When Congress enacted Section 409A of the Internal Revenue Code (the “Code”) in 2004, it made sweeping changes to the rules governing “nonqualified deferred compensation plans.” These changes are easily the most extensive changes in this area since the Code was first enacted in the early years of the Twentieth Century.

Although Code § 409A went into effect at the beginning of 2005, its full impact has not yet been felt. For the past two years, we have been operating within an official IRS transition period while waiting for the issuance of final IRS guidance. During this transition period, plans have been required to operate in “good faith operational compliance” with Code § 409A but formal plan amendments have not been required.

That will soon change. After a long wait, the Final Treasury Regulations were finally published on April 17, 2007. These regulations are generally applicable beginning on January 1, 2008, and the current transition period will end. We do not expect the transition period to be extended past December 31, 2007. Therefore, in response to the Final Treasury Regulations, you should do the following sooner rather than later:

- **Evaluate Plans.** Evaluate all of your nonqualified deferred compensation plans or arrangements that may be subject to Code § 409A to determine whether they need to be amended to comply with the Final Treasury Regulations.

- **Amend Plan Documents.** Amend your plan documents to comply with Code § 409A and the Final Treasury Regulations. Please note that even if your nonqualified deferred compensation plans or arrangements have previously been amended to comply with Code § 409A, you should review them to make sure that the Final Treasury Regulations do not require further revisions. The last day to make amendments is December 31, 2007.

We would be happy to review your nonqualified deferred compensation plans or arrangements to determine if they are affected by Code § 409A and, if so, to help you comply with Code § 409A.

Additional information about Code § 409A may be found in the accompanying client memorandum. The client memorandum was originally mailed in 2004, shortly after Code § 409A was enacted. We have updated it to reflect the Final Treasury Regulations.

The Final Treasury Regulations number almost 400 pages and cover a number of areas, including the following:

- **Initial Deferral Elections.** In general, an employee must make the initial election to defer compensation before the year in which services are performed.

- **Timing of Payments.** In general, payments must be made at a fixed date, under a fixed schedule, or upon any of the following events: separation from service, death, disability, change in control of the employer, or unforeseeable emergency.
• **Anti-Acceleration Rules.** In general, payments of deferred compensation cannot be accelerated.

• **Change in Payment Elections.** In general, the time and form of a payment must be elected before the year in which services are performed. The time and/or form of payment can be changed later, but the following conditions must be satisfied:
  
  o The election may not take effect for at least 12 months;
  
  o The payment must be deferred for at least an additional 5 years, unless the payment is on account of death, disability, or unforeseeable emergency; and
  
  o Any election related to a payment at a specified time or under a fixed schedule must be made at least 12 months before the date of the first scheduled payment.

Every nonqualified deferred compensation plan or arrangement is potentially affected by Code § 409A, whether it is in the form of a separate plan or part of an employment contract. Types of nonqualified deferred compensation plans affected include the following:

• **Excess Benefit Plans** that attempt to “make up” the benefits that a participant might “lose” under a “qualified plan” as a result of various limits found in the Code (such as “wraparound 401(k) plans” or “pension benefit restoration plans”);

• **Supplemental Executive Retirement Plans** (also known as “top hat plans”) that allow a “select group of management or other highly compensated employees” to defer the receipt of compensation separately from or outside of a “qualified” retirement plan (such as a 401(k) plan);

• **Share (or Stock) Appreciation Right Plans (“SAR’s”)** that allow the participant to receive the difference in the value of a specified number of shares between the date the SAR rights were granted and they date they were exercised;

• **“Phantom” Stock Plans** (also known as “Shadow” Stock Plans or Stock Participation Plans) that provide a “select group of management or other highly compensated employees” with the economic benefits of ownership without giving up actual ownership;

• **Code § 457(f) Plans** (also known as “ineligible deferred compensation plans”) that are offered by tax-exempt and governmental entities, including deferral arrangements in individual contracts; and

• **Certain individual contracts of employment** that provide for the payment of compensation after an individual’s employment has been terminated, such as those that might be found in the contract of a company officer or executive.

If you have any questions about any of these developments or would like to discuss any of these topics in further detail, please feel free to call Eric Namee, Steven Smith, or Jim Spencer at (316) 267-2000.

© 2007 by Hinkle Elkouri Law Firm L.L.C. This Alert is provided solely for your information and is not intended to provide legal advice or counsel on any matter. If the law changes, Hinkle Elkouri Law Firm L.L.C. and its attorneys have no obligation to update the information contained herein.
April 30, 2007

CLIENT MEMORANDUM

NEW RULES FOR NONQUALIFIED DEFERRED COMPENSATION PLANS

Many employers offer nonqualified deferred compensation plans to some part of their workforce. These nonqualified plans come in many different forms, but are generally intended to accomplish one or more of the following objectives:

• Allow an employee to put aside money for retirement that is over and above the dollar limits that apply to 401(k) or similar defined contribution plans;

• Provide additional benefits to employees that are over and above the maximum benefit limit that applies to traditional defined benefit pension plans; or

• Allow employees to delay the receipt of their regular compensation or their bonuses until a later date in order to minimize the “tax hit” on the employee.

Congressional Concern Regarding Potential Abuses

Both Congress and the Internal Revenue Service have long recognized that nonqualified deferred compensation plans serve a legitimate function when they are used correctly. In recent years, however, Congress has become concerned that nonqualified plans were being abused and that some of the key legal principles that make such plans possible, such as the risk that the employee will not be paid if the employer becomes bankrupt, were being eroded.

In response to this concern, Congress made sweeping changes near the end of 2004 to the rules applicable to nonqualified deferred compensation plans. These changes were included in the American Jobs Creation Act of 2004 and resulted in the addition of new section - Section 409A - to the Internal Revenue Code (the “Code”).

Impact of the New Law is Sweeping

The impact of these changes cannot be understated. Any employer that has a nonqualified deferred compensation plan will need to examine that plan to determine what changes are required. If changes are required, but are not made, the tax advantages of the plan are likely to be lost and the participants in the plan may be exposed to tax penalties.
Plans and Arrangements That Are Subject to the New Law

When Congress changed the rules that apply to nonqualified plans, it chose to use a broad definition of the term “nonqualified deferred compensation plan.” The term “nonqualified deferred compensation plan” is defined to mean, “[a]ny plan that provides for the deferral of compensation” other than a qualified employer plan, such as a plan that is qualified under § 401(a) of the Internal Revenue Code, or “a bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.” The term “plan” expressly includes “any agreement or arrangement, including an agreement or arrangement that includes one person.”

The types of plans that are potentially subject to the provisions of Code § 409A include the following:

- **Excess Benefit Plans** that attempt to “make up” the benefits that a participant might “lose” under a “qualified plan” as a result of various limits found in the Internal Revenue Code. For example, the Code limits the maximum benefit that may be paid under a traditional defined benefit pension plan. If an employee would be entitled to a higher monthly benefit “but for” the limitations in the Code, an employer will sometimes “make up” the difference through an excess benefit plan. Or, if the limits found in the Code prevent an employee from deferring as much compensation into a 401(k) plan as the employee might like, the employer, in some situations, may be able to allow the employee to defer the additional amount into a nonqualified “wraparound 401(k)” plan.

- **Supplemental Executive Retirement Plans**, also known as “top hat” plans, that allow a “select group of management or other highly compensated employees” to defer compensation separately from or outside of a “qualified” retirement plan. These plans would include plans or arrangements that allow an employee to defer the receipt of certain bonus payments.

- **Share Appreciation Right Plans**, also known as “stock appreciation right” plans. These plans, which are commonly referred to as “SAR’s,” are similar to stock option plans in that they allow the participant to receive the difference in the value of a specified number of shares between the date the SAR rights were granted and the date they were exercised. They differ from stock option plans, however, in that the participant never has the actual right to purchase the underlying shares.

- **“Phantom” Stock Plans**, also known as **“Shadow” Stock Plans or Stock Participation Plans**, that provide a “select group of management or other highly compensated employees” with the economic benefits of ownership without giving up actual ownership. These plans differ from stock option plans in that the employee does not have the actual right to purchase shares. The employee is merely compensated based on the performance of the underlying business.

- **Code § 457(f) Plans**. These plans are commonly known “ineligible deferred compensation plans” in order to distinguish them from Code § 457(b) Plans. They are offered by tax-exempt and governmental entities.

- **Certain individual contracts of employment** that provide for the payment of compensation after an individual’s employment has been terminated, such as those that might be found in the contract of a company officer or executive.
New Law Limits Employee Flexibility

The overall thrust of Code § 409A is to limit the flexibility that employees have when compensation is deferred.

In the past, it was common for participants to wait until as little as thirty days before the date that compensation would become payable to them before making an election to defer that compensation. Code § 409A changes this rule. As a general rule, deferral elections must be made before the end of the preceding tax year. There are exceptions for newly eligible employees. Such employees may make a deferral election within thirty days of becoming eligible to participate in the arrangement (but only as to compensation that has not yet been earned). Additionally, there is a special rule for “performance based” compensation. If the compensation is based on services performed over a period of at least twelve consecutive months and is contingent upon certain pre-established objectives, the deferral election may generally be made as late as six months before the end of that period.

Once compensation has been deferred, there are new restrictions on the ability of a participant to make a subsequent election as to when and how the compensation will be distributed. In the past, elections as to the timing and form of a distribution were commonly made as little as thirty days before a distribution was to begin and such elections could easily be changed. Under Code § 409A, however, any election as to the time and manner of distribution will generally need to be made at or before the time the compensation is deferred. Once that election has been made, it can be changed, but a number of restrictions will apply.

In particular, if a new election as to the time and form of distribution is made, the following restrictions will generally apply:

(1) The election may not take effect for at least 12 months;
(2) The payment must be deferred for at least an additional 5 years, unless the payment is on account of death, disability, or unforeseeable emergency; and
(3) Any election related to a payment at a specified time or under a fixed schedule must be made at least 12 months before the date of the first scheduled payment.

Other Restrictions

In addition to these limits on election changes, Code § 409A imposes the following additional restrictions:

(1) Payments May Not Be Accelerated. A plan may not permit the acceleration of the time or schedule of any payment under the plan, except as allowed in regulations issued by the Treasury. The Final Regulations allow a plan to provide for a number of such accelerations, including the following:

(a) To fulfill a domestic relations order;
(b) To comply with ethics agreements with the federal government;
(c) To comply with ethics laws or conflicts of interest laws;

(d) To allow a participant in a plan subject to Section 457 of the Code to pay local, state, federal, and foreign income taxes due upon a vesting event;

(e) To require a mandatory lump sum payment of amounts deferred under the plan that do not exceed a specified amount that is not greater than the current limitation in Section 402(g)(1)(B) of the Code;

(f) To pay FICA taxes;

(g) To distribute an amount that has become included in current taxable income due to a violation of Section 409A of the Code;

(h) To distribute the entire amount of a participant’s benefit upon the termination of the plan in one of the following general circumstances:

(i) within 12 months of a corporate dissolution or bankruptcy;

(ii) within 30 days preceding or 12 months after a change in control event, provided that all other plans or arrangements that would be aggregated with the plan under Code Section 409A’s plan aggregation rules are also terminated and liquidated; or

(iii) the termination is not due to a general downturn in the health of the company and

(1) all other plans or arrangements that would be aggregated with the plan under Code Section 409A’s plan aggregation rules are also terminated and liquidated;

(2) no payments (other than previously scheduled payments) are made within 12 months of the termination and liquidation of the plan;

(3) all payments are made within 24 months of the termination and liquidation of the plan; and

(4) no other plan or arrangement is adopted that would be aggregated with the plan under the plan aggregation rules for a period of 3 years after the termination and liquidation of the plan; and

(i) Upon such other events and conditions as the IRS may prescribe in generally applicable guidance published in the Internal Revenue Bulletin.
In addition, the Final Regulations provide that making a distribution 30 days or less prior to the specified time of distribution will not be treated as an acceleration and is therefore permissible, so long as the participant who is receiving the distribution has not been permitted to directly or indirectly influence the tax year in which the distribution is made.

(1) **Employer’s Financial Health.** A plan may not provide that assets will become restricted to the provision of benefits under the plan if there is a change in the employer’s “financial health” and assets may not, in fact, be so restricted. To avoid taxation, the assets of a nonqualified plan must generally be subject to the claims of an employer’s creditors in the event of an employer bankruptcy. Some employers attempted to shield their employees from the risk of such a loss by providing that assets would be shifted into a trust that was not subject to the claims of creditors if the employer’s financial condition deteriorated. Although this would result in taxation of such amounts, the employees would be protected from loss. From Congress’s point of view, this practice was abusive and will no longer be allowed.

(2) **Offshore Trusts.** With limited exceptions, assets may not be held in an offshore trust.

**Consequences of Not Following Code § 409A**

If these rules are violated, the tax advantages of the nonqualified deferred compensation arrangement will be lost. In particular, an employee will be required to:

1. Include the employee’s entire balance under the nonqualified plan or arrangement in the employee’s gross income for the year in which the failure to follow the rules took place;
2. Pay interest on any resulting underpayment of taxes at the underpayment rate plus one percent; and
3. Pay a 20% penalty tax on any amounts that become includible in the employee’s gross income as a result of the failure.

These rules apply to any employee to whom the failure to follow the rules “relates.” In some cases, such as when the plan document violates Code Section 409A, the failure will “relate” to all employees in the plan. Therefore, it is important that the 409A rules are not “bent” to help employees. Not only could it cause significant financial harm to the employees that are the beneficiaries of the “help,” the entire plan could be put at risk.

**Effective Date**

The new provisions apply to amounts that are deferred after December 31, 2004. There is also a special provision, however, that provides that the new rules apply to amounts that were deferred before that date if an existing nonqualified arrangement is “materially modified” after October 3, 2004, unless the modification is made pursuant to guidance issued by the IRS.
This means that care should be taken in making any changes to an existing nonqualified plan that contains “old” money. If the changes are considered to be “material,” the plan will lose its “grandfathered” status and the amounts deferred in that plan will become subject to the new rules.

For some employers and their employees, the loss of “grandfathered” status may not be a “big deal.” This may be the case, for example, if the rules under their existing plan are fairly restrictive and do not permit a great deal of flexibility as to the time and manner in which distributions will be made. But for other employers and their employees, particularly those with existing plans that do permit a fair amount of flexibility, the loss of “grandfathered” status may be something that they would prefer to avoid.

**IRS Guidance**

Although Code § 409A made sweeping changes, those changes were set forth in broad strokes. Rather than working through the details itself, Congress, as is frequently the case, left it to the Internal Revenue Service (“IRS”) to address the many “nuts and bolts” questions that practitioners had as to how these changes should be implemented. The IRS has provided guidance as to a number of these questions in the final regulations, but other details are still being worked out and will be addressed in later guidance.

**Transition Rules**

One of the most important aspects of the guidance is its recognition of the concept of a “transition period.” During the transition period, nonqualified plans are generally required to comply with a good faith interpretation of the new rules; however, there are also a number of special transition rules.

The most important transition rules, from our point of view, include the following:

1. **New Distribution Elections for “New” Money.** An employer may generally permit participants in its nonqualified plans to make new distribution elections for amounts that have been deferred under the new rules - that is, “new” money - if the new distribution election is made before the end of 2007.

   There are a handful of other conditions that must be met. For example, the new election cannot be applied to money that would otherwise be distributed in 2007 and cannot cause money to be distributed in 2007 that would otherwise have been distributed in a later year. But the overall effect of this transition rule is to allow participants to make new distribution elections before the end of 2007 without having to worry about the normal rules that generally require a one year delay before a new distribution election may take effect and which further require the first distribution date to be pushed back by an additional five years when a distribution election is changed.

2. **Linkages to Qualified Plans.** Many nonqualified plans provide that the time and form of a distribution will depend on a distribution election made under a qualified defined benefit plan. The transition rules allow this linkage to continue through the end of 2007. For 2008 and later years, however, this linkage will no longer be permitted.
(3) **Updating Plan Documents.** If a nonqualified plan or arrangement includes amounts that are subject to the new rules, the documents reflecting that plan or arrangement will need to be updated to reflect the new rules. Under the transition rules, however, plan documents are not required to be updated until the end of 2007. Although we do not believe that this deadline will be further extended, this additional time is helpful because it provides time to amend plan documents to comply with Code § 409A.

**Conclusion**

The new law represents a major change in the rules governing nonqualified deferred compensation arrangements. Many current arrangements do not comply with all of the requirements in the new law. Consequently, almost every existing nonqualified deferred compensation arrangement will need to be changed in some way to conform to the requirements of the law. **This is true even if your nonqualified deferred compensation plan or arrangement has already been amended, because the publication of final regulations on April 17, 2007, may require further revisions to your plan documents.**

We would encourage you to review your existing nonqualified deferred compensation arrangements. If you have questions as to how they are affected by the new law, you are welcome to contact us. We would be happy to review your nonqualified plans or arrangements to determine if they are affected by Code § 409A and/or if they need further revisions to comply with the final regulations under Code § 409A.

The preceding summary of the provisions of Code § 409A is intended to highlight key provisions of Code § 409A as they relate to nonqualified plans or arrangements. A comprehensive analysis of these provisions is beyond the scope of this summary. This summary is provided solely for your information and is not intended to provide legal advice or counsel on any matter. Hinkle Elkouri Law Firm L.L.C. and its attorneys are under no obligation to update the information contained herein. This summary is Copyrighted © 2007 by Hinkle Elkouri Law Firm L.L.C.