



BROWN RUDNICK'S STRUCTURED RESOLUTION GROUP

US TREASURY BAIL-OUT ALERT

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Parsing the Fine Print on Executive Compensation

The U.S. Treasury Bail-Out Legislation became law on Oct. 3, 2008. As enacted, it combines three massive pieces of legislation: (1) the Emergency Economic Stabilization Act of 2008 (the "Bail-Out Act"), (2) the Energy Improvement and Extension Act of 2008, and (3) the Tax Extenders and AMT Relief Act of 2008 (the "AMT Act") (collectively "BEAR"). BEAR is a beast, at over 400 pages, containing numerous and extremely complex provisions. The Bailout Act and the AMT Act portions of BEAR contain a number of amendments to the Internal Revenue Code (the "Code") which apply to the taxation of executive compensation. The changes to the Code are riddled with intricacies and cross-references to existing Code sections which require a detailed analysis to determine if the modifications in tax law apply to a given entity and employer.

In this edition of the Alert, we focus on the sections of BEAR which deal with executive compensation and golden parachutes. These are Section 302 of the Bail-Out Act, entitled "Special Rules for Tax Treatment of Executive Compensation of Employers Participating in the Troubled Assets Relief Program," and Section 801 of the AMT Act, entitled "Nonqualified Deferred Compensation from Certain Tax Indifferent Parties." Our examination reveals why it is essential for companies to scrutinize the defined terms in BEAR to determine if they are subject to these new tax rules. It is important to note at the outset that the rules governing deductibility of executive compensation for companies not participating in the Troubled Asset Recovery Program ("TARP") do not change. However, any applicable employer participating in TARP, regardless of whether or not the employer is a publicly-held corporation, is subject to the new limitation of deductibility. These "applicable employers" may include limited liability companies, partnerships, and S corporations. So all entities, not just publicly-traded corporations, need to be aware of the BEAR.

Section 302

Section 302 amends the Code in two substantial ways. First, the extent to which certain employers may deduct salary paid to an executive is limited. Second, the golden parachute rules applicable to severance packages have been extended to companies involved in the bailout program. These tax law changes may sound relatively straight-forward; however, the devil is in the details.

- *Limits on Deductibility of Certain Executive Compensation*

Under tax law governing companies not participating in TARP, a publicly-held corporation is permitted to deduct the first \$1,000,000 of an executive's salary. However, the tax law contains a large exception to this general rule in that performance-based compensation is not subject to the \$1,000,000 limitation. For certain employers participating in TARP, the \$1,000,000 ceiling is reduced to \$500,000 and the performance-based exception is eliminated. These modifications are accomplished by using numerous definitions and, therefore, it is essential that care be taken to review the new rules closely to determine whether a company is subject to these new limits.

Section 302 contains the following key paragraph:

In the case of an applicable employer, no deduction shall be allowed under this chapter— (i) in the case of executive remuneration for any applicable taxable year which is attributable to services performed by a covered executive during such applicable taxable year, to the extent that the amount of such remuneration exceeds \$500,000.

In order to parse this new paragraph, the meaning of the following terms must be understood: (1) applicable employer; (2) applicable taxable year; (3) executive remuneration; and (4) covered executive.

An "applicable employer" is any employer (not limited to a publicly-held corporation) that has more than \$300,000,000 of assets acquired under TARP. Participants in TARP need to know when they will reach this \$300,000,000 threshold, but attempting the math will lead to challenging questions. For instance, how will the assets acquired by TARP be valued? Is it simply the amount that the government pays or some other value? Also, assets directly purchased by the government (i.e., where market mechanisms such as auctions or reverse auctions are unavailable) will not count toward the \$300,000,000 threshold. How will affiliated purchases be treated?

The answer to this last question is that some affiliated purchases will be aggregated, but the rules are buried in BEAR. Aggregation for this purpose is accomplished by reference to a modified test under a preexisting section of the Code—§414. The application of the §414 aggregation rules for determining what is included in the "single employer" test in applying the Bail-Out Act is more limited than the general application of these rules in a non-Bail-Out Act context.

The meaning of "applicable taxable year" is clear. An applicable taxable year is the year (and subsequent years meeting the threshold amount) when the aggregate value of all of the property acquired under TARP, including the property acquired in previous years, exceeds \$300,000,000.



Executive remuneration seems to be an innocuous term; however, this term is responsible for the biggest growl of BEAR. The term eliminates the performance-based compensation exclusion generally available under prior law. Specifically, the \$1,000,000 deduction limitation imposed under prior law excludes (1) commission-based compensation, (2) other performance-based compensation, and (3) binding contract compensation that was in effect prior to February 17, 1993. All of these types of compensation are included in executive remuneration under the Bail-Out Act for an "applicable employer."

A "covered executive" under the new law is the CEO, the CFO and the next three top paid executives. The definition is broad enough to include any person acting in the capacity as a CEO or CFO even if such person does not carry the title and, since the new rules apply to non-publicly-held entities, will include people like managing partners of a partnership. Furthermore, once an employee is considered a "covered executive," the employee will remain so for all subsequent applicable taxable years and all years that compensation related to services performed during applicable years would be deductible.

- *Limits on Golden Parachute and Certain Nonqualified Deferred Compensation*

The Bail-Out Act also amended the Code to apply the golden parachute rules to a "covered executive" of an "applicable employer." The same definitions of "covered executive" and "applicable employer" as used under the executive compensation deduction limits are also used for purposes of the golden parachute limitation. Accordingly, any company defined as an "applicable employer" will be subject to the golden parachute rules under the Code and any severance payments made during applicable years will be nondeductible to the extent the payments exceed certain specified limitations. Additionally, the "covered executive" is subject to an excise tax on the severance payment equal to 20% of the excess parachute payment.

Section 801

Additional changes to the taxation of non-qualified deferred compensation were also included in the AMT Act. These changes address the timing of income inclusion where a tax indifferent entity issued deferred compensation to an employee and the compensation was no longer subject to a substantial risk of forfeiture.

Conclusion

If a company, or an affiliate of a company, has assets acquired by a program under BEAR, it will be important to continually and thoroughly monitor the amount of assets being transferred so that an inadvertent violation of these limits is not triggered.



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