

## GENERAL SUMMARY OF SECTION 409A OF THE INTERNAL REVENUE CODE

Section 409A was added to the Internal Revenue Code in 2004 to address congressional concerns about perceived abuses with respect to nonqualified deferred compensation programs for corporate executives. Section 409A accordingly contains stringent new rules governing deferred compensation payments. The rules are quite broad and apply not only to executive compensation but also to deferred compensation paid to any "service provider" that is earned one year and not paid until a future year.

The consequences of violating these rules are harsh and are borne by what the law refers to as the "service provider," i.e., employees, and independent contractors and consultants that provide services to a "service recipient", e.g., an employer. If the rules are not satisfied, then all deferred payments must be included in the service provider's taxable income for the year in which the right to payment is no longer subject to a substantial risk of forfeiture (i.e. vested), even if the service provider does not receive the payment in that year. In addition, the service provider must pay a 20% penalty of that amount, together with interest on that amount from the date it should have been included in the service provider's taxable income. Section 409A does not impose a tax or penalty on the service recipient (the "employer") for the failure to comply with Section 409A.

The rules in Section 409A are extremely complex, but in essence, they require that any payments that constitute deferred compensation be paid only upon the occurrence of one of a specific number of events, and that the service provider's ability to change the timing of such payments be severely restricted. The events upon which payment is permitted include separation from service from the service recipient for which the service provider performs services, death, disability, unforeseeable emergency, change of ownership of the service recipient for which the service provider performs services, and a specific time or schedule which is fixed and set forth in writing at the time of deferral. This list is comprehensive and any individual arrangement covered by Section 409A could include all or only one of these possible payment events.

Another requirement of Section 409A is that an arrangement must be set out in a written plan document. Although the IRS has required good-faith compliance in the operation of such arrangements since January 1, 2005, the deadline for compliance in written plan document form is December 31, 2008. If the written documents comprising the arrangements do not comply with Section 409A, appropriate amendments to the documents must be made before December 31, 2008. If such amendments are not made, the service providers benefiting from the arrangements will be subject to tax on the payments received, the 20% penalty, and the interest referred to above.

The terms of the State Farm Agent's Agreement – Form AA3<sup>4</sup> create a deferral of payments that is subject to the rules of Section 409A. As such, the proposed amendment offered by State Farm is appropriate in light of the requirement that the terms of the State Farm Agent's Agreement – Form AA3 be amended in writing to comply with Section 409A by December 31, 2008.

The terms of the State Farm Agent's Agreement – Form AA97 also create a deferral of payments that may be subject to the regulations under Section 409A. As such, the proposal offered by State Farm is also appropriate.

The foregoing summary has been prepared for the National Association of State Farm Agents (the "Association") and not for any particular member of the Association. The summary does not set forth a comprehensive analysis of the application of Section 409A of the Internal Revenue Code to the specified agreements or any other compensation agreements and does not constitute an opinion that can be relied upon for tax reporting purposes or any other purpose. Without the advance written consent of the preparer of the summary, the summary may not be: (a) used or relied upon by, or quoted, or delivered to, any other person; (b) reproduced or filed publicly; or (c) used or relied upon for any purpose other than as a general overview and summary of Section 409A and its likely application to the specified agreements.

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