Bailout Bill Contains Many Tax-Related Provisions

On October 3, 2008, the President signed into law the Emergency Economic Stabilization Act of 2008 (EESA), the Energy Improvement and Extension Act of 2008, and the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (collectively, the "Act"). The EESA provides the federal government with a number of tools aimed at restoring confidence and activity in the credit markets:

- The Troubled Asset Recovery Program (TARP) allows the federal government to purchase up to $700 billion of certain "troubled assets" from participating financial institutions.
- The Capital Purchase Program (CPP) allows for direct debt or equity capital infusions into eligible financial institutions; and
- An insurance program allowing the federal government, on behalf of eligible financial institutions, to guarantee the timely payment of principal and interest on certain troubled assets in exchange for negotiated premium payments.

The contours of the EESA and its application continue to evolve. For example, on October 12, 2008, Treasury Secretary Henry M. Paulson, Jr. announced that the federal government will place less emphasis on the purchase of troubled assets under TARP and will, in coming months, increasingly look to capital infusions under the CPP as a primary tool in curtailing the financial crisis. Subsequently, on November 25, 2008, Treasury and the Federal Reserve Board announced a new program, the "Term Asset-Backed Securities Loan Facility," intended to increase the amount of credit available in the markets to consumers and small businesses by providing a government guarantee for certain asset-backed securities issued (in particular, those collateralized by student loans, auto loans, credit card loans and loans guaranteed by the Small Business Administration).

Against this shifting backdrop, new guidance has been issued in recent weeks on a number of tax issues related to the EESA and the Act including:

Limits on Executive Compensation for Participating Financial Institutions

- *Deduction limitation*. For employers participating in TARP/CPP, new section 162(m)(5)[1] limits to $500,000 per year the deduction otherwise allowable for certain executive compensation. Unlike the general section 162(m) deduction limitation, which applies only to public corporations and then only to compensation payable to the CEO and the three other most highly paid "named executive officers" (other than the CFO), the new rules apply to public, private and non-corporate entities, include the CFO in the covered group, and make no exception for performance-based compensation. For employers participating in the CPP, the limitation effectively applies to the deductibility of compensation for as long as the government holds a debt or equity position in the employer. Where the employer participates in TARP and the totality of troubled assets purchased from the employer exceeds $300 million, the deduction limitation applies during any tax year of the employer that includes any portion of the TARP authority period—that is, the period during which the TARP authority is in effect (generally until December 31, 2009, with a potential for extension until October 3, 2010). A special provision of new section 162(m)(5) extends its reach to amounts earned during the period the government holds a debt or equity position acquired pursuant to the CPP (or the TARP authority period, as applicable) but deferred to a later year.

[1]Unless otherwise noted all section references are to the Internal Revenue Code of 1986, as amended

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- *Severance payment limitation*. New section 280G(e) subjects to potentially adverse tax treatment severance payments that may be paid to covered executives (the same group whose compensation is subject to new section 162(m)(5)). If the executive is terminated during the TARP authority period, either involuntarily or in connection with the bankruptcy, liquidation or receivership of the employer, payments made to the executive during an applicable taxable year on account of the termination will be nondeductible to the employer and subject to a 20% excise tax to the extent they exceed the executive's "base amount" (generally, the executive's average annual taxable compensation determined on a five-year look-back basis). An exception applies where the severance payments aggregate to less than three times the base amount. While new section 280G(e) affects only the tax treatment of these severance payments, separate provisions of the EESA expressly prohibit certain institutions from either paying or agreeing to pay similar severance amounts (depending on the circumstances).
- *Corporate governance standards and risk appropriate compensation*. Financial institutions participating in the CPP must meet "appropriate standards" for executive compensation and corporate governance. The statute and interim guidance include some details, including a requirement that bonus or incentive compensation be subject to recovery or "clawback" if the payments were based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate. Note that this clawback language is significantly broader than the "clawback" language added by Section 304 of the Sarbanes-Oxley Act in 2002.

Other Related Guidance

- *Elimination of Hedge Fund deferrals*. New section 457A eliminates the deferral of compensation by most offshore hedge funds, among other payors. See our October 2008 alert titled "Congress Blocks Offshore Hedge Fund Deferrals" to learn more. Although plainly directed in significant part at hedge funds, depending on the facts, new section 457A could also limit deferrals of compensation payable by non-hedge fund offshore employers or by employers (whether domestic or foreign) that are organized as partnerships or LLCs and have tax-exempt investors such as pension funds and/or offshore investors.
- *CFC Short Term Lending Clarified*. The IRS has announced that it will issue regulations providing that certain controlled foreign corporations (CFCs) may disregard an obligation held by the CFC that would otherwise constitute an investment in U.S. property if the obligation is collected within 60 days of when it is incurred. The guidance supplements existing laws on certain short-term obligations held by CFCs. This relief will not apply to taxable years of CFCs beginning after December 31, 2009.
- *Extension of CFC-related rules*. The Act provides a one-year extension of the effectiveness of certain provisions of the Internal Revenue Code which provides for (i) the deferral of tax on certain "active financing income" and (ii) the "look-through" treatment of certain foreign personal holding company income paid from one CFC to a related CFC. As extended, these provisions are effective for tax years of CFCs beginning prior to January 1, 2010.
- *Section 382 Treatment of Banks*. The IRS has issued several pieces of guidance on the proper treatment under section 382 of losses of banks following a more than 50 percent change in ownership. The general effect of this guidance is to (i) potentially allow private acquirers of a bank to preserve unrealized tax losses in the bank's assets for use following the acquisition and (ii) to effectively disregard the acquisition of equity in a bank by the government for purposes of applying the section 382 limitations.
- *Tax Return Preparer Rules*. The Act amends section 6694 to generally conform the tax preparer penalty standards to the standards for determining whether there has been a taxpayer understatement. Under the revised section, a penalty will generally be avoided where there is "substantial authority" for the position instead of the more stringent "more likely than not" standard existing under prior law. This reduced standard does not apply to positions on returns attributable to a tax shelter or a reportable transaction. The amendment to section 6694 is effective for returns prepared after May 25, 2007.

- *Guidance on valuing troubled financial assets and TARP warrants*. The Financial Accounting Standards Board (FASB) has issued a staff position providing guidance on how to assign fair values to the kinds of troubled financial assets that figure in the current financial crisis, particularly where the market for the asset is not active. The position is currently effective and will be applied to third-quarter financial reports. FASB and the SEC have also indicated that financial institutions participating in the TARP or CPP programs will be able to accord equity treatment to warrants issued to the government under TARP.
- *Suspension of mark-to-market accounting*. The EESA grants the SEC authority to suspend mark-to-market accounting and requires the SEC to study mark-to-market accounting and submit recommendations on the topic to Congress by January 1, 2009.

Contact Information

If you would like to discuss these or any other tax issues, please contact any member of the Ropes & Gray Tax & Benefits Department or your usual Ropes & Gray advisor.

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