

NON QUALIFIED DEFERRED COMPENSATION PLANS AND ARRANGEMENTS UNDER SECTION 409A OF THE INTERNAL REVENUE CODE

October 10, 2008

In September 2004, Congress enacted § 409A of the Internal Revenue Code (the “Code”) which requires certain non qualified deferred compensation plans and arrangements (“NQDCs”) to satisfy new rules. Since December 31, 2004, NQDC’s have been required to be operated in good faith compliance with the new rules. **NQDCs must be in writing and must be amended to comply with the new rules no later than December 31, 2008.**

The following is a general overview of Code § 409A and the regulations under the statute. The law and the regulations under Code § 409A are complex and it is necessary to separately consider each NQDC to determine what changes must be made in the plan or arrangement to cause it to comply with Code § 409A.

I. Plans and Arrangements Subject to Code § 409A.

Any plan or arrangement which provides for a vested payment at a future date for services performed currently may be subject to Code § 409A. The rules apply to both services of employees and independent contractors. Plans and arrangement which may be subject to Code § 409A include:

- Non-qualified deferred compensation plans and arrangements.
- Bonus plans and arrangements.
- Employment contracts.
- Offer letters.
- Phantom stock and stock appreciation rights.
- Discounted stock options.
- Separation and retention plans and arrangements.
- Post retirement fringe benefit arrangements.
- Certain types of split dollar life insurance agreements.
- Top hat and supplemental employee retirement plans (“SERP”).
- Section 457(f) plans and agreements.
- Change in control arrangements.
- Certain types of expense reimbursements and indemnification arrangements.

- Some tax gross up arrangements.

Plans and arrangements not subject to Code § 409A include:

- Qualified retirement plans; tax deferred annuities (Code § 403(b) plans); Code § 457(b) plans; simplified employee pensions (“SEP”); SIMPLE retirement accounts; and bona fide vacation, sick leave, disability pay and death benefit plans.
- Certain involuntary or “good reason” severance arrangements provided that benefits are paid no later than the end of the second year following severance. Generally benefits under a severance agreement or plan that exceed the lesser of two times a participant’s compensation or \$460,000 (for 2008 - this is an indexed amount) are subject to Code § 409A.
- Payments made no later than two and a half months after the end of the year in which a benefit vests.
- Stock option and stock appreciation rights plans and arrangements where the exercise price equals the fair market value of the underlying stock on the grant date.
- Benefits which become vested before January 1, 2005. However, a vested benefit which is enhanced or added after October 3, 2004 is generally subject to Code Section § 409A.
- Post employment reimbursement arrangements, including arrangements to reimburse an employee for excludible trade or business expenses, moving expenses, outplacement expenses, medical expenses and other payments that do not exceed \$15,500 (for 2008 – this is an indexed amount) provided the expenses are incurred no later than the end of the second year following termination and they are reimbursed no later than the end of the third year following termination. The reimbursement period for medical expenses is for the period of time the employee could have elected COBRA coverage.
- Tax gross-up payments if paid by the end of the year following the end of the year the related taxes are submitted to the government.
- Legal (and other) fee reimbursements made by the employer to the employee or independent contractor if (1) the plan or arrangement provides an objectively determinable, non-discretionary description of the expenses available for reimbursement; (2) the reimbursements are for expenses incurred during an objectively and specifically provided period; (3) the amount of expenses incurred in one year cannot affect the expenses eligible for reimbursement in another year (except with respect to expenses covered by a health plan); (4) the reimbursement is made before the end of the taxable year following the taxable year in which the expenses are incurred and (5) the right to reimbursement is not subject to liquidation or exchange for another benefit.
- An indemnification arrangement or insurance policy providing coverage to an employee or independent contractor and paid for by the employer for expenses incurred and damages paid with respect to a bona fide claim based upon actions taken or failure to act

by the employee or independent contractor in his or her official capacity as an employee or independent contractor with respect to the employer.

- An agreement to which an employee or independent contractor is a party to the extent the agreement provides for payment of amounts obtained as a settlement or award of a bona fide legal claim, or for expenses incurred in relation to such claim, based upon unlawful termination, the Fair Labor Standards Act, worker's compensation statutes or other applicable laws.
- Payment pursuant to the settlement of a bona fide dispute over our employee's or independent contractor's right to deferred compensation.

II. Consequences of Failing to Comply with Code § 409A.

- The consequences of a plan or arrangement failing to comply with Code § 409A are severe. At the time of a Code § 409A violation or failure, the following taxes are imposed:
 - All vested deferrals are subject to regular income taxes.
 - A twenty percent excise tax is imposed on vested deferred compensation.
 - An additional excise tax equal to the Federal interest rate on tax deficiencies plus one percent is imposed on deferrals for the years they are vested. This rate is currently about eight percent.

While participants are directly liable for these taxes, the employer can be impacted either through indemnification, obligation to affected employees or employee claims or concerns.

III. Code § 409A Requirements.

- Deferral Elections.

In general, an employee or independent contractor must make an election to defer compensation before the year in which services are performed with respect to the compensation. In the employee's or independent contractor's first year of eligibility, he or she may make the deferral elections in the first thirty days of eligibility, but the election may only apply to compensation earned after an election was made. An election to defer performance based compensation that is based on services performed over twelve months or more must be made no later than six months before the end of the performance period.

- Distributions.

Distributions under a NQDC may only be made upon one of the following occurrences:

1. The participant's termination of employment with the employer.
2. The participant's death.

3. The participant's disability within the meaning of the Social Security Act or a disability plan of the employer.
4. A change in control of the employer.
5. An unforeseen emergency. Generally, this is a hardship such as a financial need for uninsured medical expenses or to avoid eviction from a residence.
6. At a specified time such as a specific future date or when the participant attains a certain age, such as sixty. Other than the occurrence of events described in 1-5, above, payment cannot be made on an event, such as the birth of a child.

A NQDC may also provide for distributions.

1. To a spouse pursuant to a court order in a domestic relations matter.
2. To pay taxes incurred with respect to deferred compensation, such as taxes incurred in connection with a Code § 409A violation.
3. Upon certain terminations of the NQDC.

Finally, payment of distributions on account of severance of certain key employees of publicly traded companies generally must be delayed for six months after severance.

- Election of Form of Distribution.

A participant may elect the time and form of payment under a NQDC (such as in a lump sum or installments over time); however, the election generally must be made at the time the participant commences participation in the NQDC. A NQDC may also permit a participant to elect the form of payment with respect to each year's deferrals, but such an election must be made prior to the year in which services are rendered with respect to the deferrals.

A NQDC may provide that a participant may elect to change the time and form of a distribution but this must be done at least one year prior to the original commencement date of distribution and payment of the distribution cannot commence until at least five years after the date the distribution was originally scheduled to commence.

Under Code § 409A, a third party, such as the employer's board of directors, cannot determine when a participant's distribution commences or the form of distribution (such as installments or a lump sum).

- Funding of NQDCs

1. NQDCs cannot be funded through foreign trusts. This restriction does not apply to the extent funding relates to deferred compensation earned outside of the United States.
2. The funding of trusts for NQDC cannot be triggered by a decline in the employer's financial condition.

IV. Reporting Requirements.

- Annual reporting.

Employers, under Code § 409A, will eventually be required to report information about NQDC deferrals for each employee in Box 12 of Form W-2 and for each independent contractor in Box 15a of Form 1099-MISC. The Internal Revenue Service has suspended these rules until further notice.

- Reporting a Code § 409A Violation

Deferred compensation that is taxable to an employee or independent contractor because of a Code § 409A violation is reported as wages on Form W-2, Box 1 and Box 12 (using Code 2) for an employee and on Form 1099-MISC, Box 7 for an independent contractor.

- Withholding taxes.

Employers are required to withhold income tax or income arising from violations of Code § 409A for the year of violation. Withholding of penalty taxes is not required.

V. Transition Relief Available in 2008.

The Internal Revenue Service has made available the following transitional relief for sponsors of and participants in NQDCs:

- **Change in Payment Elections.** A NQDC may provide or be amended before the end of 2008 for new elections as to the timing and form of benefit payments. In this event, participants must make new written elections before the end of 2008. Such elections cannot delay payments that would otherwise be made in 2008 or accelerate payments that would not otherwise be made this year.
- **Change Stock Options and Stock Appreciation Rights to Provide for Fixed Terms.** A stock option or stock appreciation rights arrangement, which was granted at an exercise price below fair market value on the grant date, is subject to Code § 409A. Such option or arrangement will comply with Code § 409A if it is amended before the end of 2008 to provide for a specific date on which it can be exercised.
- **Exchange Discounted Stock Options or Stock Appreciation Rights for Non-Discounted Awards.** A non-discounted option or stock appreciation award may be substituted for a discounted option or stock appreciation award which is not

subject to Code § 409A. There can be no payment made in connection with such an exchange. This relief does not apply to discounted stock options held by individuals who were subject to Section 16(a) of the Securities Exchange Act of 1934 at the time the options were granted.

- **Modify Good Reason Condition.** Under some circumstances, severance paid on account of an involuntary severance of employment is not subject to Code § 409A. Termination for “good reason,” as defined in the Code § 409A regulations, can constitute an involuntary severance of employment. Employment and severance agreements must be amended by December 31, 2008 to provide for termination for good reason in order to take advantage of this exception to Code § 409A.

If you have questions regarding Code § 409A, please contact Larry Sewell (ext. 7255) or Scott Hunt (ext. 7223) at 314-621-5070 or 800-243-5070.

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