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**Re: Minnesota Department of Revenue Issues Guidance on New Minnesota Tax
on Deferred Compensation Paid to Former Residents**

Dear Clients and other Friends:

The Minnesota Department of Revenue issued Revenue Notice # 08-10 and Withholding Tax Fact Sheet 19 in October. These items provide guidance about the 2008 Minnesota tax law change that eliminated a previous exclusion from taxable income for wages earned while a taxpayer was a Minnesota resident and received in a year when the taxpayer was a full-year nonresident. The law change became effective beginning with the 2008 tax year. Payers are required to withhold Minnesota tax beginning with payments made after April 1, 2008.

This Minnesota tax law change was the subject of our firm's prior Client Letter issued on May 2 of this year (see this link for KHB newsletters: <http://www.khblaw.com/newsletters.jsp>).

Though the new Minnesota tax targets deferred compensation, it does not impact "retirement income" paid to nonresidents. Retirement income generally includes:

- Qualified retirement plans, qualified annuity plans or individual retirement accounts;
- Nonqualified plans that would have been qualified plans had applicable income thresholds not been exceeded ("excess benefit" plans);
- Nonqualified plans where payments are made in at least ten substantially equal annual installments or over the life of the ex-employee; and
- Income recognized by a nonresident on the sale of stock purchased through statutory stock options.

The three categories of remaining sources of deferred income that are affected by the new Minnesota tax are:

- severance pay;
- equity based awards; and
- other non-statutory deferred compensation.

The recently issued Minnesota Department of Revenue guidance provides information concerning the extent to which these sources of deferred income are assigned to Minnesota. A summary of guidance provided by the revenue notice and examples taken from the withholding tax fact sheet are included below.*

Severance Pay

If an employer pays severance pay to a nonresident, the resulting income from wages is assigned to Minnesota to the extent that such severance pay is related to work performed in Minnesota.

Examples:

- (1) **Facts:** Assume Mr. Aea is a Minnesota resident and works his entire career at XYZ, Inc. in Minnesota. XYZ, Inc. downsizes and offers Mr. Aea a severance package based upon the number of years worked. Severance payments are to be made over a 3 year period. Mr. Aea changes his residency to Florida before the first severance payment is issued on January 1 of the following year.

Result: Because the severance pay related to work performed in Minnesota the full amount of each severance payment is assigned to Minnesota.

- (2) **Facts:** Ms. Bee's employment contract entitles her to severance payments if she is terminated without cause or pursuant to a change of control in XYZ, Inc. Ms. Bee works for 10 years in Minnesota while a resident of Wisconsin. During this time, Ms. Bee is exempt from Minnesota individual income tax due to reciprocity. XYZ, Inc. terminates Ms. Bee without cause and severance is paid pursuant to her employment contract over 3 years. Ms. Bee changes her residency to Florida before the first severance check is issued.

Result: Because the severance pay related to work performed in Minnesota the full amount of each severance payment is assigned to Minnesota. The reciprocity exclusion does not apply because Ms. Bee does not live in a reciprocity state when the severance payments are received.

Slight change in facts/results: If Ms. Bee had worked under the contract for 9 years in Minnesota and 1 year in Florida, then 90% of each severance payment would be assigned to Minnesota, representing the percentage of time work connected with the employment from which the severance pay was received was performed in Minnesota.

* The Minnesota Department of Revenue notes that its withholding tax fact sheet is intended to help taxpayers become more familiar with Minnesota tax laws but that the fact sheet does not supersede, alter or otherwise change any provisions of tax law, administrative rules, court decisions or revenue notices.

Equity Based Awards

If an employer pays a nonresident with an equity based award, including non-statutory stock options, stock appreciation rights or restricted stock, the resulting income from wages is assigned to Minnesota in the ratio of days worked in Minnesota during the “allocation period” to the total number of days worked during the “allocation period.”

The allocation period begins on the date the equity based award is granted and ends at the earlier of (1) the date the award or corresponding stock is substantially vested or (2) the date the award or corresponding stock is sold.

Examples (each example assumes the stock options do not have a readily ascertainable FMV at grant date):

- (3) **Facts:** Ms. Cee works for XYZ, Inc. in Minnesota and is a Minnesota resident in Year 1. Ms. Cee is granted non-statutory, vested stock options. After receiving the options, Ms. Cee continues to work for 2 years in Minnesota. In Year 3, Ms. Cee changes her residency to Florida where she continues to work for XYZ, Inc. In Year 5, Ms. Cee exercises the options recognizing \$50,000 of income from wages.

Result: Because the options were both granted and vested while working in Minnesota, \$50,000 is assigned to Minnesota.

- (4) **Facts:** Mr. Dee is a resident of Kentucky. When hired by XYZ, Inc. in Kentucky, Mr. Dee is granted non-statutory stock options that vest after 5 years. During Year 2, Mr. Dee is assigned to spend 6 months in Minnesota overseeing the building of a new plant and then returns to his home in Kentucky. In Year 5, Mr. Dee retires. At the time of retirement, the options vest and are exercised by Mr. Dee. As a result of exercising the options, Mr. Dee recognizes \$90,000 of income from wages.

Result: Because the time worked in Minnesota between the option grant and vesting dates is 6 months out of 5 years, \$9,000 ($6/60 \times \$90,000$) is assigned to Minnesota.

- (5) **Facts:** Ms. Eff is a resident of Minnesota. When hired in Minnesota by XYZ, Inc., Ms. Eff is granted non-statutory stock options for 1,200 shares that vest ratably over 4 years; 300 shares vest in each of Years 1, 2, 3 and 4. Ms. Eff remains employed in Minnesota during Years 1 and 2 and then changes her residency to Washington where she is employed during Years 3 and 4. Ms. Eff exercises all 1,200 shares at the end of Year 6 while a resident of Washington.

Result: Six hundred shares vested prior to Ms. Eff leaving Minnesota. 100% of income from wages recognized from the exercise of these shares is

assigned to Minnesota. Because the time worked in Minnesota between the option grant and the vesting dates for the 300 shares that vested in Year 3 is 2 out of 3 years, 66.67% (2/3) of income from wages recognized from the exercise of these shares is assigned to Minnesota. Finally, because the time worked in Minnesota between the option grant and vesting dates for the 300 shares that vested in Year 4 is 2 out of 4 years, 50% (1/2) of income from wages recognized from the exercise of these shares is assigned to Minnesota. In sum, 79.12% $([600+200+150])/1,200$ of the income from wages recognized upon exercise will be assigned to Minnesota.

Other Non-Statutory Deferred Compensation

If an employer pays a nonresident other non-statutory deferred compensation, the resulting income from wages is assigned to Minnesota in the ratio of days worked in Minnesota during the “allocation period” to the total number of days worked during the “allocation period.” The allocation period is the period of time during which the employee accrued the right to the deferred compensation.

Examples:

- (6) **Facts:** XYZ, Inc. maintains a supplemental retirement plan (SERP) that provides income that does not meet the criteria necessary to be preempted under federal law from state taxation when paid to a nonresident.

Ms. Gee is a resident of California and works for XYZ, Inc. for 2 years in California. Ms. Gee then changes her residency to Minnesota where she works for 11 years. Upon terminating employment, Ms. Gee changes her residency to another state. Ms. Gee is entitled under the SERP to a monthly payment of \$4,000 for 5 years.

Result: Because Ms. Gee accrued the right to the deferred compensation throughout Ms. Gee’s 13 years of service, the allocation period is 13 years. Because the time worked in Minnesota during the allocation period is 11 out of 13 years, 85% or \$3,385 of each monthly payment $(11/13 \times \$4,000)$ is assigned to Minnesota.

- (7) **Facts:** Mr. Eighj defers compensation earned annually in excess of \$1,000,000. In Year 1, Mr. Eighj worked in Minnesota for 365 days, deferring \$500,000. In Year 2, a leap year, Mr. Eighj worked in Minnesota for 210 days and worked in New York for 156 days, deferring \$750,000. In Year 3, Mr. Eighj worked in New York for 331 days and then retired, deferring \$1,250,000. While a resident of New York, Mr. Eighj receives all deferred compensation within a 5 year period.

Result: Because Mr. Eighj accrued the right to the deferred compensation on an annual basis, each year is a distinct allocation period. For Year 1,

\$500,000 is assigned to Minnesota because Mr. Eighj worked in Minnesota for 365 out of 365 days. For Year 2, \$430,328 ($210/366 \times \$750,000$) is assigned to Minnesota because Mr. Eighj worked in Minnesota for 210 out of 366 days. For Year 3, none of the \$1,250,000 deferred in that year is assigned to Minnesota because Mr. Eighj did not work in Minnesota during that year.

Because \$930,328 of the \$2,500,000 deferred is assigned to Minnesota, a corresponding 37.21% ($\$930,328/\$2,500,000$) of each payment received by Mr. Eighj is subject to Minnesota withholding tax and individual income tax. Any earnings on the deferred compensation that constitute wages are also assigned to Minnesota in the same manner.

- (8) **Facts:** Mr. Eye is a Texas resident and resides in Texas for 5 years. During Year 6, Mr. Eye accepts a 2 year assignment in Minnesota overseeing the development and installation of new computer software at a branch office. As an incentive, Mr. Eye is offered a \$50,000 bonus for remaining in Minnesota for the duration of the 2 year assignment. In Year 8, Mr. Eye returns to Texas and 3 months later receives the \$50,000 bonus.

Result: Because Mr. Eye worked in Minnesota for the entire 24 months during which the right to the \$50,000 bonus accrued, \$50,000 is assigned to Minnesota.

Slight change in facts/result: If in addition to the requirements above, Mr. Eye had been required to be employed at the time of payment to receive the bonus, then the percentage of time Mr. Eye worked in Minnesota while accruing the right to the deferred compensation would be 24 out of 27 months. As such, \$44,444 ($24/27 \times \$50,000$) would be assigned to Minnesota.

- (9) **Facts:** XYZ, Inc. maintains a qualified pension plan that provides income that meets the criteria necessary to be preempted under federal law from state taxation when paid to a nonresident. In addition, XYZ, Inc. maintains a supplemental retirement plan (SERP) that provides income that also meets federal law preemption criteria.

Ms. Jay is a resident of Minnesota and works in Minnesota accruing benefits under XYZ, Inc.'s qualified pension plan and SERP. Ms. Jay retires and becomes a resident of Arizona, thereafter receiving a combined payment of \$4,000 per month for 5 years under the qualified pension plan and SERP.

Result: Because the payments qualify as income that meets the criteria necessary to be preempted under federal law from state taxation when paid to a nonresident, the payments are not assigned to Minnesota.

Administrative Guidance

In its revenue notice the department acknowledges the administrative burdens on employers as they “improve” their administrative systems to comply with this new law for 2008 and future years. Presumably one of these burdens is trying to remember whether a former employee receiving SERP or deferred compensation benefits was physically present in Minnesota on a given day, say, 20 years ago. When allocation issues arise that could result in penalties for failure to withhold the correct amount of tax as a result of limited historical data available to the employer, the department suggests that a taxpayer may request abatement consistent with Minnesota procedures. The department asserts that whether to grant an abatement request is a case-by-case determination based on reasonable cause.

Conclusion

The revenue notice provides only an outline of the 2008 tax law change and the examples, while helpful, are all fairly basic. Unfortunately, the administrative guidance from the revenue notice does not include a “good faith” compliance standard for employers or employees. Therefore, employers and employees only have this general information available as they work through much more intricate “real life” situations. Still, our view is that a good faith application of the guidance provided by the department to more complex arrangements should help guide compliance with this new Minnesota tax law.

If you have questions about this 2008 Minnesota tax law change or the Minnesota Department of Revenue guidance summarized in this Client Letter, please contact us.

Sincerely,

Ted Rice

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