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**Re: How the Proposed §409A Regulations Apply to Salary and Bonus Deferral Plans**

Dear Clients and Other Friends:

This letter will explore how the proposed §409A Regulations released by the IRS on September 30<sup>th</sup> will affect a typical plan that allows executives to defer receipt of salary and bonuses. Let's assume that the employer, a public company, is a calendar year taxpayer and that its plan as in effect before §409A was enacted included these terms:

- Participants can elect by December 31 of each year to defer a percentage of the following year's salary.
- Employer pays an annual bonus that is totally contingent on the year's financial results. Financial targets and potential bonus amounts for a year are set at that year's May board meeting. By November 30 of the year a bonus is earned, the participant can elect to defer receipt of all or a portion of it. Amounts not deferred are paid in February of the following year.
- New participants can sign up for salary deferral within 60 days after becoming eligible.
- Participants may cancel salary deferrals at any time, but a participant who cancels may not reenter the plan for two years.
- Deferrals are credited to a deferred compensation account, which is adjusted periodically to reflect a return based on hypothetical investments. (Participant may choose from among several measures).
- A participant may withdraw up to \$100,000 per year from his or her deferred compensation account, subject to a 10% penalty ("haircut").
- Participant may withdraw from the account to cover significant financial needs and unforeseeable emergencies. No haircut penalty is taken on such withdrawals. Employer considers these requests on a case-by-case basis and has been pretty flexible about allowing withdrawals.

- Account is paid in a lump sum (if under \$500,000) or 10 annual installments (if \$500,000 or more) upon termination of employment. However, as part of any deferral election, participant may elect different payment schedule for their deferral.
- Before terminating employment, a participant may change the payment schedule for his or her account. Such elections must be made at least one year before termination of employment.
- If participant dies before receiving the account in full, the remaining balance is paid to the beneficiary within one year after the participant's death.
- If employer has a change in control (defined by plan as sale of 20% of the employer's stock or assets to an unrelated party), deferred compensation account balances are paid out immediately.

Lets take a look at how the new regulations apply to this plan:

**Deferral Rules.** This plan's salary deferral rules comply with §409A by requiring that the deferral election be made before the year the salary is earned. However, the bonus deferral rules need to be changed. Assuming the bonus is totally contingent on the employer's financial results, it can be considered "performance-based", which means the §409A deadline for the bonus deferral election is June 30 of the year the bonus is earned. (If on any earlier date the bonus amount became readily ascertainable and substantially certain to be paid regardless of the performance criteria, then the deferral election would have to be made before that time.) To use the special deadline for deferrals of performance-based compensation, the board will have to establish the performance criteria by the 90<sup>th</sup> day<sup>1</sup> of the year the bonus is earned—earlier than their customary May schedule.

The rules for signing up new participants will have to be changed. The regulations require that initial deferral elections be made not later than 30 days after the date a new employee becomes a participant (rather than this plan's 60-day deadline).

The rule allowing a participant to terminate his deferral election at any time will have to be changed. Under §409A, once the election deadline is past, the deferral election must be irrevocable until the following year. For example, an election to defer part of 2006 salary becomes irrevocable after December 31, 2005, the end of the participant's prior tax year. However, if a participant takes a hardship withdrawal under this plan or the employer's 401(k) plan<sup>2</sup>, this plan may terminate deferrals for the remainder of the year.

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<sup>1</sup> If the outcome of the performance criteria became substantially certain before that day, the criteria would have to be set even earlier.

<sup>2</sup> Termination due to a 401(k) hardship distribution may only be allowed only if the 401(k) plan requires it, for example, because the 401(k) plan uses the safe harbor for determining whether the hardship distribution is necessary to satisfy the participant's need.

**Rules regarding in-service withdrawals.** The rule allowing a participant to withdraw up to \$100,000 at any time subject to a 10% penalty will have to be eliminated. §409A totally prohibits such withdrawals. The provision permitting withdrawals for emergency needs can be retained but those withdrawals will have to be limited to severe financial hardship due to extraordinary and unforeseeable circumstances such as:

- illness or injury of a participant or dependent (such as, but not necessarily limited to, uninsured medical expenses);
- uninsured casualty losses;
- imminent foreclosure on a primary residence; or
- funeral expenses of a dependent.

The employer will have much less discretion to accommodate participant requests for hardship withdrawals.

**Distribution Rules.** The plan's standard payout rules (lump sum if \$500,000 or less; ten year installments if over \$500,000) meet the new requirements because the \$500,000 cashout level is specified before the deferrals occur. If the plan did not contain a de minimis cashout rule and the employer wanted to add one later, the mandatory cashouts would have to be limited to account balances \$10,000 or under (or to future deferrals).

Since the employer is a public company, distributions to certain "key employees" (as defined in Code §416) may not occur until at least six months after termination of employment. This requirement does not apply to employers that do not have publicly traded securities.

The provision allowing a participant to make a special election regarding payment timing as part of his or her deferral election is fine under the regulations.

The plan's rule regarding subsequent elections will need to be changed. Under the proposed regulations, such an election must have the effect of deferring the payments until at least 5 years after the scheduled payment date. This plan currently does not include that restriction. (The regulations also require that subsequent elections not take effect until at least 12 months after they are made. That requirement should be met by this plan.)

Accelerating payment of the remaining balance upon death is permitted by §409A, but the plan will have to be more specific about the payment date. For example, the plan would satisfy the new requirements if it specified that the death benefit would always be paid by December 31 of the year of death (or 2 ½ months after the date of death, if later).

The provision accelerating payment if there is a change of control will need some changes because the plan's change of control definition is different than the provision in the regulations. A 20% change in the employer's ownership triggers accelerated payment under this plan, while the proposed regulations generally require at least a 35% change.

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**Summary.** You can see that §409A requires this plan to make a lot of changes, most of them fairly minor, in response to the new rules. It is important that the employer get these details right because otherwise the employees who participate in this plan will be subject to significant tax penalties. However, none of the changes are particularly burdensome.

The employer will have to amend the plan by December 31, 2006. In the meantime, the employer must operate the plan in accordance with a good faith interpretation of the new requirements.

Note that the above changes only apply to amounts deferred after 2004. Amounts that were “earned and vested” by December 31, 2004 and subsequent earnings on such amounts can remain subject to the old plan provisions. For example, the old plan rules allowing annual withdrawals up to \$100,000 subject to a 10% penalty can remain in effect for pre-2005 deferrals but cannot apply to post-2004 deferrals.

Some other types of deferred compensation arrangements will be subject to more significant changes as a result of the new regulations, but garden variety deferred compensation plans of the type discussed above will not be particularly burdened by the new rules.

Please let us know if you have any questions.

Sincerely,

A. David Kelly

ADK/rah/jks