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Deferred Compensation Legislation Impacts Mutual and Hedge Funds

On October 11, 2004, the Senate gave final approval to the American Jobs Creation Act (the "Act"). The Act was passed by the House of Representatives on October 7, 2004 and was signed into law by President Bush on Friday, October 22, 2004.

The Act affects all nonqualified deferred compensation arrangements, including the nonqualified deferred compensation arrangements and deferred fee arrangements of directors, officers and other employees of investment advisers to hedge funds. Nonqualified deferred compensation plans (the "Plans"), as defined by the Act, include "any plan that provides for the deferral of compensation, other than (i) a qualified employer plan, and (ii) any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan."

The Act sets forth new requirements regarding distributions from Plans, acceleration of benefits and elections to defer compensation. In general, the only types of events that may trigger a payment from a Plan are (i) separation from service, (ii) disability, (iii) death, (iv) a time specified in the Plan (or pursuant to a fixed schedule) at the date of the deferral of compensation, (v) a change in the ownership or effective control of the adviser, or (vi) the occurrence of an unforeseeable emergency. A Plan may not permit acceleration of the time or schedule of any payment under the Plan, except as provided in regulations. Plan participants must make such a deferral election in the taxable year prior to the taxable year in which compensation for services will be earned.

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If at any time a Plan fails to meet the distribution, acceleration of benefits and election requirements, all compensation deferred under the Plan for the taxable year and for all preceding taxable years will be includible in the Plan participant's gross income for the current taxable year.

In addition to the deferred compensation being included in the Plan participant's gross income for the current taxable year, the tax imposed is increased by the sum of:

- 20 percent of the compensation that is required to be included in gross income, and
- interest at the underpayment rate plus 1 percent on the underpayments that would have occurred had the deferred compensation been includible in gross income for the taxable year in which first deferred or, if later, the first taxable year in which such deferred compensation was not subject to a substantial risk of forfeiture.

The Act also imposes new requirements on the funding of trusts for the purpose of paying deferred compensation under a Plan. If assets are set aside in a trust outside of the United States for the purpose of paying deferred compensation under a Plan, the Act treats such assets as property transferred to the Plan participant in connection with the performance of services for purposes of Section 83 of the Internal Revenue Code. The Act also contains provisions aimed at eliminating the funding of Plans through the use of so-called "rabbicular trusts" or "springing trusts." Violation of the funding requirements will similarly cause immediate taxation along with a 20 percent penalty and interest.

Finally, the Act requires that deferred compensation be reported on an individual's

Form W-2 (or Form 1099) in the year in which deferrals are made.

The Act generally affects compensation deferred after December 31, 2004. However, the Act also affects amounts deferred under a Plan that is materially modified after October 3, 2004. Therefore, all hedge fund managers who have established or are contemplating establishing Plans should review those Plans and amend or modify them as necessary as soon as possible to avoid immediate taxation of compensation that is intended to be deferred.

However, recognizing that it has given employees and employers a very short time in which to come into compliance with the new tax law, Congress directed the Internal Revenue Service to issue guidance within 60 days following the enactment of the Act. This guidance is to provide a limited time period during which a Plan adopted before December 31, 2004, may, without violating the Act, provide that a participant may either cancel an outstanding deferral election with respect to amounts deferred after December 31, 2004, or conform to the requirements of the Act.

In addition to the changed substantive requirements applicable to deferred compensation, including most deferred fee arrangements, the new 20 percent penalty provisions and interest assessments make non-compliance very expensive. Thus, scrupulous adherence to the requirements of the new deferred compensation election, acceleration and distribution rules is essential to ensure that the deferred compensation arrangements will be respected and tax penalties will not be incurred.

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