

***NONQUALIFIED DEFERRED COMPENSATION PLANS
SECTION 409A OF THE INTERNAL REVENUE CODE***

Nonqualified Deferred Compensation Tax Principals In General. In general, compensation is deferred if you do not receive it until a calendar year after the calendar year in which you earned it and were vested in it. In general, the IRS thinks you should be taxed on income when you have a right to receive it; the IRS does not want you to delay receipt as a means of delaying taxation.

The constructive receipt tax rules (found in Sections 451 and 83 of the Internal Revenue Code of 1986, as amended, “Code”) state that you cannot avoid taxation by telling someone who is about to pay you that you do not want the money now, you want it later. In addition, employees of tax-exempt employers have been taxed on their deferred compensation in the year when they vest (i.e., when the compensation is no longer subject to a substantial risk of forfeiture) pursuant to Code Section 457(f). **Note:** Many tax-exempt employers are unaware that 457(f) requires employees to pay tax when they vest in deferred compensation, even if they do not receive the payments until a subsequent tax year.

Courts have generally permitted deferrals any time before scheduled pay date.

IRS believes must defer before compensation is earned (i.e., before you start the work that earns the salary, bonus or other pay).

Large deferred compensation payments to executives of Enron and Worldcom gave the IRS the political pull to get Congress to add Section 409A to the Code, placing severe restrictions on deferred compensation arrangements by using the threat of immediate taxation and a 20% penalty tax on vested deferred amounts.

General Features of Nonqualified Deferred Compensation Arrangements. In general, nonqualified deferred compensation arrangements (NQDC) are contractual agreements in which an employee agrees to be paid in a future year for services rendered.

- Payments generally commence upon termination of employment or preretirement death or disability.
- Plans are geared toward anticipated retirement in order to provide cash payments to the retiree and to defer taxation to a year when the recipient is in a lower bracket.
- Employer’s contractual obligation is typically unsecured. This means that all assets used to fund non-qualified plan benefits must remain assets of the employer, subject to claims of the employer's general creditors.

Types of NQDCs. Any plan, program or arrangement that defers the receipt of income, including:

- Nonqualified deferred compensation or supplemental retirement plans
- Employment agreements
- Severance or separation agreements
- Bonus and incentive plans

Equity plans (e.g., stock options, SARs)
Deferred directors' fees
Split dollar life insurance
Certain partnership payout arrangements
Certain tax exempt deferred compensation arrangements under 457

Three types of deferred compensation plans

Excess benefit plan. NQDC maintained by an employer to provide benefits for certain employees in excess of the IRC section 415 limitations for qualified plans.

Top-hat plans. The “top-hat” plan is the most common approach for an ERISA exemption. A NQDC that is “un-funded and is maintained by an employer primarily ... for a select group of management or highly compensated employees” is exempted from most Title I requirements apart from an abbreviated reporting and disclosure provision. The DOL has formulated no definitive standard, but has indicated that the requisite top-hat group should be limited to individuals who, by virtue of their position or compensation level, have the ability to affect or substantially influence the design and operation of the NQDC.

Supplemental Executive Retirement Plan. May be elective or nonelective, designed to supplement executive compensation. Typically limited to top hat group to obtain advantages of ERISA exemption.

Funding of NQDCs. In general, plans are funded from general assets. In some cases, executives feel reassured by having assets held in trust, but this jeopardizes the tax benefits of such plans.

A Rabbi trust is an irrevocable trust created by the employer in which assets are segregated by the employer in a separate trust administered by an independent Trustee. The trust assets remain the property of the employer and can be seized by the employer's creditors and applied to pay claims if the employer becomes bankrupt. However, the assets are not available to the employer for its general use. A properly drafted Rabbi trust is not a "funded" plan for ERISA purposes. IRS has released a model trust instrument.

A Secular trust is a trust in which the executive's interest vests either immediately or upon the happening of one or more events, such as the attainment of a stated age, change of control, termination of employment, death, disability, etc. Secular trusts are problematic from both tax and ERISA standpoints.

Rabbicular trust is a hybrid of the Rabbi Trust and Secular trust. The trust is designed as a Rabbi trust until the occurrence of an event indicating financial difficulty of the employer (short of bankruptcy), such as a stipulated decline in debt-equity ratios, net worth, gross sales, earnings per share, etc., and when the event occurs, the trust becomes a Secular trust and the executive is given the right to withdraw benefits. The objective is to protect the assets from the claims of the

employer's creditors if events occur which make insolvency likely, but to take advantage of the tax deferral and ERISA exemptions until that time.

Additional Tax Affects of NQDC

Employer's deduction from the NQDC. Deduction is permitted (subject, of course, to IRC section 162 reasonable compensation limitations) in the taxable year in which the employee recognizes income from the NQDC.

Social Security Taxation of NQDCs Generally, nonqualified deferred compensation will be subject to FICA and FUTA at the later of when the related services are performed or when there is no substantial risk of forfeiture.

Overview of 409A.

Rules govern:

- timing of elections to defer receipt of pay
- events upon which deferred compensation can be paid

Requires:

- W-2 reporting for information purposes deferred compensation in year deferred

Prohibits:

- Use of offshore trusts to fund benefits for US Citizens and Residents working in US without immediate taxation of benefits

- Financial difficulty triggering the funding of a trust covering plan benefits

Effective Date:

- Final regulations have been issued and plans must be in compliance operationally and as to form by December 31, 2008.

Penalty for Noncompliance:

The employee is taxed on the deferred compensation on the later of when it is earned or becomes vested, plus the employee must pay a tax equal to 20% of the income. If the taxes were not paid on time, interest is owed on the back taxes. There is no exception to the 20% penalty for believing in good faith that you were in compliance with 409A (e.g., due to reliance on advice of lawyer, accountant, consultant).

What is “Deferred Compensation” for purposes of 409A?

Amounts (cash or property) paid to employees or directors in a tax year (usually the calendar year) following the year in which you have “earned” the pay and it is no longer subject to a “substantial risk of forfeiture”.

“Earned” means you have a legally binding right to receive the pay, even if the amount of receipt of the pay is subject to contingencies outside of the control of you or your employer (e.g., offsets for other compensation you might receive, adjustments for final average pay, vesting schedules or other substantial risks of forfeitures). For example, a discretionary annual bonus where the employer can decide after you have completed the service for the year whether or not you will receive a bonus, or the amount of the bonus, is not “earned” until the employer decides whether you will receive a bonus for that year and, if so, the amount. An amount can be “earned” even if it is not vested (e.g., subject to a condition that you work through a certain date or event).

“Substantial risk of forfeiture” has generally covered more than just a vesting schedule. For example, if you had to comply with a noncompete in order to receive pay, you would normally not be taxed on the pay until it was received (or you were no longer subject to a substantial risk of forfeiture). However, under 409A, noncompetes do not create a substantial risk of forfeiture. Only the requirement to perform future services for the employer creates a substantial risk of forfeiture for purposes of 409A.

Exceptions from 409A.

409A does not apply to:

tax-qualified retirement plans (pension, 401(k) plan, 403(b), 457(b))

bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. “Bona fide” generally means a broad based plan the purpose of which is to provide the welfare benefit, not defer receipt of income.

Short term deferrals, which occurs when payment is made no later than March 15 of the calendar year after the calendar year in which the pay becomes earned and vested. ***Note: this is a key exception which often applies to bonus, incentive, severance and change of control benefits.*** For example, if you have to be employed on the date the bonus is to be paid, and not simply through the end of the performance period, then there is no deferral and the bonus is not subject to 409A. Similarly, if you have to be employed when the change of control occurs (and payment is made after the change of control even if your employment is not terminated), then there is no deferral and the change of control benefit is not subject to 409A. In contrast, suppose you have an annual incentive plan where you only have to be employed on December 31 to receive the bonus. If the evaluation of the Company’s performance is not completed and the bonus is not paid until after March 15, the bonus constitutes deferred compensation that is subject to 409A.

Stock Option and SAR Plans where the exercise price is not less than fair market value of the stock on date of grant, and there is no ability to further defer receipt of the spread upon exercise. Grants of “in-the-money” (i.e., discounted) options or SARs are subject to (and would generally violate) 409A. 409A sets forth stringent rules for determining fair market value. Changes in exercise price (that are not the result of a change of control) if treated as a new grant, which can cause the grant to be discounted and subject to 409A. Extensions of term of option beyond later of 2 ½ months or December 31 of year when would have originally expired is treated as a deferral feature, causing the option to be treated as subject to 409A from the original grant date. Acceleration of vesting is not treated as a new grant. If a SAR participant is paid dividends, the right to payment must be in a document separate from the SAR plan, because the dividends will be subject to 409A if receipt is deferred.

Employee Stock Purchase Plans that comply with Code Section 423.

Severance plans if only paid upon involuntary termination (termination for “good reason” is *not* treated as involuntary termination), the amount does not exceed the lesser of twice the employee’s annual pay or \$440,000 (increased annually based on IRS table), and payments are completed by the end of the second calendar year after termination.

Certain equity or draw arrangements between partners.

Timing of Elections to Defer Receipt of Pay.

Must be made prior to the calendar year in which you start doing the work that earns you the bonus. Elections cannot be changed after the beginning of the calendar year in which you begin earning the bonus.

Exceptions:

Initial Eligibility. When you first become eligible to participate in the deferred compensation arrangement, you have 30 days to make an election that will apply to amounts earned in that calendar year after the election is made.

Performance-Based Compensation. If you have a performance-based bonus or other incentive program conditioned upon service of at least 12 months, the deferral election can be made as late as 6 months before the end of the performance period for bonus or incentive compensation. In order to be “performance-based compensation”, whether the compensation is paid, or the amount of the payment, must be contingent on the satisfaction of organization or individual performance criteria that is not substantially certain to be met at the time the deferral election is permitted. The performance criteria may be subjective related to the employee’s performance or a business unit (or the company) which the employee serves. The criteria need not be approved by the Board, compensation committee or shareholders or other governing body. **Note:** The performance criteria must be established during the first 90 days of the performance

period (e.g., by March 30 for a calendar year bonus plan). Any amount you are substantially certain to receive is not performance based. In addition, compensation that is based on the value of, or appreciation in value of, the employer or its stock is not performance based compensation.

Note: This is a big change from how deferrals of bonuses have been handled in the past. Until 409A, bonuses could be deferred prior to the year the bonus is paid.

Timing of Distributions.

In general, neither the employer nor employee can have any discretion regarding the form or timing of payment. Distributions cannot be made earlier than:

Separation from service (which means termination of employment from employer and its affiliates, not simply transfer to an affiliate). **Note:** key employees of publicly traded companies cannot receive their first payment until 6 months after separation.

Death or Disability (special definition of disability).

Change in Control (special definition)

Unforeseeable Emergency

Specified Date or Fixed Schedule (not the occurrence of an event). Examples of specified dates include a date or year or birth date of the employee when the payment would be made (or installments would begin).

The payment can be made (or installment payments begin) on the specified date, or a certain specified period of time after date (e.g., 1 year after separation from service, six months after change of control). Distribution can be made on the earlier or later of one or more event. The employee can be permitted to elect when the payment will be made or begin, as long as the election is made before the calendar year when the employee begins earning the compensation (or 6 months before the end of the performance period for performance-based compensation).

Elections to Delay Payouts. A plan can permit the employee to further delay the benefit commencement as long as the first payment is extended at least 5 years, the election is made at least 12 months before the original scheduled pay date, and the election is not effective for at least 12 months. For example, if payment was scheduled to be made when the employee attains age 65, prior to attaining age 64, the employee could elect to have the payment made at age 70. Similarly, if payment was scheduled to be made when the employee separates from service, the employee could elect to have the payment made 5 years after separation from service, as long as the election is made at least 1 year before the employee separates.

Change of Control. If payment is made upon a change of control, it must be made within one year of the change. If the employer is publicly traded and payment is to be made upon

termination of employment after a change of control, the 6-month delay requirement applies to key employees.

No Payment Acceleration. Neither the employee nor employer can elect to accelerate payments, even if the employee takes a “haircut” (a reduction in the amount received) or the employer terminates the Plan. Termination of the plan can cease additional benefits from being earned, but cannot change the timing of benefit payments.

Prohibition on Use of Foreign Trusts and Trusts with Funding Triggered by Financial Distress.

Beginning 1/1/05, US Citizens and Residents who are working in the US cannot have their deferred compensation secured by a trust located outside the US. For example, a Canadian citizen who transfers from the Canadian parent to a US subsidiary cannot continue to earn benefits in a nonqualified Canadian pension that is funded by a trust in Canada, even if that trust is a rabbi trust subject to the Canadian parent’s creditors in the event the Canadian parent becomes insolvent.

In addition, the plan or trust cannot require funding of the trust upon the financial distress of the company.