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AG COOP NEWS

A publication of the Agribusiness, Cooperative and Rural Electric group at Dorsey & Whitney LLP

TIME TO ACT: REVIEW BONUS, SEVERANCE, AND DEFERRED COMPENSATION ARRANGEMENTS FOR COMPLIANCE WITH SECTION 409A

By Timothy Goodman

The Internal Revenue Service ("IRS") is preparing final regulations that implement significant changes to the tax law that govern deferred compensation, and certain bonus, retention, severance, and even equity compensation arrangements. The scope of these regulations and the new tax law, section 409A of the Internal Revenue Code, is broad. They affect compensation paid to individuals ranging from officers to directors and independent contractors. Failure to comply with the new tax law may result in these officers, directors, and other individuals being required to pay a 20% penalty tax on the compensation in addition to regular income and employment taxes. Although section 409A generally was effective as of January 1, 2005, the IRS has given employers a transition period through December 31, 2007 to amend their arrangements to comply with section 409A. The IRS, however, is already requiring employers to report certain information relating to section 409A on Form W-2. Cooperatives and agribusiness entities, like other employers, should act now to review their arrangements (including employment, change-in-control, and severance arrangements) to determine if they are subject to section 409A and, if so, to amend the arrangements.

BACKGROUND

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. In late December 2004, the IRS issued Notice 2005-1, which provides the IRS's initial limited formal guidance for employers on how to comply with section 409A. Then, in late September 2005, the IRS issued proposed regulations on the substantive requirements for section 409A.

Although the IRS has not issued final regulations, because section 409A generally was effective as of January 1, 2005, employers should already be complying with section 409A as interpreted in Notice 2005-1 or in the proposed regulations.

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SCOPE

Section 409A has a broad scope.

- **Individuals**. Section 409A applies to all individuals; including officers, employees, directors, independent contractors, and partners (the regulations refer to these individuals as "service providers").
- **Employers**. Section 409A applies to all employers; including for profit corporations, nonprofit corporations, cooperatives, and governmental entities (the regulations refer to employers as "service recipients").
- **Plans**. Section 409A applies to a broad array of arrangements; including any agreement, arrangement, or plan (including SERPs, SARs, and elective deferral plans) that defers compensation, even those covering one individual.
- **Compensation**. Section 409A applies to certain compensation when the employer enters into the legally binding right with the individual to pay the individual the compensation in a subsequent year and the individual includes the compensation in income in that subsequent year.

There are a number of exceptions to the scope of section 409A, which are helpful but make it more difficult for an employer to determine when compensation is subject to section 409A. The exceptions include:

- Compensation paid within a short period of time after the end of the employer's or individual's tax year (the short term deferral exception). If an employer and individual both have calendar tax years, then the compensation must be paid not later than March 15 of the following year to qualify for this exception.
- Property transfer arrangements under section 83 of the Internal Revenue Code (which governs the transfer of property for services).
- Stock option arrangements that value the stock at fair market value (provided certain other requirements are satisfied).
- Severance arrangements that pay less than $5,000 and/or pay for reasonable outplacement services, moving expenses, and medical expense reimbursement; provided the payments are made for only a limited period of time.
- Tax favored retirement plans; including 401(k) plans, profit sharing plans, defined benefit plans that satisfy section 401(a), and 403(b) and 457(b) plans.

This list provides an overview of the significant exceptions; there are other exceptions and employers need to confirm that an exception applies.

REQUIREMENTS

Section 409A provides 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 many 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, neither an employer nor individual may accelerate payment to an individual (*e.g.,* no more 10% haircut payments). In addition, for payments based on certain events, an individual may not delay payment unless the election to delay distribution is made at least 12 months before the date the first payment was originally 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 to an individual who is a "key employee" (which for 2006 includes up to 50 officers (or more) who earned $135,000 or more in 2005) based on the individual's termination of employment until at least six months after the key employee's separation from service.

Second, section 409A requires an individual's election to defer compensation to be made in the year preceding the year in which the individual performs the services that earn the compensation (with limited exceptions).

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

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

TRANSITION RELIEF

The IRS has given employers transition relief through the end of 2007. The transition relief includes:

- **Time to Amend**. Employers have until December 31, 2007 to amend arrangements subject to section 409A to bring them into compliance.
- **An Opportunity to Make New Elections**. Employers may allow individuals who have made elections regarding when deferred compensation will be paid to make new elections in 2007.

GRANDFATHERED AMOUNTS

The IRS guidance indicates that if (i) an individual had a legally binding right to deferred compensation on or before December 31, 2004, and (ii) the right to the deferred compensation was "earned and vested" no later than December 31, 2004, then generally that deferred compensation is not subject to section 409A; in effect, that deferred compensation is a grandfathered amount and subject only to the prior rules governing deferred compensation. A grandfathered amount, however, may become subject to section 409A if the employer makes a material modification to the grandfathered amount. A material modification is a materially enhanced or new material benefit or right added to a grandfathered amount. Before amending an arrangement to comply with section 409A, an employer should determine whether it desires to preserve the grandfathered amount or, if due to administrative concerns, the employer desires to amend the plan.

ACTION STEPS

Employers should begin acting now to comply with section 409A. Cooperatives and agribusiness entities should take the following steps now with respect to their arrangements:

- **Identify arrangements**. Employers should identify any arrangement that creates a legally enforceable promise in one year for payment in a subsequent year. In addition to arrangements traditionally thought of as deferred compensation arrangements, employers should review employment agreements, change-in-control agreements, separation agreements, severance plans, bonus and incentive compensation programs, and retention programs.
- **Review arrangements**. Employers should review the arrangements potentially subject to section 409A to determine whether they need to be amended.
- **Consider the transition relief**. Employers should consider the transition relief.
- **Determine design for arrangements**. Employers need to consider how to structure their arrangements.
- **Amend arrangements**. Employers must amend their plans no later than December 31, 2007. This date applies both to transition rules amendments and to the amendments that must be made to comply. Because most plans only allow the Board of Directors to amend the plan, employers need to be prepared to adopt amendments no later than the last Board meeting this year. In addition, some arrangements require that the individual also approve or consent to the amendment.

The IRS is expected to issue final regulations soon. Although the final regulations have not been issued, an employer should take action now so that it is prepared to amend its arrangements.

CONCLUSION

Cooperatives and agribusiness entities should act now to review their deferred compensation and equity award arrangements, and employment and other agreements with individuals to determine if they are subject to section 409A. Cooperatives and agribusinesses must act to bring the arrangements into compliance before the end of this year.

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WISCONSIN ADOPTS SECOND COOPERATIVE STATUTE: THE WISCONSIN COOPERATIVE ASSOCIATIONS ACT

By Doug Paul

The State of Wisconsin has joined a handful of other states in adopting a flexible alternative to the traditional cooperative statute. The Wisconsin State Legislature passed the new statute with bi-partisan support and Governor Jim Doyle signed it into law.

The new statute is a "hybrid" cooperative statute that borrows many features from limited liability company laws. It is hoped the statute will lead to the creation of additional cooperatives under Wisconsin law, notably those cooperatives that require a large commitment of up-front capital that patron members often do not have access to, such as value-added processing facilities and ethanol plants. The new statute is of general applicability and is suitable for use by many different businesses, not only agricultural business.

The first new such hybrid statute was the Wyoming Processing Cooperative Law, adopted in 2001. Since then, Minnesota (2003), Iowa (2005), and Tennessee (2005) have adopted similar statutes. A common feature of these new statutes includes the ability of investors to be non-patron members of the cooperative as a means to provide an additional source of equity capital for a cooperative.

The existing Wisconsin cooperative statute, codified at Chapter 185 of the Wisconsin statutes, has not been replaced. The new statute, codified at Chapter 193 of the Wisconsin statutes, will serve as an alternative host statute in certain circumstances. This new statute provides formation alternatives to cooperatives, but does not require implementation of all such options in a cooperative's bylaws.

THE NEW CHAPTER 193

Chapter 193 authorizes the formation of an unincorporated cooperative association upon the filing of articles with the Wisconsin Department of Financial Institutions. Highlights of Chapter 193 include:

Members

- A Chapter 193 cooperative must have at least one patron member. If any patron member is an individual (rather than another cooperative or other business entity) then the cooperative must have at least five patron members who are individuals.
- Chapter 193 authorizes non-patron membership interests, most likely an investor-member, that may have voting rights if authorized in the articles or bylaws. Collectively, the patron membership interests must have rights to at least 51% of the profit allocations and distributions of the cooperative. However, the patron members may authorize that the required 51% be a lower amount, but not less than 30%, of the profit allocations and distributions of the cooperative.
- If voting rights are granted to non-patron members, the collective voting rights of patron-members may not be reduced to less than 51% of total member voting power. The collective vote of the patron members is determined by a majority vote of the patron members voting on the matter. Chapter 193 allows, if authorized in the articles or bylaws, patron members to have an additional vote in certain circumstances in determining the collective vote.
- Unless the cooperative's articles or bylaws otherwise provide, a non-patron member may force the cooperative to buy the non-patron member's interest if the articles or bylaws are amended in a way that materially and adversely affects the non-patron member's rights and preferences.

Board of Directors

- The directors elected by the patron members must have at least 51% of the voting power on "general" matters of the cooperative. In addition, the patron member directors vote must be voted as a bloc, as determined by a majority vote of the patron member directors. This ensures the patron membership controls routine issues facing the cooperative.

However, it also will allow non-patron interests to essentially have a veto right on "non-general" or special matters of the cooperative. The bylaws of such a cooperative may specify certain matters that will require the consent of the non-patron interests.

- The patron members may also elect an outside director who is an expert in financial matters but does not possess a financial interest in the cooperative. Such a director may not vote unless the articles or bylaws authorize voting rights for the outside director.
- All directors must, at least annually, attend a course given by a "recognized provider of cooperative director education" on at least two out of eleven topics mandated in Chapter 193. As with the establishment of an audit committee, this requirement is an added expense a start-up cooperative must consider.
- Chapter 193 requires that the cooperative establish an audit committee to ensure an independent review of the cooperative's finances is conducted. The board of directors must ensure audited financial statements (or unaudited, if authorized by the articles or bylaws) are given to the members.

Entity Conversion

- Chapter 193 allows existing businesses to elect to convert into a Chapter 193 cooperative. However, a Wisconsin cooperative formed under Chapter 185 may not convert into a Chapter 193 cooperative, either directly or indirectly with a business entity formed outside of Wisconsin.

Tax

- A cooperative formed under Chapter 193 is an unincorporated association, and similar to a limited liability company, may elect to be taxed as a partnership under Subchapter K of the Internal Revenue Code, or as a cooperative under Subchapter T. Partnership taxation (with single tax pass through treatment) may be preferable if a cooperative will be conducting non-patronage sourced business that would otherwise be subject to corporate double-taxation.

THE FUTURE OF COOPERATIVES UNDER CHAPTER 193

Other states with hybrid cooperative statutes have had moderate success. About 17 new cooperatives have formed under the Minnesota statute. To date, we are aware of one cooperative forming under the Tennessee statute and we are not aware of any forming under the Iowa statute. At least one new cooperative has already been formed under Chapter 193.

A new cooperative forming under Chapter 193 must also consider the potential impact of a flexible structure. Although a new entity may use the term "cooperative" in its name, it may also lose many benefits of forming as a traditional cooperative. A traditional cooperative may be eligible for a Capper-Volstead anti-trust exemption or a 521 tax-exempt status. However, if adopting a flexible structure, a new cooperative may find itself denied such benefits. For example, a Capper-Volstead cooperative can completely lose its anti-trust exemption if a single member is not a producer of agricultural products. Additionally, potential members of a newly formed cooperative may resist joining a hybrid cooperative, preferring the model and operation of a traditional cooperative.

However, Chapter 193 offers flexibility, but does not mandate a cooperative forming under it use all the available features. We have worked with numerous cooperatives that formed under the new Minnesota statute, but have maintained traditional cooperative principles. Chapter 193 may be appropriate for cooperatives that require additional up-front capital and do not require certain cooperative benefits, such as the Capper-Volstead anti-trust exemption.

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