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Economic Stabilization Act: Employee Benefits and Executive Compensation

October 2008
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The recently enacted Economic Stabilization Act of 2008 (the “Act”) contains a number of significant employee benefits and executive compensation provisions, some that apply to employee benefit plans generally, and some that apply only to the executive compensation arrangements of Financial Institutions taking advantage of the Troubled Asset Relief Program (“TARP”) offered under the Act.

A summary of these provisions follows:

Treasury Secretary to Consider Protecting Some, but Not All Employee Benefits.

In exercising authority under TARP, the Treasury Secretary is required to take various criteria into consideration, including the purchase of troubled assets from certain tax-qualified plans holding such assets. (Division A, Title I, Section 103(8) of the Act.) For this purpose, the plans that are eligible for protection include 401(k) plans, defined benefit pension plans, 403(b) plans, and qualified 457 plans of governmental and tax-exempt entities.

Individual Retirement Arrangements (IRAs) are not eligible for protection under this provision. Also, specifically excluded from consideration of protection are any compensation arrangements to which Section 409A of the Internal Revenue Code (the “Code”) applies. Section 409A arrangements generally include unfunded deferred compensation plans, but can also include severance, change in control, and other similar arrangements. Therefore, this provision of the Act does not protect, for example, deferred compensation benefits held by an employer in a “rabbi trust.”

Treasury Secretary Given Broad Power over Design and Operation of Certain Financial Institutions’ Executive Compensation Arrangements.

Financial institutions taking advantage of TARP are subject to new limitations on executive compensation. (Division A, Title I, Section 111 of the Act.) In cases where direct purchases of troubled assets are made from a financial institution under TARP where no bidding process or market prices are available and the Treasury Secretary holds a meaningful equity or debt position in the institution, the Treasury Secretary has the power to restrict the executive compensation the institution affords to its executive officers. The criteria the Act permits the Treasury Secretary to consider in limiting a financial institution's executive compensation include (i) excluding incentives for executive officers to take unnecessary and excessive risks that threaten the value of the financial institution, (ii) prohibiting any golden parachute payments to the institution's senior executive officers, and (iii) providing for the recovery of any bonus or incentive compensation paid to a senior executive officer that was based on statements of earnings, gains, or other criteria that are later proven not to be materially accurate.

In cases where the Treasury Secretary determines that the purpose of the Act is best met through auction purchases of troubled assets, and where such purchases in the aggregate exceed $300 million, the Treasury Secretary is required to prohibit any new employment contract with a senior executive officer that provides a golden parachute in the event of an involuntary termination, bankruptcy filing, insolvency, or receivership. It is not clear how 'golden parachute' will be defined for purposes of this provision, but that question may be answered under regulations that the Treasury Secretary is directed to issue within two months following enactment of the Act. The provision described in this paragraph will expire on December 31, 2009, unless extended by certification by the Treasury Secretary to Congress.

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For purposes of these rules a 'senior executive officer' is defined as an individual who is one of the top five highest-paid executives of a public company whose compensation is required to be disclosed under the Securities Exchange Act of 1934, as well as non-public company executive counterparts.

Tax Law Changes Affecting Executive Compensation

In addition to giving the Treasury Secretary power over the design of executive compensation and benefit plan provisions of financial institutions participating in the TARP program, the Act also makes tax law changes that affect such institutions:

Limitation of Employer's Deduction for Compensation over $500,000. With respect to an employer from whom more than $300 million in troubled assets is acquired under TARP (other than an employer whose only sales of troubled assets under the Act are direct purchases), no deduction is allowed to the employer for executive remuneration of a covered executive that exceeds $500,000 in any taxable year. (Division A, Title III, Section 302(a) of the Act.) In addition, any deferred compensation that an executive earns in any year cannot be deducted in a subsequent year (when it is ordinarily paid to the executive) to the extent it exceeds $500,000 in the year that such deferred compensation was earned reduced by the amount of taxable pay the executive received in the same year.

For purposes of this rule, 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. Any individual who is considered a covered executive for any year retains that status for all succeeding years. This provision is included as an amendment to the existing $1 million limit on deductible executive pay under Code Section 162(m), and borrows certain concepts from 162(m), but also deviates from the existing provisions in important ways. For example, the $500,000 limitation on deductibility added by the Act applies to private as well as public companies, and also to partnerships. In addition, for purposes of this new rule, 'executive remuneration' that is counted toward the $500,000 cap means all amounts taxable to a covered executive in any taxable year, without any offset or reduction for amounts that would be excludable under the $1 million cap under Section 162(m) of the Code, such as commissions, performance-based pay, and existing binding contracts.

Limitation of Employer's Deduction for Severance Pay Equal to or in Excess of Three Times Employee's Base Pay. Another provision in the Act limits the deductibility to an institution participating in TARP 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 employees' base amount. (Division A, Title III, Section 302(b) of the Act.) An executive's base amount is calculated the same way as under existing golden parachute rules 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, if an executive receives severance pay equal to or exceeding three times the executive's base amount, the Treasury Secretary is given power to implement regulations that would also impose an excise tax on the covered executive equal to 20% of any severance pay he or she receives equal to or exceeding the executive's base amount.

New Employee Benefit Tax Provisions Unrelated to TARP

In addition to the new tax provisions discussed above, the Senate added a couple of other employee provisions that are not related to the TARP Program.

Nonqualified Deferred Compensation of Foreign Entities. The Act adds new Section 457A, which applies generally to any compensation deferred under a nonqualified deferred compensation plan of an entity that is a foreign corporation where substantially all of its income is not effectively connected with the conduct of a trade or business in the United States or subject to a comprehensive foreign income tax. (Division C, Title VIII, Section 801 of the Act.) This new provision also applies in cases where substantially all of the income of a partnership is allocated to foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax or to organizations that are exempt from U.S. income tax. Any nonqualified deferred compensation that is subject to this rule becomes taxable in the year in which it is no longer subject to a substantial risk of forfeiture, which generally requires the future performance of substantial services or, to the extent provided in regulations prescribed by the Treasury Secretary, compensation determined solely by reference to the amount of gain recognized on the disposition of an investment asset. This provision is effective for service performed after December 31, 2008.

Mental Health Parity and Addiction Equity Act of 2008

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This provision amends current law and applies in the case of a group health plan, or health insurance coverage offered in connection with such a plan, that provides both medical and surgical benefits and mental health or substance-use disorder benefits. (Division C, Title V, Subdivision B of the Act.) Under these new provisions, any such plan or insurance must provide that the financial requirements and treatment limitations[1] applicable to mental health or substance-use disorder benefits are no more restrictive than the predominant financial requirements and treatment limitations that apply to medical and surgical benefits covered by the plan or coverage. This provision is generally effective for plan years beginning one year after the date of enactment of the Act.

Footnotes:

[1] An example of a treatment limitation is a limit on the maximum number of visits per year.

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