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The Emergency Economic Stabilization Act's Effect on Employee Benefits and Executive Compensation

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In an earlier legal update (Economic Stabilization Act: Employee Benefits and Executive Compensation, October 2008) we summarized the employee benefits and executive compensation provisions contained in the Emergency Economic Stabilization Act of 2008 (the "Act"), which became law on October 3, 2008. This update addresses the provisions of Internal Revenue Service Notice 2008-94 (the "IRS Notice"), issued on October 14, 2008, which provides guidance on the executive compensation tax provisions of the Act.

Following is a more detailed discussion of these rules:

Applicable Employers: The Entities to Which Executive Compensation Tax Provisions Apply

The first issue a financial institution may wish to consider is whether the executive compensation tax provisions of the Act are likely to apply to it. In general, these provisions apply to financial institutions participating in the Act's Troubled Assets Relief Program ("TARP") if (i) the institution has sold assets under TARP in sales that are not solely direct purchases, and (ii) the amount sold (including direct purchases) exceeds $300 million in the aggregate.[1] These institutions are referred to in the Act and in the IRS Notice as "Applicable Employers." These provisions apply during the "TARP Authorities Period," which runs from October 3, 2008, to December 31, 2009, or to an extended date no later than October 3, 2010, that the Treasury Secretary may establish in its discretion by certification to Congress.

Controlled Group Rules for Determination of Applicable Employers
The IRS Notice clarifies that all entities that are in the same "controlled group" are aggregated for purposes of applying the executive compensation provisions of the Act. In general, entities are in the same controlled group for purposes of these provisions if they have a common parent and are connected directly or indirectly in a chain of ownership of 80% or more, as measured by value or voting power. So, for example, if a bank holding company owns 80% or more of two different banks, any assets sold under the TARP program by either bank would be added together to determine whether the $300 million threshold has been reached to qualify the bank holding company and its bank subsidiaries as an Applicable Employer. Furthermore, the IRS Notice clarifies that Applicable Employers can be any form of entity (e.g. corporation, partnership or limited liability company) and can be public or private.

Mergers and Acquisitions
The IRS Notice provides useful guidance as to how an acquisition or merger of financial institutions participating in TARP can affect whether they are considered Applicable Employers. In the event that a financial institution that has sold any assets under TARP is later acquired by an unrelated entity, the IRS Notice provides that the assets sold by the target prior to the acquisition will not be aggregated with any assets sold by the acquiring institution under TARP, prior to or after the acquisition, for purposes of determining whether the combined entity is an Applicable Employer by virtue of having reached the $300 million threshold. The IRS Notice adds, however, that in determining whether the acquirer's controlled group has exceeded the $300 million threshold after

the acquisition, all sales of the acquirer, before or after the acquisition, including any assets of the target sold after the acquisition, are aggregated to determine whether the $300 million limit has been exceeded.

For example, If a target entity has sold $250 million of assets under TARP prior to being acquired, and the acquirer has sold $100 million of assets prior to the acquisition, the acquisition will not cause the acquirer and its control group to become an Applicable Employer because the target's $250 million of asset sales will not be aggregated with the acquirer's $100 million of asset sales. If, however, after the acquisition the acquirer sells $220 million in assets under TARP, which may or may not include assets of the target (which is now in the acquirer's controlled group) the acquiring entity will have sold $320 million in assets under TARP, and will be treated as exceeding the $300 million threshold.

The IRS Notice states further that if the target was already an Applicable Employer prior to the acquisition, the acquirer will not become an Applicable Employer merely as a result of the acquisition, although any covered executive of the target who continues to work in the controlled group of the combined entity will continue to be treated as a covered executive after the acquisition for purposes of the executive compensation rules of the Act. The gist of these rules appears to be to avoid discouraging an institution from acquiring a target that has already sold assets under TARP, but at the same time not to let the executives of the target escape the executive compensation limitations of the Act if the target had itself become an Applicable Employer before the acquisition. These rules, however, could also encourage an acquirer to have a prospective target sell assets under TARP before its acquisition rather than afterward.

Executive Compensation Tax Provisions Addressed by IRS Notice

The executive compensation tax provisions addressed by the Act that the IRS Notice discusses are (1) the $500,000 annual limitation on an Applicable Employer's deduction for compensation paid to an executive, and (2) the limitation of an Applicable Employer's deduction for severance pay to an executive, with a 20% excise tax on the executive on any such non-deductible severance pay.

When the Executive Compensation Tax Limitations Apply.
The IRS Notice provides that the $500,000 limitation on executive compensation (discussed in II.A. below) as well as the severance and excise tax provisions (discussed in II.B below) first apply during any taxable year of the entity in which it and/or its controlled group members have sold assets under TARP during that year or any preceding year in the TARP Authorities Period (see above) in excess of $300 million. From that initial taxable year, the designation of that entity and its controlled group members as an Applicable Employer will continue until the end of the TARP Authorities Period.

Limitation of Employer's Deduction for Compensation over $500,000. The Act provides that no deduction is allowed to an Applicable Employer for the compensation of a covered executive that exceeds $500,000 in any taxable year. Compensation for this purpose includes amounts taxable to the executive during the year plus any deferred compensation that an executive earns during the year that will not be taxable to the executive, or deductible to the employer, until a later year.

For example, if a covered executive is paid $400,000 cash compensation in 2009 and also earns $250,000 in deferred compensation in 2009 that will be paid in 2010, the entire $400,000 cash compensation is deductible to the employer, but only $100,000 of the $250,000 in deferred compensation will be deductible to the employer (when it is paid in 2010) (because $400,000 + $100,000 = the $500,000 annual limit). Note that because the extent of the deductibility of the deferred compensation is determined with respect to the year in which the compensation is *earned* (2009) rather than when it is *paid* (2010), a $500,000 cash compensation to the executive in 2010 would be fully deductible, because the $250,000 deferred compensation payment made in 2010 (of which only $100,000 is deductible) is not taken into account for purposes of determining the $500,000 limit in 2010. By the same token, the IRS Notice clarifies that the non-deductible portion of a covered executive's deferred compensation will never be deductible, even if it is paid after the end of the TARP Authorities Period.

When Deferred Compensation is Considered Earned for Application of $500,000 Deduction Limit. The IRS Notice contains guidelines to determine in which year deferred compensation is treated as earned for purposes of applying the $500,000 limitation on deductible compensation. In general, a covered executive is considered to have earned deferred compensation when he or she obtains a legally binding right to it, unless he or she has to continue to perform services for some period of time after that in order to receive the payment and avoid forfeiting the amount, in which case the deferred compensation is treated as becoming earned as the services are performed and the deferred compensation becomes vested.

Identification of Covered Executives. For purposes of the $500 million limitation on deductible executive compensation, the Act provides that a "covered executive" includes the chief executive officer, the chief financial officer, and the other three most highly compensated executive officers for the taxable year. The IRS Notice provides that to determine the other three highest compensated officers of the Applicable Employer, the same rules are used that are used under the Securities Exchange Act of 1934 shareholder disclosure rules, which include total compensation without regard to whether the compensation is included in the officer's gross income, except that (i) these rules are applied to private entities not subject to the Exchange Act, as well as to entities that are, and (ii) the measurement period for making the compensation determination is the taxable year of the determination, not the last completed fiscal year as required under the Exchange Act. Any individual who is considered a covered executive for any year retains that status for all succeeding years in the TARP Authorities Period. Unlike the $1 million cap on deductible compensation under Section 162 (m) of the Internal Revenue Code, the $500,000 limitation on deductible compensation under the Act does not permit exclusions for compensation in the form of commissions, performance-based pay, or under existing binding contracts.

Limitation of Employer's Deduction for Severance Pay and Excise Tax on Executive
The second executive compensation tax provision addressed by the IRS Notice is the limitation on the deductibility to an Applicable Employer for severance payments it makes to covered executives who are involuntarily terminated from employment from the financial institution, or who terminate employment in connection with any bankruptcy, liquidation, or receivership of the institution and who receive severance pay that equals or exceeds three times the employee's base amount. The IRS Notice clarifies that the executive will also be subject to a 20% excise tax on the portion of any severance payment that is not deductible to the Applicable Employer. As with the $500,000 deduction limitation on compensation discussed above, this rule applies to covered executives of an Applicable Employer during the TARP Authorities Period.

When a Covered Executive's Termination is Considered "Involuntary". The IRS notice contains rules for determining whether a covered executive's termination of employment from an Applicable Employer was "involuntary." In general the IRS Notice provides that "involuntary termination" means a severance from employment due to the independent exercise of the unilateral authority of the Applicable Employer to terminate the covered executive's services, other than due to the covered executive's implicit or explicit request, where the covered executive was willing and able to continue performing services. The IRS Notice adds that an employer's refusal to renew an employment contract at the end of its term could constitute an involuntary termination, as could a termination by the covered executive for "good reason" as defined in the regulations under Code Section 409A. Because of its highly factual nature, we would expect to see disputes arising over this issue.

Calculation of Nondeductible Portion of Payment and 20% Excise Tax on Covered Executive.
An executive's "base amount" is calculated the same way as under existing golden parachute rules under Section 280G of the Internal Revenue Code, and generally means the executive's average compensation from the institution over the five most recent years. Once an executive triggers this rule by having compensation equal to or exceeding three times the executive's base amount, the amount that is not deductible to the institution is the amount of severance pay that equals or exceeds the executive's base amount (not three times the executive's base amount). In addition, the IRS Notice provides that if a covered executive receives severance pay that is not deductible under this provision, the executive will be subject to a 20% excise tax on the non-deductible portion of the payment.

Footnotes:

[1]The Treasury Department has issued additional guidance relating to financial institutions that are TARP participants solely by virtue of direct sales. *See* Interim Final Regulations at 30 C.F.R. Part 30, and Treasury Department Notices 2008-TAAP and 2008-PSSFI. The substantive requirements outlined in this additional guidance are substantially similar to those appearing in the IRS Notice regarding the $500,000 compensation limitation and severance pay to certain executives of

participating financial institutions.