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Re: Plan Document/Amendment Requirements Under New §409A Regulations

Dear Clients and Other Friends:

Final §409A regulations published in the April 17, 2007 Federal Register require employers to finalize amendments to their deferred compensation plans by December 31, 2007. In this letter we address issues that should be dealt with in such amendments.

- (1) **Required Content.** Plans that provide deferred compensation must be set forth in a written plan document. The plan must include these provisions:
 - (a) Amount of benefits that the plan will provide to each participant or the formula for determining those benefits.
 - (b) Dates that benefits will be paid, or events that will trigger payment (e.g. separation from service, death, disability, change of control...).
 - (c) Form of payment that will apply following each payment event.
 - (d) If the plan covers any "specified employees" (i.e., certain officers of a public company), how the plan will delay benefits payable upon separation from service until at least six months after the separation.
 - (e) The conditions for making deferral elections or for making subsequent elections to further defer receipt of benefits.

These provisions do not all have to appear in the same document. For example, the deferral election procedures could be set forth in the election form rather than in the main plan document.

- (2) **Optional Provisions.** In addition to the provisions that must be addressed, there are a number of optional provisions which many employers will want to include in their plan documents. Some of these options, such as higher service thresholds for separation for service and changes in the ownership standard used to trigger a separation, may be fully utilized for already earned benefits only if added this year. Optional provisions include:
 - **Definition of separation from service.** Many plans provide for payment upon an employee's separation from service. Under the final regulations,

separation is presumed to happen if the employee's expected level of services is reduced to 20% or less of his or her average work load during the three years preceding the change. To accommodate "phased retirement" situations, the regulations allow an employer to specify a higher percentage in the plan document so long as the percentage is more than 20% and less than 50% of the individual's prior average work load. For example, a plan could specify that if a participant's workload is reduced to less than half of his or her previous workload, this is considered a separation from service and will trigger benefit payments.

- **Definition of service recipient/employer.** The proposed regulations triggered benefits payable upon separation from service if an employee transferred to a related employer that was less than 80% owned by the former employer. The final regulations set a more relaxed 50% standard. However, the regulations also allow a plan to specify a different percentage so long as it is not more than 80% or less than 20%. A percentage from 20% to 49% is permitted only if there is a legitimate business reason. For example, a plan could state that the "employer" is the parent company and all other entities in which the parent company has a direct or indirect 60% ownership interest. Any transfer among such entities would not be considered a separation from service.
- **Expense Reimbursements.** Certain expense reimbursement arrangements may involve deferred compensation. For example, if club dues an executive incurs in one year can be reimbursed in a later year, this may be subject to §409A. The regulations provide that such an arrangement will comply with the §409A requirements so long as it specifies that expenses incurred in one year must be reimbursed by the end of the following year, and that amounts reimbursable for one year will not affect the amounts reimbursable for any other year. For example, it would be a §409A violation if unused expense allowances could be carried over and used to reimburse expenses incurred in a later year. Each year must stand on its own. The details of these arrangements will need to be set forth in writing in the appropriate plan document.
- **Cashouts.** A plan may provide that if a participant's benefit is below a specified level, the benefit will be cashed out rather than being paid in installments. For example, the benefit would be paid in installments over five years if the total value is \$100,000 or more, and in an immediate lump sum if under \$100,000. The details should be specified in the plan document. The final regulations also allow discretionary cashouts up to the dollar limit used to cap elective deferrals (currently \$15,500) if each exercise of that discretion is in writing.
- **Change of Control Definition.** The regulations include a standard definition of change of control. Employers are free to specify their own more restrictive definition, so long as the definition used in the plan document also qualifies as a change of control under the regulations. For

example, acquisition of a 30% ownership interest qualifies a change of control under the regulations, but a plan is free to set 50% as the change of control standard.

- (3) **Suspect Provisions.** The regulations also address some commonly used plan provisions which will not be effective anymore:
- “Savings” clauses that purport to nullify plan terms which do not comply with applicable law, or to supply missing legally required terms, will not be effective. A plan with non-compliant or missing plan terms will violate §409A regardless of whether it contains a savings clause.
 - Provisions that nullify deferrals of participants who do not qualify under the ERISA “top hat” standards – that is, individuals who are not members of a “select group of management or highly compensated employees” – would be treated as accelerating payment, and therefore are not permitted by §409A.
- (4) **Transition Rules.** Some of the prior IRS guidance on §409A suggested that the plan documents would need to specify how the plan handled various transition issues during the period from January 1, 2005 through December 31, 2007. Subject to some very limited exceptions, the final regulations waive this requirement.

We have helped a number of our clients in preparing §409A related amendments. Many of you are pretty far along with that process. Now that the IRS guidance is out, it will be necessary to finalize those amendments and get them adopted by year-end.

We know that many employers are not as far along with this process. If your company is in that category and needs help in getting its arms around the §409A requirements, please let us know. We also want to emphasize that the new rules sweep in many pay practices that have not traditionally been thought of as involving deferred compensation. For example, severance pay plans, expense reimbursements, and executive stock plans all can be subject to §409A if they don't qualify for an exemption. Many of those programs will also need attention to assure that they are documented in compliance with the §409A rules.

December 31, 2007, the §409A compliance deadline, will be here before we know it. Let us know if we can help you assure that your plans satisfy the §409A requirements by this fast-approaching deadline.

Sincerely,

A. David Kelly

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