

NEWS FOR NONPROFITS

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Now is the time to act: review bonus, severance, and deferred compensation arrangements for compliance with section 409A

Timothy D.S. Goodman

In October 2004, the American Jobs Creation Act amended the Internal Revenue Code to add section 409A, which imposes significant new requirements and restrictions on deferred compensation plans. Amounts deferred that fail to comply with section 409A are subject to a 20% penalty tax in addition to regular income taxes. In late December 2004, the Internal

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Revenue Service ("IRS") issued its initial limited formal guidance on section 409A (Notice 2005-1). The IRS has promised but not yet provided additional guidance. This article reviews section 409A and provides an action plan for employers.

Scope

Section 409A has a broad scope. Section 409A applies to:

- **Individuals.** Section 409A applies to all individuals, including employees and directors.
- **Plans.** Section 409A applies to any agreement, arrangement, or plan (including SERPs, SARs, and elective deferral plans) that defers compensation, even those covering one individual.
- **Deferred compensation.** Section 409A covers compensation ranging from bonuses to severance.

Notice 2005-1 generally indicates that if an employee has a legally binding right during a year to compensation not actually or constructively received in that year and the compensation is to be paid in a subsequent year, then the compensation will be deferred compensation subject to section 409A. There is a limited exception for compensation paid no later than March 15th of the subsequent year. Section 409A does not apply to tax-qualified plans (e.g., 401(k) plans), 403(b) plans, and 457(b) plans, but does apply to other plans and arrangements that

defer compensation. Examples include a bonus program that pays bonuses after March 15th of the following year or an employer funded deferred compensation arrangement for amounts that exceed section 457(b) (a 457(f) plan).

Effective date

Section 409A was generally effective as of January 1, 2005. Notice 2005-1 advises employers that until there is further guidance, employers are permitted to rely on a good faith, reasonable, interpretation of section 409A.

Requirements

Section 409A provides that deferred compensation must satisfy a number of requirements (or be subject to a substantial risk of forfeiture) to delay the date at which the compensation is included in income and subject to income taxes. The following four points summarize most of the requirements:

First, section 409A imposes a number of restrictions on when deferred compensation may be paid and on an employee's ability to accelerate or delay payment. Payment may only be made upon (i) separation from service (termination), (ii) disability, (iii) death, (iv) a specified date, (v) a change in ownership, or (vi) an unforeseeable emergency. Except in limited circumstances, payments may not be accelerated (e.g., no more 10% haircut payments). In addition, for payments based on certain events an employee may not

delay payment unless the election to delay distribution is made at least 12 months before the date the first payment was initially scheduled to be made and the first payment is delayed for at least five years from the original payment date. Section 409A also imposes an additional restriction on publicly traded companies. Such employers must delay payment upon a separation from service to a "key employee" (which includes up to 50 officers earning \$130,000 or more) until at least six months after the key employee's separation from service. Note: This restriction does not apply to tax-exempt employers.

Second, section 409A requires an employee's election to defer compensation to be made in the year preceding the year in which the employee performs the services that earn the compensation (with limited exceptions). For example, an employee must elect before December 31, 2005 to defer compensation paid in 2006.

Third, section 409A restricts an employer's ability to fund deferred compensation upon an adverse change in the employer's financial health or through an offshore rabbi trust.

Fourth, section 409A requires an employer to report deferred compensation on the employee's Form W-2 or Form 1099 for the year in which there is a deferral.

Transition relief

Notice 2005-1 provides limited formal guidance, but provides significant transition relief. The transition relief includes:

- **Time to amend.** Notice 2005-1 gives employers until December 31, 2005, to amend their deferred compensation plans to comply with section 409A. Because most deferred compensation arrangements require board action to amend them, for all practical purposes the amendment deadline is the last board meeting in 2005.
- **An opportunity to terminate plans.** Notice 2005-1 allows employers to terminate deferred compensation arrangements during 2005. The IRS has informally indicated that because plan termination is not a permitted distribution event, in the future an employee receiving a payment due to plan termination will be subject to the 20% tax.
- **An opportunity to make new elections.** Notice 2005-1 allows employers to provide employees with the opportunity to make new elections during 2005 with respect to amounts subject to section 409A. The plan must be amended to permit the election and the participant must make the election no later than December 31, 2005.

Overall, Notice 2005-1 offers employers significant and generous transition relief if they affirmatively act before December 31, 2005.

Tax-exempt employers

Prior to the enactment of section 409A, tax-exempt employers were already subject to the restrictions of section 457. The IRS has indicated that section 409A serves as an overlay on top of the already existing restrictions under section 457. Under section 457, unless deferred compensation

- (i) complies with the requirements under section 457(b) (457(b) plans) or
- (ii) is subject to a substantial risk of forfeiture under 457(f) (457(f) plans)

The deferred compensation is immediately included in income and subject to regular income taxes.

The statutory definition of "substantial risk of forfeiture" under section 457(f) is the same as used under section 409A. Therefore, the concern is that the IRS will apply the same standard to both sections.

Notice 2005-1 is significant for tax-exempt employers because it states that non-compete covenants do not constitute a substantial risk of forfeiture and that a substantial risk of forfeiture cannot be extended (i.e., rolling risks are not effective).

In addition, Notice 2005-1 indicates that generally an

employee is not able to elect to defer compensation subject to a substantial risk of forfeiture unless the amount received by the employee is materially greater (ignoring earnings). The IRS has informally indicated that this guidance is likely to be applied to section 457(f). Because many tax-exempt employers use a non-compete covenant to satisfy the substantial risk of forfeiture requirement under section 457(f), such an extension would have a significant impact on them. The IRS has indicated that it intends to issue guidance on section 457(f), but has not indicated when it will be issued.

Now is the time to act

Employers have four months left in 2005 to act. In general, if amounts deferred fail to comply with section 409A, the deferred compensation is included in income and is subject to penalty taxes, unless the amount is subject to a substantial risk of forfeiture. If you have not already done so, you should take the following actions:

- **Identify plans and programs potentially subject to section 409A.** First, employers should identify arrangements, agreements, and plans that may be subject to section 409A. Any that create a legally enforceable promise in one calendar year for payment in a subsequent calendar year is potentially subject to section 409A. Section 409A applies to a variety of arrangements not commonly thought of as deferred

compensation, including employment, separation, and change-in-control agreements; severance plans; and bonus, incentive compensation, and retention programs. Section 409A applies to individual arrangements as well as to plans. As noted earlier, section 409A not only applies to employees, but also to independent contractors and directors.

- **Review agreements, plans, and arrangements.** Second, employers should review all their plans for provisions that may need to be amended to comply with section 409A.
- **Consider special transition rules.** Third, employers should consider whether they wish to use or allow employees to use the transition relief rules available this year. Notice 2005-1 offers transition relief rules that are only available until the end of 2005.
- **Amend plans.** Finally, employers should prepare to amend their plans. In some cases, employers may wish to use section 409A to review the objectives of their deferred compensation plans. In any case, unless the IRS grants a further extension, employers must amend their plans no later than December 31, 2005. Because most plans require board action to amend the plan, amendments need to be adopted no later than the last board meeting this year. Some may require that the

employee affirmatively agree to the amendment and that may add time to the process. If an employer intends to adopt transition relief rules, the employer must allow some time after adoption to implement the rules.

Conclusion

The penalty taxes for noncompliance are substantial. Generally, the penalties fall on the employees (typically executives and professionals) covered by deferred compensation plans. An employer may expect employees faced with these penalties to make some demand on the employee. Employers should begin now to review their arrangements, agreements, and plans for compliance with section 409A.

IRS to audit 501(c)(3) bonds

Thomas D. Vander Molen

The IRS recently announced that it plans to commence an enforcement initiative sometime after October 1, 2005, to determine whether 501(c)(3) organizations are complying with applicable requirements when they borrow funds using tax-exempt bonds. The IRS initially plans to examine 30 to 40 bond issues that were issued in 1995 and 1996. Its primary focus will be on compliance with "private use" restrictions. Only a limited percentage of bond-financed facilities may be used in unrelated trades or business or leased to or

managed by private businesses or individuals. The IRS has received referrals and closing agreement requests indicating that this may be a problem area. The IRS expects exempt organizations to conduct periodic post-issuance compliance checks and to retain records relating to the use of bond-financed facilities to demonstrate compliance. Organizations concerned about noncompliance may request voluntary closing agreements, which generally are available from the IRS on terms better than those available in the event of an unfavorable audit.

Panel on the nonprofit sector makes its recommendations

Alysia Zens

The Panel on the Nonprofit Sector (the "Panel") released its final report on June 21, 2005. The Panel was formed in October 2004 at the encouragement of the U.S. Senate Finance Committee and is comprised of 24 nonprofit leaders. The Panel sought input from experts and organizations across the country and the final report recommends over 120 actions that nonprofits, Congress, and the Internal Revenue Service can take to strengthen the nonprofit sector's transparency, governance, and accountability.

Nonprofit organizations can demonstrate to the public their commitment to the highest standards of ethical operation by signing on to the final report (sign on form available on the Panel's website - see below). Over 125 organizations have already signed on to the report, including Minnesota organizations such as American Indian Services, Inc., the Archdiocese of Saint Paul and Minneapolis, the Otto Bremer Foundation, Community Support Programs, Inc., Families Moving Forward, Wingspan Life Resources, and the Minnesota Council of Nonprofits.

The Panel issued a press release that provided the following summary of the final report's proposals:

- To strengthen governance, charitable organizations should adopt, implement, and publicize audit procedures and policies on travel expenses, conflicts of interest, and whistleblower protection.
- To make financial information more reliable, Congress should require audits by charitable organizations with annual revenues of \$1 million or greater and an independent accountant's review for organizations with annual revenues between \$250,000 and \$1 million. Congress should also require mandatory electronic filing of charitable organizations' annual information returns (Forms 990), the IRS should improve the design and instructions for Forms 990,

and charitable organizations should have their CEOs or CFOs certify the accuracy of their information returns.

- To prevent abuse of charitable entities, Congress should establish clearer legal guidelines for donor-advised funds, supporting organizations, and participation by tax-exempt entities in potentially abusive tax shelters. Congress should tighten up rules and strengthen penalties to help prevent transactions that benefit donors, rather than the public.
- To ensure that non-cash contributions support charitable causes, rather than provide improper tax deductions for donors, Congress should establish clearer rules for valuing donated property and should mandate stricter guidelines for appraisals of land and other appreciated property.
- To address instances of excessive executive compensation, Congress should strengthen the penalties on board members who approve and executives who receive excessive compensation, the IRS should revise the Form 990 to make total compensation of executives clearer to the public and regulators, and charitable organization boards should approve executive compensation each year.

For more information, visit the Panel's website: www.nonprofitpanel.org.

IRS audits executive compensation

Timothy D.S. Goodman

The Internal Revenue Service continues to work on its initiative to contact tax-exempt employers regarding their compensation practices. The focus of the initiative is to curb excessive compensation. A news release regarding this initiative is available at the IRS web site: <http://www.irs.gov/newsroom/article/0,,id=128328,00.html>

The IRS audits are primarily examining the reasonableness of compensation paid. If the amount paid is not reasonable, then the amount may be subject to intermediate sanctions. In addition, the IRS audits have taken on a new significance with initial guidance from the IRS that non-compete covenants do not constitute a substantial risk of forfeiture under section 409A of the Internal Revenue Code. The IRS has informally indicated that this guidance is likely to be applied to section 457(f).

Tax-exempt employers may wish to take the following steps to review their executive compensation:

- Review the process used to set the level of executive compensation and whether it follows the best practices outlined in the regulations under section 4958.

- Review the documentation that supports that an executive's level of compensation is reasonable.
- Review the reporting of executive compensation on Form 990.
- Review the substantial risk of forfeiture requirement used in any arrangement (if the employer sponsors a deferred compensation arrangement subject to section 457(f)).
- Review the deferred compensation arrangements the employer offers, determine whether they are subject to section 409A, and amend as appropriate.

UBTI trap for the unwary – possibly devastating for charitable remainder trusts

Thomas D. Vander Molen

Who would think a passive investment in a real estate investment trust ("REIT") or a mutual fund (regulated investment company or "RIC") would create unrelated business taxable income ("UBTI")? Yet a relatively obscure provision in the Internal Revenue Code can produce that result.

Normally dividends, which is what one receives from a REIT or a RIC, and capital gains produced from the sale of shares in a REIT or RIC, are excluded from UBTI under sections 512(b)(1) and (5) of the Code, unless the shares are "debt-financed," and there is nothing in the REIT or RIC provisions of the Code to the contrary. But section 860E(b) of the Code, relating to real estate mortgage investment conduits ("REMICs"), provides that any holder of a residual interest in a REMIC that is subject to the tax on UBTI is treated as receiving UBTI to the extent of any "excess inclusion" income from the REMIC. "Excess inclusion" generally refers to the holder's share of the REMIC's taxable income in excess of at defined return that is based on market interest rates determined from time to time.

One might ask what this has to do with investments in REMICs and RICs. Code section 860E(d) provides that certain excess inclusion income of a REIT or RIC that owns a residual interest in a REMIC is allocated among the shareholders of the REIT or RIC in proportion to the dividends they receive and that any such allocated amount is treated as an excess inclusion, and therefore UBTI, of such a shareholder. It is fairly common for REITs to own residual interests in REMICs, and some RICs own shares in REITs or beneficial interests in REMICs.

Some exempt organizations with excess inclusion income will be able to avoid the tax on UBTI by using the annual \$1,000 "specific deduction" available in the computation of the tax on UBTI, but charitable remainder trusts face potentially devastating consequences from the receipt of UBTI, even if unwittingly through a REIT. Normally, charitable remainder trusts are not subject to federal income tax, but if a charitable remainder trust has any UBTI in a taxable year (as if it were subject to the tax on UBTI), it is subject to tax on all of its income, not just the UBTI. See Code § 664(c); Treas. Reg. § 1.664-1(c).

Contact our practice group representatives

Joseph M. Gaffney

Trusts and Estates, Charitable Giving
206 903 5448
gaffney.joe@dorsey.com

Timothy Goodman

Employee Benefits
612 340 2825
goodman.timothy@dorsey.com

Michael Iwan

Labor and Employment
612 340 5613
iwan.michael@dorsey.com

Stanley M. Rein

Tax, Trusts and Estates
612.340.2912
rein.stan@dorsey.com

Claire H. Topp, Chair

Nonprofit and Tax-Exempt Organizations
612.343.8278
topp.claire@dorsey.com

Thomas D. Vander Molen

Public Finance and Tax
612.340.2934
vander.molen.tom@dorsey.com

Alysia Zens

Trusts and Estates, Charitable Giving
612.752.7333
zens.alysia@dorsey.com

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Dorsey & Whitney LLP
Suite 1500
50 South Sixth Street
Minneapolis, MN 55402-1498