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TAX DEPARTMENT

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Key Tax Provisions of the Emergency Economic Stabilization Act of 2008

Introduction

The Emergency Economic Stabilization Act of 2008 ("EESA"), the primary impetus for which was authorization of the Secretary of the Treasury to purchase and insure troubled assets held by financial institutions so as to provide stability to the economy, also contains numerous tax provisions. These will result in billions of dollars of tax savings to business and individual taxpayers through new tax incentives and extensions of existing incentives. This massive tax reduction is in part offset by revenue-raising provisions. This memorandum discusses some of the key tax provisions in EESA that relate to business taxes and considers them in three general categories: (1) those that are directly related to the Troubled Asset Relief Program ("TARP"); (2) those that are concerned with energy production and energy conservation; and (3) those designed to raise tax revenue in order to partially offset the tax benefits and other costs estimated to flow from EESA.

Tax Provisions Relating to TARP

There are two important tax provisions related to TARP. The first provides special income tax rules for executive compensation paid by employers who are participating in TARP. The second deals with characterization of gain or loss on sales of certain assets by financial institutions participating in TARP.

Executive Compension

Under Section 162(m) of the Internal Revenue Code (the "Code") as in effect prior to EESA, generally no income tax deduction was allowed to a publicly-held corporation for compensation paid to certain highly-compensated officers in excess of $1 million per employee. EESA extends the Code Section 162(m) deduction limitation to entities (whether publicly-traded or not) that own mortgage-backed securities, if at least $300 million of such securities were acquired under either an "auction" or "reverse auction" mechanism. Moreover, the Code Section 162(m) "deduction cap" is reduced to $500,000 per year per "covered executive" (defined below) for affected taxpayers. Covered executives include the entity's CEO, CFO and the three other most highly-compensated executive officers.

EESA also includes changes to the "golden parachute" rule under Code Section 280G for employers who participate in TARP. Under Code Section 280G, such an employer cannot claim an income tax deduction for any "excess parachute payments" and a 20 percent excise tax is imposed on the employee who receives such payments. EESA expands the definition of "parachute payments" to cover any payments in the nature of compensation paid to the executive on account of an "applicable severance" from employment, if the aggregate present value of such payments is at least equal to three times the executive's base compensation. An "applicable severance" from employment is any severance from employment of an executive by reason of an involuntary termination of the executive by the employer or in connection with a bankruptcy, liquidation or receivership of the employer.

The Code Section 162(m) provision is effective for the first tax year that the employer reaches the $300 million threshold (and all tax years thereafter in which TARP is in effect). The amendments to Section 280G of the Code are effective for payments with respect to severances from employment occurring during or after the first taxable year, which includes any portion of the period during which the TARP provisions are in effect with respect to the employer.

Gain or Loss Characterization on Transfers of Certain Assets
The second significant tax provision in EESA that is related to TARP provides that gain or loss from the sale or exchange of certain preferred stock by applicable financial institutions (*i.e.,* banks, financial institutions and depository institution holding companies) will be treated as ordinary (as opposed to capital) income or loss. Because ordinary losses, unlike capital losses, can shelter all future income of these financial institutions (*i.e.*, not just capital gains), this provision may provide a substantial tax benefit to financial institutions that have incurred losses with respect to such preferred stock. This provision applies to preferred stock in "Fannie Mae" and "Freddie Mac" that was either (a) held on September 6, 2008, or (b) sold or exchanged on or after January 1, 2008, and before September 7, 2008.

Key Tax Provisions Relating to Energy Production and Energy Conservation
As noted in our October 2008 Tax Client Alert, EESA provides billions of dollars in savings to taxpayers through new tax incentives and extensions of existing incentives for clean energy sources over the next decade. To read the major energy-related tax provisions of EESA, please see the link below.

http://www.kayescholer.com/web.nsf/0/82564CF84E3107A6852574F0004EFA87/$file/TA102008.pdf?openelement

Tax Revenue Raisers
The tax cuts under EESA are funded, in part, by a number of revenue raisers. Some of the most significant of these revenue raisers are discussed below.

Offshore Nonqualified Deferred Compensation
EESA includes a new provision (Section 457A of the Code) intended to prevent certain U.S. service providers (notably, hedge fund managers) from using off-shore tax haven corporations and other structures to defer U.S. income tax on compensation received for providing investment services.

Previously, U.S. individuals could defer paying tax on compensation until paid, so long as the corporation paying the deferred compensation deferred its deduction. Matching the timing of the deduction with the income inclusion was designed to ensure that the individual could not achieve the tax benefits of deferred compensation at the expense of the Treasury. However, where payment was made by an offshore tax haven corporation or by a partnership, substantially all of the income of which was allocated to tax-exempt organizations or non-U.S. persons not subject to tax, the payor was indifferent as to the deduction. As a result, in such situations the matching of a deferral of deductions as a condition for deferring the recognition of taxable income to the U.S. individual had no meaningful tax consequences to the payor entity. Many hedge funds took advantage of this tax-planning opportunity and used structures whereby payment of management fees was deferred by tax-indifferent payors.

EESA requires certain deferred compensation owed by certain non-U.S. entities to be taken into income as it accrues, regardless of the timing of the payments, so long as the entitlement to the compensation is not subject to a "substantial risk of forfeiture" (*i.e.*, is not conditioned upon the future performance of substantial services or the possibility of forfeiture is not substantial). Any amounts owed but not currently ascertainable would be taken into income when ascertainable, subject to both an interest charge imposed on the related (deferred) tax liability and an additional 20 percent tax. The rule covers deferred compensation paid by (1) any non U.S. corporation, unless substantially all of its income is (a) effectively connected with a trade or business in the United States or (b) subject to a comprehensive non U.S. income tax, and (2) any partnership (U.S. or non U.S.), unless substantially all of its income is allocated to persons other than (a) non U.S. persons for whom that income is not subject to a comprehensive foreign income tax and (b) organizations that are exempt from U.S. income tax. The new law contains an exception for payments that are received not later than 12 months after the end of the taxable year in which the right to compensation is no longer subject to a substantial risk of forfeiture.

Certain "carried interests" in investment funds are specifically excluded from the new rule. Specifically, if compensation is determined solely by reference to the amount of gain recognized on the disposition of an "investment asset," that compensation is treated as subject to a substantial risk of forfeiture until the date of the asset disposition. "Investment asset" is defined to mean any single asset (other than an investment fund or similar entity) that is (1) acquired directly by an investment fund or similar entity, (2) with respect to which neither the entity nor any person related to the entity participates in the active management of that asset (or if that asset is an interest in an entity, in the active management of the activities of the entity) and (3) substantially all of any gain on the disposition of which (other than the deferred compensation) is allocated to investors in the fund.

This provision generally is effective for deferred amounts attributable to services performed after December 31, 2008.

Modification to Section 199 Deduction Related to Domestic Oil-Related Qualified Production Activities

Section 199 of the Code provides a deduction — currently 6 percent — equal to a portion of the taxpayer's "qualified production activities income." Under prior law, the deduction was scheduled to increase to 9 percent in 2010. EESA freezes it at 6 percent for gross receipts derived from the sale, exchange or other disposition of oil, natural gas, or any primary product thereof. This provision could potentially affect the investment decisions of companies in the oil and gas industry.

Modification of Rules Regarding Foreign Oil and Gas Income

EESA eliminates the distinction between foreign oil and gas extraction income ("FOGEI") and foreign oil-related income ("FORI") under Section 907 of the Code, which contains limitations on utilization of credits for non-U.S. income taxes. FOGEI relates to production of oil to the point the oil leaves the wellhead. FORI is defined as all downstream processes once the oil leaves the wellhead (that is, transportation, refining, *etc.*). FOGEI currently is subject to a separate foreign tax credit limitation. The new provision combines FOGEI and FORI into one foreign oil income basket, and applies the existing FOGEI limitation. This change, which is effective for taxable years beginning after December 31, 2008, likely will reduce the foreign tax credits available to U.S. taxpayers who derive FORI.

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