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— PROPOSED LEGISLATION UPDATE —

JOBS Provisions Affecting Deferred Compensation

Under the Jumpstart Our Business Strength Act of 2004 (“JOBS”) which was passed by the Senate on May 11, deferred compensation will be taxable on a current basis, unless it meets certain requirements. If the deferred compensation is subject to vesting, it will not be taxable until the vesting requirements are satisfied. In addition to current tax, deferred compensation not satisfying the requirements would be subject to additional tax equal to:

- Interest at the underpayment rate (currently 5%) on the underpayments of tax resulting from the failure to include the compensation in income when first deferred; and
- An additional 10% tax applied to both the principal balance as well as any earnings on the deferred compensation.

Key Requirements

The key requirements in order for vested deferred compensation to avoid current tax are:

- The initial election to defer must be made during the calendar year prior to the year in which the compensation is earned, unless otherwise provided in regulations (or within 30 days after initial participation in the deferred compensation plan)
 - E.g., the election to defer a bonus earned in 2005 which would be paid in 2006 must be made before end of 2004
 - Presumably, the election to defer a long-term bonus earned over a multi-year performance period must be made before the beginning of the first calendar year in the performance period
 - This is different than exists currently, under which most practitioners permit the deferral election to be made either before the last year of the performance period or during the first half of the last year
- There may be only one subsequent election to further defer payment or change form of payment, which must not be effective for at least 12 months
 - Payment under a subsequent election may not be made for at least 5 years from the original payment date, except in the event of death, disability or an unforeseeable emergency

- No acceleration of the time or schedule of payment of deferred amounts, except as may be provided in regulations, is permitted
- There can be no distributions prior to (i) separation from service (subject to a 6-month delay in the event of certain “key employees”), (ii) a specified time or under a fixed schedule, specified under the plan as of the date of deferral, (iii) disability or death, (iv) a change in control (subject to a 1-year delay for Section 16 officers), or (v) the occurrence of an unforeseeable emergency
- The plan may only provide investment options comparable to those available under the employer’s tax-qualified defined contribution plan with the fewest investment options; if there is no such plan, the options will be those prescribed by regulations
- In addition, JOBS would provide for current tax of income in the event of the “exchange” of stock options or restricted stock for the right to receive future payments (i.e., the deferral of stock option or restricted stock gains).

Effective Dates

If the above becomes law, these requirements would be applicable to amounts deferred or exchanged after December 31, 2004. Within 90 days after enactment, guidance is to be provided by the IRS which permits a limited period for participants in deferred compensation plans adopted before January 1, 2005 to terminate their participation or cancel outstanding deferral elections for amounts earned after 2004.

Implications

The JOBS deferred compensation provisions would materially affect the way companies administer their deferred compensation arrangements. In addition, the proposed provisions would eliminate the tax timing flexibility of stock appreciation rights in the absence of an interpretation by Congress or the IRS that SARs are not covered by the provisions. The provisions would also apply to restricted stock units (and deferred stock units); although not clear, an election to defer payment prior to vesting of restricted stock units appears to be a “subsequent election” rather than an “initial election”.

It is unclear whether legislation will be passed by House of Representatives and signed into law. The JOBS deferred compensation provisions are very similar to provisions in legislation approved by House Ways and Means Committee last year. If tax legislation becomes law this year, it is likely that deferred compensation provisions will be included.

This letter is intended to alert compensation professional about developments that may affect their companies. General questions applicable to deferred compensation legislation may be directed to Richard Alpern in our New York offices at 212-986-6330 or by email at ralpern@fwcook.com. This letter and other published materials are available on our website, www.fwcook.com.