rule, a series of installments is treated like a single payment, unless the NDCP is amended to treat each scheduled installment as a separate payment.

No payment scheduled under an NDCP can be accelerated by the employer and/or the employee, except in rare cases permitted by the Final Regulations. Under this rule, a participant cannot change from a periodic payment method to any shorter payment period, or a lump sum, unless the installments were treated as a single payment under the Final Regulations and the starting date is delayed at least five years. However, the Final Regulations do allow changes between different forms of life annuity, if they are actuarially equivalent. The Final Regulations also allow early distributions from an NDCP (a) if the value of the remaining benefit is small (\$15,500 or less in 2007), (b) to cover FICA taxes and income taxes (but not penalties) imposed under Section 409A, or (c) to satisfy court orders assigning benefits to a participant's former spouse.

*Restrictions on Events Allowing Benefit Payments.* Payments from an NDCP to a participant are allowed only at the following events or times, unless delayed for six months under the following paragraph:

- upon (or at a stated time after) the participant's separation from service, disability or unforeseeable emergency; or the employer's change in control (as those terms are defined in the Final Regulations);
- upon (or at a stated time after) the participant's death; or
- at any other time (or according to a fixed schedule) stated in the NDCP or elected at the time of initial deferral.
- However, the NDCP may provide for distribution upon (or at a stated time after) the earliest (or latest) of two or more of the permitted events or times listed above.

*Six-month Delay of Payments to a Key Employee of a Public Company.* However, if the employer's stock is publicly traded, any scheduled distribution to a "key employee" (generally as defined for tax-qualified plan purposes) cannot be made before the end of a six-month period after his or her separation from service (unless the participant has died). This rule applies regardless of the terms of the NDCP, and must be stated in the documents if the employer's stock is publicly traded. An affected employer may choose an annual date (such as December 31<sup>st</sup>) for identifying its "key employees," who will then become bound by this rule for a 12-month period beginning three months later. The same "key employee" identification date must be used for all NDCPs of an employer and its affiliates describes in the Final Regulations.

*New Rules Will Require Reporting Deferred Compensation When Earned.* For any compensation deferred in 2005 and later years, a new reporting rule (not yet issued) will require an employer to report to the IRS any amount deferred for a participant under an NDCP, at the end of the first taxable year in which the amount is earned. This report must include all new amounts accrued under the NDCP, whether or not vested in that year. Any such amount must be reported in Box 12 on an individual's Form W-2 (or on a Form 1099) for that year, even if the amount is not yet includible in taxable income. This reporting rule will apply to all amounts newly earned (or becoming vested) after 2004.

*Section 409A Requires Withholding & Reporting on Deferred Income Taxed When a Section 409A Violation Occurs.* An employer must withhold income tax and other payroll taxes from any tax-deferred compensation that has become taxable in 2005, 2006 or 2007, as a result of any Section 409A violations discovered in that year. In addition, the employer must report any such taxable income to the IRS, on Form W-2 (or Form 1099 for non-employees). IRS Notice 2007-89 includes instructions for withholding and reporting of any such income that is taxable in 2007. Earlier Notices applied to 2005 and 2006.

*New Trust Restrictions.* If assets are set aside in a trust (such as a "rabbi trust") to make payments under an NDCP, and the NDCP or the trust violates any of the following three restrictions, the value of the trust's assets will be taxed to the participants (in proportion to

their benefits) when all substantial risks of forfeiture have expired, even if the assets remain available to satisfy the employers' general creditors:

- Neither the NDCP nor the trust can provide that, upon an adverse change in the employer's financial health, assets will be transferred to the trust or otherwise become restricted for payment of nonqualified deferred compensation.
- Neither the assets nor the trust can be located outside of the United States or later transferred outside of the United States.
- No assets can be transferred to the trust during (a) any period in which the finding status of a qualified defined benefit plan sponsored by the employer is "at risk" under the Pension Protection Act of 2006 or that plan sponsor is a Chapter 11 debtor under the federal bankruptcy law; or (b) any 12-month period beginning 6 months before, and ending 6 months after termination of a qualified defined benefit plan sponsored by the employer.

Any later investment earnings on, or increases in the value of, those taxable trust assets will be treated as additional taxable amounts. Interest will be due on any tax underpayments, and the taxable amount will also be subject to the 20% excise tax.

*Limited Use of Tax Advice.* Treasury Circular 230 requires our firm to add the following statement to this memo, because this memo is not intended to be a formal tax opinion that would satisfy the Circular's rules for such opinions. Any tax advice included in this memo is not intended to be used, and cannot be used, by any taxpayer for the purpose of avoiding tax penalties that may be imposed under the Internal Revenue Code.

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