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Client Alert

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Executive Compensation Provisions in H.R. 1424 - Emergency Economic Stabilization Act of 2008, and Tax Extenders and Alternative Minimum Tax Relief Act of 2008

After a tumultuous week on Wall Street and in Washington, the President signed on Friday, October 3 the $700 billion financial bailout bill, H.R. 1424 – P.L. 110-343. The House approved the bill on October 3, five days after it had rejected a similar bailout bill. The Senate had reworked the bill to include tax-extenders and certain giveaways, and signed it on October 1. H.R. 1424 contains significant executive compensation provisions in Division A - the Emergency Economic Stabilization Act of 2008 (the $700 billion financial bailout bill), and in Division C - the Tax Extenders and Alternative Minimum Tax Relief Act of 2008. (Division B - the Energy Improvement and Extension Act does not contain executive compensation provisions.)

Emergency Economic Stabilization Act of 2008 – Limitations on Compensation of Senior Executives of Financial Institutions Who Benefit

The Emergency Economic Stabilization Act of 2008 ("EESA" or the "Troubled Asset Relief Program") provides funds for the Treasury to buy mortgages or mortgage-backed securities ("troubled assets") in order to promote financial market stability. It is effective until December 31, 2008, or if extended, then for a maximum of two years from enactment. Like the earlier House version, which was voted down on September 29, the bill contains significant limitations on compensation for executives of companies who benefit from this legislation.

1. Where Treasury Makes Direct Purchases from the Financial Institutions of Troubled Assets - Broad Executive Compensation Limits on Incentives for Top 5 Executives to Take Excessive Risk, Clawback for Financial Irregularities and Prohibition of Golden Parachute Payments

Where the Treasury makes direct purchases from a financial institution without any bidding process and receives meaningful equity or debt interests in such institution, § 111(b) of EESA provides that the Treasury is directed to require that such financial institution meet appropriate standards for executive compensation and corporate governance. This includes:

a) limits on compensation for the "senior executives" to exclude incentives to take unnecessary and excessive risk that threaten the value of the financial institution;

b) a clawback provision for the financial institution to recover bonuses and incentive compensation paid to a senior executive based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate; and

c) a prohibition on the financial institution making any golden parachute payment to its senior executives during such period.

"Senior executives" is defined as the top five highest paid executives of (i) a public company whose compensation is required to be disclosed, or (ii) a non-public company counterpart.

These standards continue for the period that the Treasury holds any equity or debt in the institution.

Comments:

- "Golden parachute" is not defined in EESA, although presumably the Treasury will look to the definition of "excess parachute payment" in Internal Revenue Code § 280G.

- The limits on compensation to exclude incentives to take unnecessary and excessive risk that threaten the value of the financial institution is a very amorphous standard. As a result, institutions should exercise caution with respect to awards of performance-based compensation and, in certain cases, may decide to avoid performance-based compensation entirely.

2. Where Over $300 Million of Financial Institution's Troubled Assets Purchased in Auction - No New Golden Parachutes

Where the troubled assets of the institution are purchased by the Treasury through an auction, and the purchases exceed $300 million (including direct purchases), § 111(c) of EESA provides that the Treasury is directed to provide that new employment agreements may not contain golden parachutes in the event of involuntary termination, bankruptcy, insolvency or receivership.

This provision will sunset once the Troubled Asset Relief Program expires (December 31, 2009 unless extended).

Comments:

- This provision should have no impact on golden parachutes in existing employment agreements, but it is not clear whether it will apply if an employment agreement is amended or renewed.

- Auction purchases are not defined in EESA, but § 113(b) of EESA provides that the Treasury shall make purchases maximizing the efficiency of the use of taxpayer resources by using market mechanisms, including auctions or reverse auctions. In a reverse auction, many potential sellers would bid on the price to be accepted by the government, and the lowest bidders would win.

- Where troubled assets bought in auction are $300 million or less, no restrictions under EESA apply.

3. Additional Restrictions Where Troubled Assets Exceed $300 Million are Acquired (by Auction or Directly)

a) ***Deduction Limit on Compensation Over $500,000 Under Code § 162(m) for Employers Participating in the Troubled Asset Relief Program.*** EESA § 302(a) adds new Internal Revenue Code § 162(m)(5), which provides that there will be no employer deduction for any compensation of "covered executives" for an "applicable taxable year" in excess of $500,000 with respect to an employer from whom troubled assets are acquired under EESA and the troubled assets are in excess of $300 million (an "applicable employer").

The $300 million and $500,000 amounts are generally determined on a controlled group basis.

"Covered executive" is defined as the CEO, CFO and other top-three highly compensated employees of the applicable employer. If the employee is a covered executive in any year in which EESA is in effect, the executive remains a covered executive for the duration of the Troubled Asset Relief Program.

"Applicable taxable year" is defined as any taxable year during which the Troubled Asset Relief Program is in effect.

Code § 162(m)(5) also denies a deduction for any deferred compensation for services performed during an applicable taxable year in excess of (i) $500,000 reduced by (ii) the sum of (A) nondeferred compensation for such year, plus (B) the portion of the deferred compensation for such services which was taken into account in a preceding taxable year.

For example, a covered executive receives a salary of $350,000 from an applicable employer in year 1, and earns $300,000 of deferrred compensation in year 1 that is payable in year 5. The $350,000 of salary is fully deductible in year 1. However, the $300,000 of deferred compensation paid in year 5 will be deductible only with respect to $150,000 (the unused portion of the $500,000 limit in year 1). (The executive separately receives a $500,000 limit for new compensation paid in year 5.)

Comments:

- In contrast to the $1 million deduction limit under Code § 162(m), the $500,000 deduction limit of Code § 162(m)(5) for applicable employers applies regardless of whether the financial institution is public or private, and whether the compensation is performance-based.

b) ***Parachute Excise Tax and Nondeductibility under Code § 280G(e) for Severance in Excess of Three Times Base Amount for Employers Participating in the Troubled Asset Relief Program.*** EESA § 302(b) adds new Code § 280G(e), which provides that if during the Troubled Asset Relief Program a covered executive of an applicable employer (as defined above) receives severance equal to or in excess of three times base compensation, the 20% excise tax for the executive and nondeductibility for the employer will apply even if the severance is not in connection with a change of control as defined in Code § 280G but merely by reason of an "applicable severance from employment."

"Applicable severance from employment" means any severance from employment by reason of an involuntary termination of the executive by the employer, or in connection with any bankruptcy, liquidation, or receivership of the employer.

This provision will apply to any severance that occurs during the duration of the Troubled Asset Relief Program.

Comments:

- Under Code § 280G(b)(5), there are exceptions from the general excess parachute change of control payment rules of § 280G: (i) for payments made by a small business corporation that would be eligible for an S corporation election, (*i.e.*, it is a domestic corporation, it has no more than 100 shareholders, all shareholders are individuals, and it has no more than one class of stock); or (ii) for payments made by a privately-held corporation that does not have any readily tradable stock on an established securities market, and which also receives more than 75% shareholder approval of the parachute payments and the general 280G gross-up provisions makes adequate disclosure to its shareholders. These exceptions are not applicable to the special rule under § 280G(e) for employers participating in the Troubled Asset Relief Program.
- Because this EESA change was incorporated into Code § 280G, existing executive agreements may automatically cover this new "severance" excise tax (inadvertently, now that Code § 280G has been amended). Accordingly, companies contemplating participating in EESA should review those gross-up provisions in advance to determine if that is the case, and if so, whether any modifications would be appropriate.

Tax Extenders and Alternative Minimum Tax Relief Act of 2008 – Taxation of Deferred Compensation from Certain Tax-Indifferent Entities

The Tax Extenders and Alternative Minimum Tax Relief Act of 2008 ("TEAMTRA"), which is Division C of H.R. 1424, enacts in § 801, as a revenue raiser, new Code § 457A. Code § 457A will limit a taxpayer's ability to defer compensation paid by certain tax indifferent parties. The most significant aspects of new Code § 457A include the following:

1. **General Rule.** TEAMTRA is aimed at managers of offshore investment funds, and generally eliminates the ability of taxpayers to defer compensation for services performed after December 31, 2008 for certain offshore entities - referred to as "nonqualified entities" (e.g., offshore hedge funds) to the extent such compensation is no longer subject to a "substantial risk of forfeiture."

   Deferred compensation for services performed prior to 2009 must be included in income by the later of the end of 2017 and when the compensation is no longer subject to a substantial risk of forfeiture.

2. **Substantial Risk of Forfeiture.** For these purposes, the definition of "substantial risk of forfeiture" is more restrictive than the definition contained in Code § 409A and is generally limited to the taxpayer's continued performance of substantial services. However, to the extent provided in regulations, compensation determined solely by reference to the amount of gain recognized on the disposition of an "investment asset" shall be treated as subject to a substantial risk of forfeiture. For this purpose, "investment asset" means any single asset (other than an investment fund or a similar entity): (i) that is acquired directly by an investment fund; (ii) with respect to which the investment fund (or a person related to the investment fund) does not participate in active management; and (iii) substantially all of any gain on disposition of which will be allocated to investors in the investment fund.

3. **Nonqualified Entities.** "Nonqualified entities" include (i) any foreign corporation unless substantially all of its income is effectively connected with a U.S. trade or business or subject to a comprehensive foreign income tax and (ii) any partnership (domestic or foreign) unless substantially all of the partnership's income is allocated to persons other than tax-exempt organizations or foreign persons not subject to a comprehensive foreign income tax. For these purposes, a foreign income tax qualifies as comprehensive if the person is eligible for benefits under any comprehensive income tax treaty between the U.S. and a foreign country or otherwise demonstrates to the satisfaction of the Treasury that the country has a comprehensive income tax.

4. **Definition of Deferred Compensation.** Deferred compensation is generally defined in the same way as it is defined in Code § 409A. However, deferred compensation under Code § 457A always includes a right to compensation based on appreciation in value of a specified number of equity units of the service recipient. Also, compensation is not treated as deferred under Code § 457A if the taxpayer receives payment of the compensation from the nonqualified entity no later than 12 months after the end of the nonqualified entity's taxable year during which the substantial risk of forfeiture lapses. Any compensation that is deferred and not determinable in amount at the time it is no longer subject to a substantial risk of forfeiture and required to be included in income will be subject to an additional 20% penalty and interest at the underpayment rate plus 1% when such amount is determinable.

5. **Accrual Basis Taxpayers.** Service providers that are accrual basis taxpayers are not subject to Code § 409A. However, the Joint Committee of Taxation Explanation of Code § 457A suggests that service providers that are accrual basis taxpayers are subject to the provisions of Code § 457A.

6. **Additional Guidance.** The Treasury is directed to issue guidance providing for a transition period during which deferred compensation arrangements (including certain back to back deferrals) can be amended to comply with the new law.

Comments:

- Although investment managers will generally no longer be permitted to defer fees from their offshore funds (and, accordingly, back to back deferral arrangements can no longer be implemented), Code § 457A should not effect "carried interest" arrangements structured as a partnership interest and certain properly structured hedge fund "side pocket" investments.

- Amounts attributable to services performed before January 1, 2009 may continue to be deferred until a taxable year beginning before 2018. However, new Code § 457A also does not specifically address whether it is permissible to redefer deferrals of amounts attributable to pre-January 1, 2009 service after December 31, 2008.

- All partnerships and foreign corporations (and not just offshore hedge funds) should determine whether they are potentially considered "non-qualified entities" and subject to new Code § 457A. For example, it is possible that a private equity fund that has a significant number of tax exempt investors could qualify as a "non-qualified entity."

- Entities subject to new Code § 457A should determine whether the transition relief available relating to change in time and form of payment under Code § 409A until the end 2008 should be utilized to address the application of the new rules.

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