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Revised Deferred Compensation Rules

To: Clients and Friends of Tannenbaum Helpern Syracuse & Hirschtritt LLP

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The American Jobs Creation Act of 2004 (the “Act”) signed by President Bush on October 22, 2004 significantly revised the tax rules which are applicable to nonqualified deferred compensation plans. The Act adds a new Section 409A to the Internal Revenue Code which includes specific rules regarding permissible events triggering deferral distributions, the timing of deferral elections and funding methods. The IRS is required to issue guidance on the new rules no later than December 21, 2004.

The new rules eliminate a great deal of flexibility in the structuring of deferred compensation arrangements.

Distributions. Under the new rules, deferred compensation may be distributed only upon the following trigger events:

- (a) separation from service,
- (b) death,
- (c) the date a participant becomes disabled (as specifically defined under the Act),
- (d) a specific time or pursuant to a fixed schedule established at the time of deferral,
- (e) a change in the ownership or effective control of the employer to the extent provided in future Treasury regulations, or
- (f) an “unforeseeable emergency” (as defined under the Act).

In addition, distributions may not be subject to acceleration except as provided in future Treasury regulations.

Timing. An election to defer will need to be made before the end of the tax year *preceding* the year in which the services attributable to the compensation are performed, or, with respect to a

newly-eligible participant, within 30 days of eligibility to participate in the deferred compensation arrangement. However, if the election is with respect to performance-based compensation covering a period of at least 12 months, the election can be made as late as 6 months before the end of that period. This last time is exceedingly important to many investment management clients.

Deferring the Deferral. A subsequent election to delay the timing or form of payment of deferred compensation is allowed under the Act if certain rules are followed. Any such election cannot be effective until at least 12 months after the date on which the election is made. Also, if such election relates to payments which are not triggered by death, disability or an unforeseeable emergency, any additional deferral election must be for a period of at least 5 years from the date the payment otherwise would have been made. Finally, elections changing a specified payment date must be made at least 12 months prior to the first scheduled payment date.

Funding. If assets become (or may become under the deferral plan) set aside for the payment of deferred compensation upon a change in the employer's financial health, then the compensation is taxable upon vesting, even if the assets remain subject to the claims of the employer's general creditors. Accordingly, under the Act, a plan which provides that a rabbi trust will become funded upon a change in the employer's financial health will trigger current compensation even if the funding event never occurs. The Act also penalizes the use of offshore trusts to fund deferred compensation unless substantially all of the services are performed in the same jurisdiction as the trust.

Reporting. The Act requires that employers report annually on an employee's Form W-2 the total amount of compensation deferred by the employee.

If the new rules are not complied with in form or operation with respect to a specific participant, all amounts deferred and vested (and any earnings thereon) will be taxable to that participant immediately, rather than at the deferred payment date. In addition, a 20% penalty tax and interest assessments will apply to deferred compensation that is not paid in accordance with Section 409A.

In general, the new rules will apply to amounts deferred with respect to services performed after December 31, 2004. However, amounts previously deferred and not yet vested as well as amounts deferred under plans materially modified after October 3, 2004 will also be subject to the new rules. Material modifications do not include modifications made to comply with the new rules with respect to post-2004 deferrals. Accordingly, a deferral plan should not be modified other than to comply with the new rules without serious consideration.

All employers are urged to now begin reviewing all of their deferred compensation arrangements and consider preparing the necessary plan amendments to comply with the new rules under Section 409A.

Please call David Schulder at (212) 508-6715 or Michele Gibbs at (212) 508-6732 if you would like more information on this matter.

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