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**Re: New Minnesota Tax on Deferred Compensation Paid to Former Residents**

Dear Clients and Other Friends:

A March 2008 Minnesota tax change will impose significant new taxes in the fairly common situation where an executive who lived and worked in Minnesota retires, moves to another state, and then receives deferred compensation earned while a Minnesota resident. Under prior Minnesota law, deferred compensation earned while a Minnesota resident was exempt from Minnesota income tax if it was paid after the individual moved to another state. The March legislation repeals this exemption effective back to January 1, 2008, and requires the employer to withhold Minnesota income tax from such amounts effective April 1, 2008.

**Amounts Subject to New Minnesota Tax.** The following types of compensation may now be subject to Minnesota income tax as a result of this law change:

- Stock options that are in effect while an individual is a Minnesota resident but are exercised after he or she moves to another state.
- Amounts an executive chose to defer from income while a Minnesota resident that are paid after he moves elsewhere.
- Supplemental retirement benefits fully or partially earned while working in Minnesota but paid after the individual moves out of state.

For senior-level executives, the above amounts can be quite substantial, so the potential additional Minnesota income taxes that will result from this legislation will also be large.

**Federal Law May Still Shelter Deferred Compensation from Minnesota Income Tax.** Certain types of compensation earned while a Minnesota resident and paid after moving to another state will remain exempt from Minnesota income tax pursuant to 1996 federal legislation. The federal exemption applies to:

- Benefits paid under a qualified pension or 401(k) Plan.

- Supplemental retirement plans through which the employer pays benefits that cannot be paid by a qualified plan due to various IRS limits (sometimes referred to as excess benefit plans).
- Other deferred compensation paid in installments over the recipient's lifetime or over a period of at least 10 years.

Under the federal statute, Minnesota is prohibited from taxing such amounts, and this prohibition remains in place. The interplay between the new Minnesota tax increase and the 1996 federal law is illustrated by this example:

An individual earns \$1 million of deferred compensation while living and working in Minnesota. This amount is simply deferred from his salary and bonus – it is not under a qualified plan or excess plan. The deferred compensation plan currently provides that payment will be made in a lump sum one year after the individual's retirement. He retires in 2008 and establishes Florida residency effective January 1, 2009.

If this individual receives his deferred compensation in a lump sum in 2009 while he's a Florida resident, the entire amount will be subject to Minnesota income tax under the new Minnesota law because it was earned while he was a Minnesota resident. However, if the plan is changed to pay the benefit over at least 10 years or over the individual's lifetime, the federal source tax law will apply and Minnesota will not be able to tax the benefit.

In such cases, it may be attractive to change the plan and pay the benefit in installments rather than as a lump sum. As readers of this letter probably are aware, Internal Revenue Code §409A significantly restricts the ability to make such changes. However, remember that during 2008 we are still in the 409A transition period where employers are free to change the form of payment of deferred compensation payable in 2009 or later. This would be a good time to review your deferred compensation payout rules to see if they adequately address state tax law concerns.

**Executives with multi-state careers.** So far this letter has dealt with the relatively simple situation where an employee lives and works in Minnesota and then receives his deferred compensation after moving to another state. However, many Minnesota executives' career paths are more complicated. One executive we know started his career in Minnesota, later worked for the same employer in Indiana, eventually returned to the employer's Minnesota office, ultimately finished his career at the employer's Wisconsin location, and retired to Florida. Tracing the exact portion of this individual's supplemental retirement benefit or stock options that is subject to Minnesota income tax will be a computational nightmare.<sup>1</sup> An even scarier nightmare is that at least part of the deferred amounts will be subject to Minnesota income tax when the individual planned to escape from the clutches of the Minnesota tax system by retiring to balmy Florida

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<sup>1</sup> Also a nightmare for the employer, which must compute the withholding.

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where there is no income tax.<sup>2</sup> We understand the Minnesota Department of Revenue is working on regulations addressing these complexities and we will be interested to see the results. In the meantime, since the new withholding obligation applies to deferred compensation paid out on or after April 1, 2008, employers will need to figure out a good-faith way to deal with the new requirements in the absence of Revenue Department guidance.

Let us know if we can be of help with the above issues.

Sincerely,

Jule M. Hannaford IV

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<sup>2</sup> This same concern applies to executives who have already retired, moved to Florida and are already receiving deferred compensation.