

December 8, 2005

Deferred Compensation/December 31, 2005 Deadlines Under Section 409A

Hedge funds and other employers which sponsor deferred compensation (or deferred fee) arrangements know that Internal Revenue Code section 409A has radically changed all the rules, starting in 2005. Failure to comply can accelerate tax and add a 20% penalty on top of regular tax, so timely compliance is critical.

Most employers can wait until the end of 2006 to formally amend their deferral documents, although employers must try in good faith to follow the new rules even before documents are formally amended. For example, employers may need to change now the deferral election forms which employees use in December 2005 to make deferrals out of salary, bonus and fee compensation for 2006.

December 31, 2005 is an opportunity deadline for some section 409A purposes -- some changes can be made in 2005 that simply cannot be made in 2006. In particular, action by December 31, 2005 may be useful in the following cases:

- Employers can give employees a chance to change old deferral elections -- both as to the time and form of payment. However, the changes must be made in 2005 if the purpose is to delay a payment otherwise due in 2006 or to accelerate into 2006 a payment otherwise due in a later year.

Changes to time and form of payment under old elections may still be made in 2006, but changes made in 2006 can only be applied to payments due in later years, and cannot accelerate those payments into 2006.

- Deferral arrangements can be terminated in 2005 without having to comply with any of the new section 409A rules; termination payments and required documentation would have to be completed in 2005. Under many deferral

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documents, a termination which accelerates existing deferrals would require mutual consent of employer and employee, and the section 409A rules allow employees to be given an opportunity to consider a 2005 termination on this basis. Employers can be selective in using the 2005 termination rule -- the employer can pick and choose among employees and does not have to terminate all of the deferrals applicable to any selected employee.

After 2005, old arrangements can still be terminated in a way that will allow accelerated payouts, but (i) the arrangement will first have to be amended to comply with section 409A, (ii) the termination payments must be made within a 12-month termination window starting one year after the termination date, and (iii) the employer will have to wait 5 years before starting a new deferral arrangement of the same type. In addition, terminations after 2005 must be applied to all arrangements of the same type and to all employees participating in those arrangements -- no more opportunity to pick and choose among employees and/or arrangements. (When plans are restated for section 409A, it may be desirable to include a provision that allows the employer to terminate and accelerate payout.)

Participants may lose grandfathering treatment (total exemption from section 409A) merely by being offered an opportunity to change grandfathered elections, so these year-end 2005 opportunities need to be considered carefully. (In general, payments are grandfathered from section 409A if vested by December 31, 2004 under arrangements in place by October 3, 2004.) Section 409A can limit the ability to modify the employer/employee business deal as circumstances change, but many employers have nevertheless decided to modify (rather than terminate) their non-qualified deferral arrangements despite the possible lack of future flexibility.

The rules and deadlines for section 409A compliance are generally set out in interim guidance, and the Internal Revenue Service may well change the rules and/or extend some of the deadlines. For now, employers should assume that the Service will not change the described deadlines for December 31, 2005 action.

If you have not given any thought to section 409A compliance -- the situation is probably urgent and you should call ASAP! If you want to discuss year-end planning opportunities or section 409A compliance generally, please call any member of the Paul, Weiss Tax Department. Lawyers who have focused intensively on section 409A include: Richard J. Bronstein (212-373-3744); Robert C. Fleder (212-373-3107); Tristan M. Brown (212-373-3573); Stephanie R. McCavitt (212-373-3558); and Michael J. Segal (212-373-3364).

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