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“Deferred Compensation” Rules Are Finalized



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As a response to circumstances at Enron and other

perceived abuses in the area of executive compensation, Congress enacted a comprehensive regulatory framework in the area of nonqualified deferred compensation, generally effective as of January 1, 2005. The provisions are contained in Section 409A of the Internal Revenue Code and provide rather harsh sanctions for their violation – immediate taxable income (even if there is no right to payment for many years), a 20% penalty tax, and interest – all imposed on the employee or other service provider.

What is “Deferred Compensation”?

Although generally referred to as dealing with “deferred compensation,” the 409A rules extend far beyond what many of us think of as traditional deferred compensation. Indeed, any compensation arrangement may be subject to the rules if an employee or other service provider receives a binding legal right to compensation in one year but does not actually receive the compensation until a subsequent year. This even

includes situations where the binding promise is subject to conditions (risks of forfeiture) that could prevent payment from ever being made. The rules apply to employees, independent contractors and all other service providers.

Arrangements that are, or may be, subject to 409A include:

- Deferred Compensation Plans
- Restricted Stock Units
- Employment Agreements
- Expense Reimbursements
- Supplemental Employee Retirement Plans and Excess Plans
- Income Continuation Arrangements
- Incentive Plans
- Severance Agreements
- Bonus Plans
- Phantom Stock Plans or Awards
- Commission Programs
- Consulting Agreements
- Equity Awards, including Nonqualified Stock Options and Stock Appreciation Rights
- Split-Dollar Life Insurance
- Change of Control Agreements
- 401(k) Mirror or Wrap Plans

Effective Dates and Required Actions

On April 10, 2007, the Internal Revenue Service issued final regulations under 409A, effective

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New Business Court in Hillsborough County



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Hillsborough County state circuit court recently created a

new division. The new division, called “the Complex Business Litigation Division (CBLD),” handles only complex business cases and is modeled after Orlando’s state circuit business court, created in 2003.

The CBLD has mandatory jurisdiction to handle certain complex business cases, regardless of the amount in controversy, such as cases dealing with (1) the internal affairs of business entities, (2) trade secrets and noncompete agreements, (3) intellectual property, (4) securities, (5) antitrust, (6) shareholder derivative actions, and (7) corporate trust affairs or director and officer liability. Additionally, the CBLD will handle other types of complex business cases where the amount in controversy is greater than \$75,000, such as: (1) non-consumer Uniform Commercial Code transactions, (2) sales of businesses, (3) non-consumer bank or brokerage accounts, (4) the sale or lease of commercial property and security interests within such property, (5) commercial surety bonds, (6) franchise relationships, (7) malpractice claims relating to services rendered to businesses

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New Business Court continued...

(other than claims against health care providers), (8) business torts, (9) complex construction litigation, (10) certain insurance actions, and (11) other complex commercial disputes.

The first judge assigned to the CBLD, the Honorable Richard A. Nielsen, was a commercial business litigation attorney before becoming a judge, and has an expertise in this specialized area of the law. In addition, the rules of the court recognize the nature and complexity of commercial disputes. Thus, the CBLD will have an advantage over the previous procedure of having such cases handled in the regular circuit civil division. Furthermore, cases in the CBLD will be assigned to a "track," which sets a trial date for each case within a specified number of months from the filing of the complaint, which is similar to the procedure utilized in the federal courts.

One possible disadvantage of the CBLD, may be an increase in the time and expense of litigating these types of cases. Traditionally, it cost less to litigate in state courts than in federal courts because state courts utilize less formal procedures than federal courts, particularly for motions where, in state court, accompanying briefing is not required. Procedurally, cases within the CBLD will be treated more like federal cases. For example, in the CBLD certain types of motions must be accompanied by a memorandum of law. To mitigate costs, in the CBLD some motions will be decided based solely on the papers submitted, without the opportunity for a hearing.

Only time will tell if the advantages of the CBLD outweigh any potential disadvantages. Either way, business courts such as the CBLD appear to be the wave of the future and we can expect to see more of these courts in other Florida counties. ■

Deferred Compensation Rules continued...

January 1, 2008. Existing arrangements may need to be amended prior to this effective date in order to comply with the regulations on a prospective basis.

In addition, although the final regulations are effective on January 1, 2008, affected persons have been required to administer existing arrangements since January 1, 2005 in accordance with a good faith interpretation of the law and any currently outstanding official guidance. Generous "transition" rules under the proposed regulations and other IRS guidance will allow many existing plans and deferral elections to be revised and/or reduced to writing by December 31, 2007 in order to bring them to compliance retroactive to 2005.

Timely action is important. In order to meet the applicable time deadlines, employers may be required to draft and distribute employee communications and election materials significantly in advance of December 31, 2007. Computer programs relating to the administration of the arrangements may also need to be revised before then.

Therefore, the sooner you attempt to move forward with the resolution of any issues, the more likely you will be able to meet the deadline and the easier the implementation process should be. First, you should try to identify all arrangements that may include deferred compensation. Second, you should make a list of all of the issues and decision points within the relevant plans that must be resolved and then determine how you are going to deal with each issue. Plans or agreements that were previously reviewed or drafted under the proposed regulations should be revisited and considered under the final regulations. Third, you need to

complete any appropriate communications with employees and obtain any required elections from them. Fourth, you need to update and execute plan documents. All four of these steps must be completed by December 31, 2007. In addition, you will need to develop a process so that covered arrangements that are adopted in the future will be compliant.

The Final Regulations – Some Key Changes

A review of the entire scope of the final regulations is not possible within this newsletter, but we have highlighted below a few welcome (in the most part) clarifications and additions.

1. Stock Rights. The final regulations provide that the exercise period for a stock right (a nonqualified stock option or a SAR) may be extended without losing an exemption under 409A if the exercise period is not extended beyond the earlier of the original maximum term of the stock right or 10 years from the original grant date. This modification will be very useful for employers who desire to allow the exercise period for a terminated employee to be extended beyond the typical 90-day period following termination of employment. Such an extension was not permitted under the proposed regulations. Other changes in the final regulations deal with the nature of the stock that may underlie these arrangements.

2. Timing of Payments. Arrangements subject to 409A must specify the form and timing of payments. And, once fixed, payment dates cannot be accelerated as a general rule. Under the final regulations, additional flexibility was added — payments will be considered made on a specified payment date if

payment is made not earlier than 30 days before the specified date and not later than the last day of the calendar year in which the specified payment date occurs, or if later, the 15th day of the third month following the specified payment date (provided that the employee is not permitted to select the taxable year of payment).

Also, specific rules were added that will permit many common expense reimbursements, indemnification provisions, and tax gross-up provisions to comply with the fixed schedule requirement.

3. Separation Pay. Section 409A allows for certain severance arrangements to be exempt entirely from 409A. The rules relating to this exception were significantly revised. One should remember, however, that qualifying for the exception is only one way to avoid the negative tax consequences that can be imposed under 409A on a severance arrangement. Even if the requirements for the severance pay exemption are not met, a severance arrangement can still be structured to comply with 409A and avoid the negative tax consequences.

Consistent with the proposed regulations, a severance agreement will not, as a general matter, be subject to 409A if: (1) the employee is involuntarily terminated, (2) the dollar amount of separation pay does not exceed twice the dollar amount of the employee's annual compensation or, if less, \$450,000, as indexed to inflation, and (3) all payments are made no later than the end of the second year following termination of employment.

The final regulations expanded the severance pay exception to allow certain employees who are

terminated for good reason to be deemed to have involuntarily terminated employment. However, employers should be cautioned that many existing good reason provisions will not qualify under the final regulations and will require modification to take advantage of this exception.

The final regulations also allow severance arrangements to be bifurcated so that payments up to the specified dollar limits can be exempt from 409A with only the excess amounts being subject to 409A. Among other things, this revision should allow severance pay packages to be structured so that public company specified employees will be entitled to receive some compensation within the six-month blackout period after separation from service.

There is a trap for the unwary in dealing with establishing severance arrangements. The IRS has been concerned that employers might try to "convert" benefits under a previously existing deferred compensation plan into benefits under a severance arrangement. The final regulations expand upon and emphasize the concept that if a severance arrangement essentially replaces amounts under a previously existing deferred compensation plan, the severance agreement will be deemed to be an amendment to the existing deferred compensation plan rather than a new severance arrangement. As a result, not only will the severance exception not be available but an impermissible change to the payment schedule of the existing arrangement may result, thus triggering the negative tax consequences under 409A. This provision can be expected to limit the flexibility of severance negotiations.

The author, Thomas A. Sutton is admitted to the Wisconsin Bar, but is not yet admitted to The Florida Bar. ■

Medicare Fraud and Abuse in the Diagnostic Testing Industry Leads to Greater Regulation



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Medicare, as the largest payer of

healthcare expenses in the country, continues to target wasteful spending, particularly claims for healthcare services it deems unnecessary or fraudulent. A recent example of these efforts is the addition of fourteen new supplier standards that independent diagnostic testing facilities ("IDTFs") must comply with in order to participate in Medicare.

IDTFs are facilities that provide diagnostic testing, such as MRIs, and that are not primarily physician practices or hospitals. The new standards stem from a report by the Office of Inspector General ("OIG"), the office within the Department of Health and Human Services responsible for preventing abuse of the Medicare system. The report, issued in June 2006, was based on an audit performed on a sample of claims submitted by IDTFs in 2001. OIG found that out of 1,804 claims for services included in the audit, 1,231 (68%) did not comply with applicable laws, regulations, and guidelines. Of those, 546 claims were found to be not reasonable or necessary under the Medicare guidelines. A mere fifty-five patients accounted for 1,095 of the questionable 1,231 services performed, averaging some 20 tests per patient. Even more disturbing, 102 claims contained physician names who told OIG they had no knowledge of the patients involved and had not ordered the testing.

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Medicare Fraud continued...

The new regulations target a group of IDTF characteristics found to be common among entities that have billed improperly or fraudulently. One IDTF problem area was a failure to report changes in equipment used, types of tests offered, types and number of technicians employed, or ownership changes. In several cases, the IDTFs failed to report a change in location or business closure, and in fact OIG could not find six of the IDTFs, making it difficult to determine if an IDTF is operating in a manner that meets the minimal requirements, or even if the facility is safe for patients.

In an attempt to curb abuses, the Centers for Medicare and Medicaid Services ("CMS") issued new regulations effective January 1, 2007. Among them is the requirement of a physical location that is accessible to both the public and CMS. Each IDTF must maintain a fixed physical location that provides for adequate storage of patient records, adequate hand washing, provides for patient privacy, and includes the equipment necessary to perform the tests it bills to Medicare. A mobile unit, such as mobile MRIs, must maintain a fixed location as well, meaning the owner will need to own or lease space in a building.

The new regulations impose additional requirements targeting suspected abuses. For example, all IDTF technical staff must have

proper credentials to perform the tests as well as proper training on the equipment, and the IDTF must maintain the calibration of all testing equipment according to manufacturer standards. While most providers are obligated to notify CMS of changes in information on their enrollment applications within 90 days following a change, the new regulations require that IDTFs notify CMS within 30 days of a reportable change. In addition, the IDTF must disclose the name of any person with an ownership, financial, control, or other legal interest in the entity.

Perhaps the biggest change required by the new regulations, and one stemming directly from OIG's recommendations to CMS, is the requirement that Medicare payers must conduct an on-site inspection of IDTF facilities, including any mobile units, in addition to a paper review of the IDTF's application.

Additionally, after the initial application, the carrier may conduct unannounced on-site inspections at any time, further pressuring IDTFs to maintain compliance at all times rather than only at the time of renewal.

While these requirements impose potentially significant new burdens on IDTFs, indications are that CMS has further abuse regulations under consideration. In February, CMS issued, and then quickly

rescinded, a transmittal changing the Medicare Program Integrity Manual as it applies to IDTFs. Included was a prohibition on IDTFs sharing equipment or space with any other Medicare provider. Given that many IDTFs are housed within the same building as other providers, this prohibition could have proven costly if not impractical. The transmittal also would have required that all technologists be full-time employees of the IDTF, meaning independent contractors or part-time employees would not suffice. Further, a supervising physician, rather than being responsible only for the clinical operations of the IDTF, would become responsible for its overall management as well. While this transmittal has been rescinded, it is expected that many of these requirements will ultimately be issued in some form.

Because the new standards are now in full force and effect, IDTFs should conduct a self-audit to determine whether they are currently meeting all of the requirements that have been mandated. IDTF owners and operators should also watch for future pronouncements from the OIG and CMS, which are sure to come. ■

If you have questions or concerns about any of these topics please call 813-223-7474 or contact the author directly.

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