

**DEFERRED COMPENSATION ALERT - MARCH 15, 2005 DEADLINE
AND NEW DEFERRAL STRATEGIES**

You should have received our Client Memorandum, "Initial Guidance on New Deferred Compensation Rules." We write again to set forth

- actions you may need or want to take before March 15, 2005 and
- deferral strategies you may wish to implement prior to December 31, 2005.

Deadline for Making Deferral Elections for 2005 Compensation Extended to March 15th

If a deferral election for 2005 compensation was not previously made, it can be made on or prior to March 15th and elections previously made can be revised on or prior to that date.

It may be advisable to elect to defer all, or substantially all, of 2005 bonus or incentive compensation. Once the amount of that compensation is known in December of 2005, the amount (or percentage) deferred on or prior to March 15th can be reduced on or prior to December 31, 2005, but it cannot be increased.

The conditions for making March 15, 2005 elections are: (a) there was a written deferred compensation plan in existence on or before December 31, 2004, (b) the election is made in accordance with the terms of the plan as in effect on or before December 31, 2005 (which may require that you amend the plan on or before December 31, 2005 to allow for a 2005 deferral election on or before March 15, 2005, (c) the plan is in operational compliance with Internal Revenue Code Section 409A with respect to deferrals subject to Section 409A and (d) the plan is amended to comply with Section 409A on or before December 31, 2005.

On or Prior to December 31, 2005, Long-Term Deferral Elections Should be Shortened

If the conditions set forth above for making new elections are met, it may make sense to shorten any long-term deferral elections. Under the prior law, a common practice was to make long-term deferrals of 10 years or so to avoid disputes with the IRS on redeferral elections. Under the new law redeferral elections are clearly permitted if (a) they are made 12 months or more before the deferred payment is due and (b) the deferral period is extended for at least five years.

Accordingly, rather than deferring for 10 years or more, it may be better to defer initially for only two or three years and then, more than one year before the payment is due, determine whether to take the payment as originally scheduled or make a redeferral election for five or more years.

Deferral Strategy for “Back-to-Back” Deferral Arrangements

1. The Reason for Back-to-Back Deferral Arrangements

Most deferral arrangements between an offshore investment fund, its investment manager and the manager’s employees are structured as “back-to-back” plans that provide or allow for a distribution of deferred amounts from the offshore fund to the manager at the same time as the manager is required to make a distribution of deferred amounts to an employee, either on a predetermined date or upon the death, disability or other termination of employment with the manager. The amount distributed from the fund to the manager offsets the amount the manager is required to pay the employee. This arrangement ensures that (i) the manager has the cash to pay the employee’s deferral and (ii) the manager eliminates or minimizes the amount of income from the offshore fund in any year for which it does not also have a corresponding tax deduction for compensation paid to employees.

2. New Section 409A Complicates Back-to-Back Deferral Arrangements

Section 409A provides that the payment of deferred amounts to a participant in a deferred compensation plan or arrangement cannot be made other than (i) on a date or dates specified in the deferral election form, (ii) on the date of the participant’s separation from service, (iii) on the date the participant becomes disabled or dies, (iv) on the date of a change in control, or (v) on account of an unforeseeable emergency. Until there is further guidance, payments upon the occurrence of any other “event” are impermissible. Moreover, once the deferral election has been made and the distribution date or event has been set, accelerations of the payment may not generally be made other than on account of an unforeseeable emergency or a change in control.

These rules create difficulties for back-to-back arrangements because, absent further guidance, an employee’s death, disability or separation from service are not events which can trigger payments to the investment manager by the fund. An investment manager’s employee is not literally a “participant” in the deferral plan between the investment manager and the fund. Unless favorable guidance from Treasury is issued to address this problem, investment managers will now need to consider their willingness to pay employee deferrals without a corresponding distribution from the fund. If the manager is unwilling to bear this liquidity risk, it will need to allow former employees to keep their deferrals in place beyond their separation from service until the originally elected payment date.

3. Structuring Back-to-Back Deferrals to Minimize Complications

To minimize the impact of Section 409A, we are recommending that investment managers take advantage of the redeferral procedure now sanctioned under Section 409A. As noted above, the redeferral of previously deferred compensation is now specifically allowed, provided (i) the redeferral election is made at least 12 months prior to the

previously elected payment date and (ii) the amounts are redeferred for at least an additional five years. For example, the manager could require that the initial deferral of participants' bonus amounts and corresponding fee deferral of the manager be limited to a short period (for example, three years), shortening the time period for either managing former employees' deferred amounts or, alternatively, the period between payment to the employee on termination and the receipt of an offsetting distribution from the fund. At least 12 months prior to the distribution date for the initial deferral, the manager and the employees may choose to redefer such deferred compensation for an additional five years. The same procedure can be used at least 12 months before the distribution date for the five-year redeferral.

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If you have any questions about the March 15, 2005 deferral deadline, or if you are interested in learning more about the deferral strategies outlined above, please feel free to call Frank A. Daniele at (212) 728-8216, Dwight W. Ellis, III at (212) 728-8218, J. Pasco Struhs at (212) 728-8109 or the attorney with whom you regularly work.

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