

### **Emergency Economic Stabilization Act of 2008 Limits Executive Compensation and Offshore Deferrals**

**October 16, 2008**

On October 3, 2008 President Bush signed into law the Emergency Economic Stabilization Act of 2008 (the Act). The Act, among other things, (i) institutes the Troubled Asset Relief Program (the TARP), which authorizes the Treasury Department to purchase or insure a financial institution's troubled assets; (ii) adds section 457A to the Internal Revenue Code (IRC), which largely eliminates the ability of taxpayers to defer compensation that is received from entities located in certain non-U.S. jurisdictions; and (iii) makes various adjustments to the application of the alternative minimum tax (the AMT). In addition to the Act, on October 14, 2008, the Internal Revenue Service (IRS) issued IRS Notice 2008-94, which clarifies certain provisions within the TARP that relate to institutions that elect to participate in this program. The impact of each of these three provisions is summarized below in Sections 1, 2 and 3, respectively.

#### **1. Limitations on Executive Compensation for Financial Institutions That Sell Assets to the Treasury Department Through the TARP**

As stated above, the TARP provides the Treasury Department with the authority to purchase or insure a financial institution's assets. Financial institutions that sell assets to the Treasury Department (Participating Financial Institutions) under the TARP are subject to new limitations with respect to the compensation of their executives. Note that the new restrictions on executive compensation summarized in this Section do not apply to (i) financial institutions that only insure assets through the TARP or (ii) entities that do not participate in the TARP.

As explained in further detail below, the additional level of executive compensation limitations imposed on a Participating Financial Institution primarily depends upon the amount of assets that the institution sells to the Treasury Department through the TARP and whether the purchase by the Treasury Department occurs through a "Direct Purchase" (meaning a purchase of a Participating Financial Institution's assets by the Treasury Department through direct negotiations as opposed to a bidding process) or an "Auction Purchase" (meaning a purchase that results from a form of reverse bidding where financial institutions submit bids to the Treasury Department for the purchase of their troubled assets).

*Compensation Limitations Applicable to Participating Financial Institutions That Engage in Direct Purchases*

In the event the Treasury Department makes a Direct Purchase of a Participating Financial Institution's assets and in connection with that purchase receives a meaningful (this term is not defined in the Act)<sup>1</sup> equity or debt interest in that Participating Financial Institution,<sup>2</sup> then, during the period that the Treasury Department holds an equity or debt interest in that Participating Financial Institution, it is prohibited from:

- Paying incentives to its Senior Executive Officers (defined below) that could result in an “unnecessary and excessive risk” (this concept is not explained in the Act) to the Participating Financial Institution.
- Paying any golden parachute payments to its Senior Executive Officers.

In addition to the bar on incentive and golden parachute payments to its Senior Executive Officers, a Participating Financial Institution that engages in a Direct Purchase transaction must provide for the recovery of any bonus or incentive compensation that is paid to any of its Senior Executive Officers based on a statement of earnings, gains, or other criteria that are later determined to be materially inaccurate (the Recovery Policy). Note that unlike the prohibition with respect to incentive and golden parachute payments, as drafted, the Act does not specifically limit the applicability of the Recovery Policy to the time period in which the Treasury Department holds an equity or debt interest in the Participating Financial Institution; it is unclear whether this omission is intentional or whether it is a typographical error (there are other such errors in the Act). Further, it is also unclear under the Act whether a Participating Financial Institution must amend its bonus and incentive plans to incorporate the Recovery Policy.

In the context of a Direct Purchase, the term “Senior Executive Officer” refers to, in the case of a public Participating Financial Institution, the top five executives whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934; in the case of a private Participating Financial Institution, the term refers to the top five executives that hold positions that are comparable to the top five executives of a public Participating Financial Institution. This definition of Senior Executive Officers, in the Direct Purchase context, closely parallels the definition of Covered Employee for purposes of section 162(m) of the IRC. Generally, section 162(m) of the IRC limits a public corporation from deducting as a business expense compensation provided to a Covered Employee that is in excess of \$1 million (subject, however, to significant exceptions for performance-based payments such as stock options and stock appreciation rights). A “Covered Employee,” for purposes of section 162(m) of the IRC, is defined as the corporation's principal executive officer and

---

1. In addition to this limitation with respect to institutions that engage in Direct Purchases, the Act contains additional limitations on executive compensation for Participating Financial Institutions, all of which are summarized below and require, as a condition to being subject to such provisions, that the Participating Financial Institution sell in excess of \$300 million in assets to the Treasury Department. While, as stated above, the Act does not define the term “meaningful”, perhaps this \$300 million threshold will be relevant in the Treasury Department's interpretation of the term “meaningful” in the context of a Direct Purchase.

2. The Act requires that, as consideration for the Treasury Department's purchase of assets (unless the purchase is *de minimis*), it must receive either an equity or debt interest in the Participating Financial Institution.

its three most highly compensated officers (other than the corporation's principal executive officer or principal financial officer).

*Compensation Limitations Applicable to Participating Financial Institutions That Engage in Auction Purchases*

In the event a Participating Financial Institution sells assets to the Treasury Department through at least one Auction Purchase (meaning that it submits at least one successful bid to the Treasury Department), and the aggregate value of all purchases (including both Auction and Direct Purchases) made by the Treasury Department of that Participating Financial Institution's assets exceeds \$300 million, that Participating Financial Institution, through the expiration date of the Act (the Act is scheduled to expire on December 31, 2009; however, its expiration date may be extended by the Secretary of the Treasury through October 3, 2010), may not enter into any new employment contracts with its Senior Executive Officers (information regarding the meaning of this term is provided in the following paragraph) that provide for a golden parachute payment in the event of an involuntary termination of the executive or the bankruptcy, insolvency, or receivership of the Participating Financial Institution.

While the section of the Act that describes the effect on executive pay as a result of a Participating Financial Institution selling assets to the Treasury Department through an Auction Purchase does not define the term "Senior Executive Officers," the text of that section of the Act specifically provides that the Secretary of the Treasury must issue guidance regarding its application no later than two months after October 3, 2008. As of October 15, 2008, the Secretary of the Treasury has yet to issue any guidance regarding the application of this section (although the Secretary of the Treasury has issued guidance related to other sections of the Act); however, when this guidance is eventually issued, it seems likely that the term "Senior Executive Officers," in the context of an Auction Purchase will be given the same meaning that it has in the context of a Direct Purchase (i.e., the top five executive officers of a public or private financial institution).

*Amendment to Sections 162(m) and 280G of the IRC*

In addition to providing for the above limitations on executive pay, the Act also amends sections 162(m) and 280G of the IRC in a manner that affects Participating Financial Institutions that sell in excess of \$300 million of assets to the Treasury Department through either (i) one or more Auction Purchases or (ii) a combination of Direct Purchases and Auction Purchases (Qualifying Participating Financial Institutions). Note that the amendments to sections 162(m) and 280G of the IRC, as described below, affect only institutions that are classified under the Act as Qualifying Participating Financial Institutions and *not* (i) Participating Financial Institutions that engage solely in Direct Purchases (regardless of the amount of assets directly purchased by the Treasury Department), (ii) financial institutions that only insure assets with the Treasury Department through the TARP, or (iii) entities that do not participate in the TARP.

*Applicability of Section 162(m) of the IRC to Qualifying Participating Financial Institutions*

The Act amends section 162(m) of the IRC by adding an additional provision to it that, as indicated above, only affects Qualifying Participating Financial Institutions.

Generally, section 162(m) of the IRC prohibits any public corporation from deducting as an expense annual compensation paid to the corporation's Covered Employees (as defined earlier) that is in excess of \$1 million (on a per-officer basis). However, all payments to each of the above-described officers that are classified as certain kinds of performance-based compensation (for example, compensation attributable to stock options and stock appreciation rights is generally classified as performance-based compensation) and commissions are exempt from the \$1 million limit (meaning that regardless of the value of any of the above-listed officer's annual compensation, the full value of certain performance-based compensation or commissions paid to such officers is fully deductible).

The additional provision added to section 162(m), which applies to both public *and* private Qualifying Participating Financial Institutions (as opposed to just public institutions), prohibits such institutions from deducting compensation paid to each of the institution's "Covered Executives" (defined below) that is in excess of **\$500,000** (as opposed to \$1 million). Further, both performance-based compensation<sup>3</sup> and commissions are now included in the calculation of this \$500,000 threshold.

The deduction limitation imposed by this section takes effect in the first tax year that a financial institution is classified as a Qualifying Participating Financial Institution and remains in effect through the Act's expiration date. Note that the Act itself is unclear as to when an institution that becomes subject to the provisions described in this paragraph will cease to be subject to such provisions; however, IRS Notice 2008-94 (which provides guidance regarding the application of the additional provisions added to sections 162(m) and 280G of the IRC by the Act) makes it clear that the provisions described in this paragraph cease to be applicable to any institution on the Act's expiration date (including an institution that continues to meet the requirements to be classified as a Qualifying Participating Financial Institution after the Act's expiration date).

Under the Act, Covered Executives include the Qualifying Participating Financial Institution's chief executive officer, chief financial officer, and three most highly compensated executives (other than the institution's chief executive officer or chief financial officer).

#### *Applicability of Section 280G of the IRC to Qualifying Participating Financial Institutions*

Similar to the revisions to section 162(m) of the IRC, the Act amends section 280G by adding an additional provision that affects only Qualifying Participating Financial Institutions.

Section 280G of the IRC generally provides that any payment classified as an excess parachute payment is not deductible by an employer and is subject to a 20% excise tax payable by the recipient of such payment. Generally, an excess parachute payment is any payment that (i) is not classified as reasonable compensation under section 280G of the IRC, (ii) is made to a "disqualified individual" (defined as an employee of a public or private employer who is an officer, shareholder, or highly compensated individual of such employer) on account of a change of control of the employer, and (iii)

---

3. As the Act does not exclude compensation that is attributable to performance-based compensation in determining if the \$500,000 threshold is exceeded, and since section 162(m) of the IRC defines performance-based compensation to include compensation derived from the exercise of stock options and stock appreciation rights, Qualifying Participating Financial Institutions must include the amount of income a Covered Executive receives on the exercise of a stock option or stock appreciation right in determining if the \$500,000 threshold has been exceeded.

is equal to or greater than three times the individual's base compensation for the five years preceding the change of control.

With respect to Qualifying Participating Financial Institutions, the Act expands the nondeductibility and 20% excise tax provision of section 280G of the IRC to apply to all payments (regardless of whether such payments are classified as reasonable compensation under section 280G of the IRC) made to the institution's Covered Executives (as defined above) on account of the executive's involuntary termination or in connection with the institution's bankruptcy, liquidation, or receivership that are in excess of three times the executive's average base compensation for the five years preceding the executive's involuntary termination or the institution's bankruptcy, liquidation, or receivership.

The deduction limitation and excise tax imposed by this section on certain severance payments take effect in the first tax year that a financial institution is classified as a Qualifying Participating Financial Institution and remain in effect through the Act's expiration date. Note that the Act itself is unclear as to when an institution that becomes subject to the provisions described in this paragraph will cease to be subject to such provisions; however, IRS Notice 2008-94 (which provides guidance regarding the application of the additional provisions added to sections 162(m) and 280G of the IRC by the Act) makes clear that the provisions described in this paragraph cease to be applicable to any institution on the Act's expiration date (including an institution that continues to meet the requirements to be classified as a Qualifying Participating Financial Institution after the Act's expiration date).

Note that, in the event a payment is classified as an excess parachute payment under the provisions of section 280G of the IRC that were in effect prior to October 3, 2008, such payment will be governed by those provisions and the above-described modification to section 280G of the IRC will not apply.

## **2. Taxation of Offshore Deferred Compensation**

In addition to instituting the TARP, the Act adds section 457A to the IRC, which generally will result in unfavorable tax treatment for individuals participating in nonqualified deferred compensation plans or arrangements maintained in certain non-U.S. jurisdictions. Under section 457A of the IRC, any compensation that is earned after January 1, 2009 and is deferred under a nonqualified deferred compensation plan of an offshore entity that is not subject to (i) the IRC or (ii) a "comprehensive foreign income tax scheme" (generally, an offshore entity will be deemed to be subject to a "comprehensive foreign income tax scheme" if the country in which the offshore entity is located has entered into a comprehensive tax treaty with the United States) is now includible in the taxpayer's gross income at the time such compensation is earned (as opposed to at the time that such compensation is actually distributed to the taxpayer under the terms of the applicable nonqualified deferred compensation plan). In the event the value of an item of compensation is not determinable at the time it would otherwise be includible in a taxpayer's gross income under the above rules, then section 457A of the IRC provides that such compensation will be included in the taxpayer's gross income in the year in which its value is actually determinable and such compensation will be subject to an interest charge as well as a 20% tax penalty.

With respect to existing deferred compensation that would otherwise meet the requirements of section 457A of the IRC but is earned prior to January 1, 2009, the Act generally grandfathers these deferrals and provides that the compensation attributable to these deferrals is not includible in the employee's gross income until 2018.

### **3. Alternative Minimum Tax (AMT) Revisions**

The Act also enacts various amendments to the IRC that impact the application of the AMT.

Individuals are subject to the AMT if in a given tax year their AMT liability exceeds their regular income tax liability. A taxpayer's AMT liability for a particular tax year is computed by applying the AMT against the taxpayer's alternative minimum taxable income (AMTI) after reduction for the taxpayer's allowable AMT exemption (an increase in the AMT exemption for a particular tax year results in a corresponding decrease in the taxpayer's AMTI, which reduces the taxpayer's AMT liability, thereby possibly exempting the taxpayer from being subject to the AMT for that particular tax year). Prior to the adoption of the Act, for the 2008 tax year, the AMT exemption was scheduled to be \$33,750 for unmarried individuals and \$45,000 for married individuals filing jointly. Further, prior to the adoption of the Act, personal credits would not have been able to be taken against a taxpayer's AMTI for the 2008 tax year.

In an attempt to limit the number of taxpayers who are subject to the AMT for the 2008 tax year, following similar relief provided for in the 2007 tax year, the Act increases the amount of the AMT exemption from \$33,750 to \$46,200 for unmarried individuals and from \$45,000 to \$69,950 for married individuals filing jointly; further, the Act also allows taxpayers to take personal credits against their AMTI for the 2008 tax year.

In addition to increasing the AMT exemption and allowing taxpayers to take personal credits against their AMTI for the 2008 tax year, the Act also reduces the recovery period for unused AMT tax credits in a manner that should be particularly beneficial to taxpayers who are subject to the AMT on the exercise of their incentive stock options (ISOs) and who later dispose of the shares derived from those ISOs at a loss.

Generally, under regular tax provisions, a taxpayer does not recognize income on account of an exercise of an ISO, but rather, the recognition event occurs when the taxpayer subsequently disposes of the shares that were derived from the exercise of the ISO. However, a taxpayer subject to the AMT, upon the exercise of an ISO, is required to pay tax on the value of the underlying stock. This tax will generate a tax credit (AMT Tax Credit); if that tax credit remains unused, it will be refunded to the taxpayer over a period of time. Generally, taxpayers who received AMT Tax Credits on account of exercising ISOs and later sold the underlying shares at a loss had to wait long periods of time before receiving refunds of their unused AMT Tax Credits. However, the Act benefits taxpayers in this particular situation because it accelerates the recovery period for their unused AMT Tax Credits. The amount of acceleration the Act will generate for an individual taxpayer depends upon his or her particular situation.

In addition to reducing the recovery period for unused AMT Tax Credits, the Act also affects the application of the AMT in other manners. Prior to the adoption of the Act, if an individual's adjusted gross income (AGI) for the tax year exceeded an annually adjusted amount, the amount of the taxpayer's AMT refundable credit would be reduced by a percentage that corresponded to his or her excess AGI; the Act eliminates this phase-out provision. Finally, the Act also abates any underpayment of tax outstanding as of October 3, 2008 related to the exercise of ISOs and the AMT, including interest penalties.

*The above summary is based on the actual text of the provisions within the Emergency Economic Stabilization Act of 2008 as well as IRS Notice 2008-94. However, with respect to many of the provisions of the Act summarized above, Congress has instructed the Secretary of the Treasury to issue regulations regarding the applications of those provisions. Therefore, in the coming months additional guidance regarding the application of the Act should be available, and that guidance will have a material effect on how those provisions are interpreted.*

For more information on the information discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

**Chicago**

David Ackerman	312.324.1170	<a href="mailto:dackerman@morganlewis.com">dackerman@morganlewis.com</a>
Brian D. Hector	312.324.1160	<a href="mailto:bhector@morganlewis.com">bhector@morganlewis.com</a>
Louis L. Joseph	312.324.1726	<a href="mailto:louis.joseph@morganlewis.com">louis.joseph@morganlewis.com</a>

**Dallas**

Riva T. Johnson	214.466.4107	<a href="mailto:riva.johnson@morganlewis.com">riva.johnson@morganlewis.com</a>
Heath Miller	214.466.4118	<a href="mailto:hmillier@morganlewis.com">hmillier@morganlewis.com</a>
Erin Turley	214.466.4108	<a href="mailto:eturley@morganlewis.com">eturley@morganlewis.com</a>

**New York**

Craig A. Bitman	212.309.7190	<a href="mailto:cbitman@morganlewis.com">cbitman@morganlewis.com</a>
Gary S. Rothstein	212.309.6360	<a href="mailto:grothstein@morganlewis.com">grothstein@morganlewis.com</a>

**Palo Alto**

S. James DiBernardo	650.843.7560	<a href="mailto:jdibernardo@morganlewis.com">jdibernardo@morganlewis.com</a>
Zaitun Poonja	650.843.7540	<a href="mailto:zpoonja@morganlewis.com">zpoonja@morganlewis.com</a>

**Philadelphia**

Robert L. Abramowitz	215.963.4811	<a href="mailto:rabramowitz@morganlewis.com">rabramowitz@morganlewis.com</a>
I. Lee Falk	215.963.5616	<a href="mailto:ilfalk@morganlewis.com">ilfalk@morganlewis.com</a>
Amy Pocino Kelly	215.963.5042	<a href="mailto:akelly@morganlewis.com">akelly@morganlewis.com</a>
Robert J. Lichtenstein	215.963.5726	<a href="mailto:rlichtenstein@morganlewis.com">rlichtenstein@morganlewis.com</a>
Vivian S. McCardell	215.963.5810	<a href="mailto:vmccardell@morganlewis.com">vmccardell@morganlewis.com</a>
Joseph E. Ronan	215.963.5793	<a href="mailto:jronan@morganlewis.com">jronan@morganlewis.com</a>
Steven D. Spencer	215.963.5714	<a href="mailto:sspencer@morganlewis.com">sspencer@morganlewis.com</a>
Mims Maynard Zabriskie	215.963.5036	<a href="mailto:mzabriskie@morganlewis.com">mzabriskie@morganlewis.com</a>
David B. Zelikoff	215.963.5360	<a href="mailto:dzelikoff@morganlewis.com">dzelikoff@morganlewis.com</a>

**Pittsburgh**

John G. Ferreira	412.560.3350	<a href="mailto:jferreira@morganlewis.com">jferreira@morganlewis.com</a>
R. Randall Tracht	412.560.3352	<a href="mailto:rtracht@morganlewis.com">rtracht@morganlewis.com</a>

**Washington, D.C.**

Althea R. Day	202.739.5366	<a href="mailto:aday@morganlewis.com">aday@morganlewis.com</a>
Mary B. (Handy) Hevener	202.739.5982	<a href="mailto:mhevener@morganlewis.com">mhevener@morganlewis.com</a>

Daniel L. Hogans	202.739.5510	<a href="mailto:dhogans@morganlewis.com">dhogans@morganlewis.com</a>
Gregory L. Needles	202.739.5448	<a href="mailto:gneedles@morganlewis.com">gneedles@morganlewis.com</a>
Dean R. Morley	202.739.5989	<a href="mailto:dmorley@morganlewis.com">dmorley@morganlewis.com</a>

To view other briefings previously released by the Morgan Lewis Financial Crisis Working Group, please visit <http://www.morganlewis.com/financialcrisis>.

### **About Morgan, Lewis & Bockius LLP**

Morgan Lewis is a global law firm with more than 1,400 lawyers in 22 offices located in Beijing, Boston, Brussels, Chicago, Dallas, Frankfurt, Harrisburg, Houston, Irvine, London, Los Angeles, Miami, Minneapolis, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, and Washington, D.C. For more information about Morgan Lewis or its practices, please visit us online at [www.morganlewis.com](http://www.morganlewis.com).

### **IRS Circular 230 Disclosure**

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. For information about why we are required to include this legend in emails, please see <http://www.morganlewis.com/circular230>.

This LawFlash is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. These materials may be considered Attorney Advertising in some states. Please note that the prior results discussed in the material do not guarantee similar outcomes.

© 2008 Morgan, Lewis & Bockius LLP. All Rights Reserved.