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

The President signed on Friday, October 3, 2008 the $700 billion financial bailout bill, H.R. 1424 – P.L. 110-343. 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.

I <u>Emergency Economic Stabilization Act of 2008 – Limitations on Compensation of Senior Executives of Financial Institutions Who Benefit</u>

The Emergency Economic Stabilization Act of 2008 ("EESA"), also known as the Troubled Asset Relief Program ("TARP"), 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.

A **Where Treasury Makes <u>Direct Purchases</u> 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**.[1] This includes:

1 <u>Limits on compensation for the "senior executives" to exclude incentives to take unnecessary and excessive risk that threaten the value of the financial institution</u> (EESA § 111(b)(2)(A)). "Senior executives" is defined as the top five highest paid

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[1] Under section 111(b)(1) of Interim Final Rules for the TARP Capital Purchase Program (CPP) (the "CPP Interim Final Regulations") were issued at 73 Fed. Reg. 62205 (10/20/08) http://frwebgate1.access.gpo.gov/cgi-bin/PDFgate.cgi?WAISdocID=012365325466+5+2+0&WAISaction=retrieve & http://www.ustreas.gov/initiatives/eesa/executivecompensation.shtml,, the financial institution must agree, as a condition to participate in the CPP, that no deduction will be claimed for federal income tax purposes for remuneration that would not be deductible if IRC § 162(m)(5) were to apply to the financial institution. This standard applies even though the financial institution is not subject to § 162(m)(5) and only limits the amount of the deduction that may be claimed. Thus, no deduction may be claimed for remuneration during a taxable year for compensation in excess of $500,000 for a SEO, and the special rules relating to deferred deduction executive remuneration would also apply. Preamble to CPP Interim Final Regulations.

executives of (i) a public company whose compensation is required to be disclosed, or (ii) of non-public company counterparts (EESA § 111(b)(3)). 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 and may cause institutions to avoid performance-based compensation entirely.[2]

2 A clawback provision for the financial institution to recover bonus 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 (EESA § 111(b)(2)(B)).[3]

3 A prohibition on the financial institution making any golden parachute payment to its senior executives during such period (EESA § 111(b)(2)(C)). "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 (although it may include even parachutes that do not exceed three times their annual compensation).[4]

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

5 Direct purchases (rather than auctions) are generally part of the Treasury's Capital Purchase Program ("CPP"). Interim Final Rules were issues for the TARP Capital Purchase Program at 73 F.R. 62205 (Oct. 20, 2008).

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2 The "CPP Interim Final Regulations adds Q&As to 30 CFR Part 30 § 30, which among other things, require the financial institution's compensation committee to identify the features in the financial institution's senior executive officer's (SEO's) incentive compensation arrangements that could lead SEOs to take unnecessary and excessive risks. The compensation committee must review the SEO incentive compensation arrangements with the senior risk officers to ensure that SEOs are not encouraged to take such risks. Such review must be promptly and in no case more than 90 days after the purchase under the CPP. The compensation committee must also meet at least annually with the senior risk officers to review the relationship between the financial institution's risk management policies and practices and the SEO incentive compensation arrangements. In addition, compensation committee must certify that it has completed the reviews of the SEO incentive compensation arrangements as outlined above. 30 CFR § 30.3

3 With respect to § 111(b)(2)(B), the CPP Interim Final Regulations provide in § 30.6 that the SEO bonus and incentive compensation paid during the period that the Treasury holds an equity or debt position acquired under the CPP must be subject to recovery or "clawback" by the financial institution if the payments were based on materially inaccurate financial statements and any other materially inaccurate performance metric criteria, similar to section 304 of the Sarbanes-Oxley Act of 2002.

4 Re, § 111(b)(2)(C) of EESA, the CPP Interim Final rules prohibit a financial institution from making any golden parachute payment to a SEO during the period the Treasury holds an interest under the CPP. Golden parachute payment is calculated in the same way as under IRC §. 280G as applied with new paragraph (e) . Thus, a golden parachute payment means any payment in the nature of compensation to (or for the benefit of) a SEO made on account of an applicable severance from employment to the extent the aggregate present value of such payments equals or exceeds an amount equal to three times the SEO's base amount. The term "base amount" for a SEO has the meaning set forth in IRC § 280G(b)(3) and Treas. Reg. § 1.280G-1, Q&A-34 (except that references to "change in ownership or control" are treated as referring to an "applicable severance from employment").

B **Where $300 Million of Financial Institution's Troubled Assets Purchased in Auction - No New Golden Parachutes**

1 New Employment Agreements May Not Contain 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), EESA § 111(c) 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.

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.

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

C **Additional Restrictions Where Troubled Assets in Excess of $300 Million are Acquired by Auction (Has not been relevant)**

1 Deduction Limit on Compensation Over $500,000 Under Code § 162(m) for Employers Participating in the Troubled Asset Relief Program.

i No Deduction for Comp in Excess of $500,000 if Employer in TARP & Auction Purchase Exceeds $300 Million. 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 "applicable employer." IRC § 162(m)(5)(A).[5]. In contrast to the $1 million deduction limit under § 162(m), the $500,000 deduction limit of § 162(m)(5) for applicable employers applies regardless of whether the financial institution is public or private, and whether the compensation is performance-based.

ii Covered Executive. "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

5 Notice 2008-04 Q&A 1 provides that applicable employer includes 80% affiliates. Q&A 2 provides that applicable employer is not limited to corporations, and applies to partnerships and non-public corporations. See Q&A 5 regarding sale of the applicable employer to an unrelated third party.

effect, the executive remains a covered executive for the duration of the Troubled Asset Relief Program. IRC § 162(m)(5)(B).[6]

iii Applicable Taxable Year. "Applicable taxable year" is defined as any taxable year during which the Troubled Asset Relief Program is in effect. IRC § 162(m)(5)(C).

iv Denies Deduction for Deferred Comp in Excess of $500,000. Code § 162(m)(5)(A)(ii) also denies a deduction for any deferred compensation for services performed during an applicable taxable years 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.[7]

For example, a covered executive receives a salary of $350,000 from an applicable employer in year 1, and earns $300,000 of deferred 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.)

2 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.

i Excise Tax and Nondeductibility for Severance in Excess of Three Times Base Amount . EESA § 302(b) adds new Code § 280G(e),[8] which provides that if during the Troubled Asset Relief Program a covered executive of an applicable employer (as defined above – **auction purchase in excess of $300 million**) receives severance equal to or in excess of three times base compensation, the executive will be subject to the 20% parachute excise tax and the employer nondeductibility even if the severance is not in connection

6 Notice 2008-94 Q&A 3 provides that the three highest officers other than CEO and CFO are determined similar to the executive compensation proxy disclosure rules, and, as set forth in Q&A 6, applies to compensation earned in that year.

7 Notice 2008-94 Q&A's 7-9 discuss the deferred compensation rules, and defines what is the applicable tax year to which the deferred compensation is attributable to. If the amounts vest on several years performance, the payments are attributable pro-rata over the vesting period.

8 Inclusion of the above provision into Code § 280G could have the effect of including this new "severance" excise tax (inadvertently, now that Code § 280G has been amended) in the general 280G gross-up provisions that may already exist under executive agreements. 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.

with a change of control as defined in § 280G but merely by reason of an "applicable severance from employment." IRC § 280G(e)(1).[9]

ii 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. IRC § 280G(e)(2)(B).

iii Effective. This provision will apply to any severance that occurs during the duration of the Troubled Asset Relief Program. EESA § 302(c).

[9] Note that under general provisions of IRC § 280G(b)(5), there are exceptions from 280G, if (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 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.

II **<u>Tax Extenders and Alternative Minimum Tax Relief Act of 2008 – Taxation of Deferred Compensation from Certain Tax-Indifferent Entities under IRC § 457A</u>**

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:

A <u>Eliminates Ability To Defer Compensation For Certain Offshore Entities</u>. 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."

B <u>Deferred Compensation For Service Prior To 2009 Included In Income By End 2017.</u> Deferred compensation for services performed prior to 2009 must be included in income by the end of 2017.

C <u>Substantial Risk Of Forfeiture More Restrictive</u> . 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 to be 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.

D <u>Nonqualified Entities</u>. "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 Department of Treasury that the country has a comprehensive income tax.

E <u>Deferred Compensation</u>. Deferred compensation is generally defined in the same way as it is defined in Code § 409A; provided that 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 plus 1% when such amount is determinable.

F Accrual Basis Taxpayers. Service providers that are accrual basis taxpayers are not subject to Code § 409A. However, there is conflicting information in the legislative history to this bill.

G Guidance. The Treasury Department 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.

H Comments:

1 Back To Back Deferral Arrangements Can No Longer Be Implemented. 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.

2 Deferrals for Services Prior to 2009. 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.

3 Nonqualified Entities May Include Partnerships and Foreign Corporations 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 § 457. 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".

4 Transition Relief. 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.