

EXECUTIVE ALERT

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HOUSE PASSES BILL LEVYING 90% TAX ON BONUSES HANDED OUT BY TARP RECIPIENTS; SIMILAR SENATE BILL FORTHCOMING; CHALLENGES CERTAIN IF LEGISLATION PROCEEDS

When AIG CEO Edward Liddy testified before the House of Representatives last week, he informed Congress that AIG has handed out \$165 million in bonuses. Because AIG has received in excess of \$170 billion in federal assistance under the Treasury's Trouble Asset Relief Program (TARP) (and likely would not have survived, let alone have been in a position to pay bonuses, without such massive federal assistance), these bonuses have understandably generated a storm of controversy among the public and among those serving in government. Upon hearing of the bonuses, House and Senate leaders introduced different bills to limit or tax out of existence bonuses paid by companies receiving significant TARP assistance.

The House Bill Taxing Bonuses

The House of Representatives acted quickly. On March 19, 2009, it passed a bill (H.R. 1586) imposing a 90 percent income tax on bonuses of individuals who:

- are employed (or formerly employed) by companies that have taken \$5 billion or more in federal assistance under the Economic Stabilization Act of 2008's TARP program (a "TARP recipient"), and
- have adjusted gross income in excess of \$250,000 (\$125,000 in the case of a married individual filing a separate return).

The bill covers any bonuses that are retention payments, incentive payments, or other bonuses which are in addition to any amount payable to such individuals for services performed by such individuals at a regular hourly, daily, weekly, monthly, or similar periodic rate.

The bill's taxation provisions apply to bonuses received on or after January 1, 2009. Bonuses will not be taxed at this rate once a TARP recipient has repaid TARP monies owed to the Treasury in excess of \$5 billion. This House bill is designed to reclaim taxpayer money used to pay for bonuses at a dozen or so companies, including AIG, Fannie Mae, Freddie Mac, Citigroup, and Bank of America.

The Senate Version

The Senate soon followed with its own version of a bill taxing bonuses—the Compensation Fairness Act of 2009. The proposed Senate bill affects TARP recipients in which the government holds an equity interest and the employees of such TARP recipients. Excluded from the bill are small banks and large banks who have received \$100 million or less in TARP funds. The bill includes two main components: an excise tax on excess bonuses and a \$1 million cap on deferred compensation.

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The excise tax on excess bonuses provision affects companies and individuals. Both employers and employees would be required to pay a 35% excise tax on all retention bonuses (whatever the amount) and all other bonuses in excess of \$50,000. When combined with other federal, state, and local taxes, this excise tax could result in near (or even over) 100% taxation of bonuses. These excise taxes would not be deductible. Like the House bill, the Senate bill applies to bonuses received on or after January 1, 2009. This tax burden would be lifted from bonuses received after the TARP recipient has repaid TARP monies owed to the Treasury in excess of \$100 million.

The \$1 million cap on deferred compensation limits the amount of nonqualified deferred compensation available to employees of TARP recipients in which the government holds an equity interest (excluding small and large banks as noted above) to \$1 million in any twelve-month period. Individuals who defer more than the amount allowed will face taxes on the excess amount and a 20% penalty tax and interest payment. Interest and earnings based on the market rate of return would not be part of the \$1 million limit. Individuals seeking to avoid exceeding the \$1 million limit would have the opportunity to stop participation in nonqualified deferred compensation plans without being subject to these new Code Section 409A penalties.

The Future of This Legislation

Senate leadership has indicated that they may bring the Senate bill to the floor the week of March 23 and hold a conference with the House the following week.

There are significant questions about the legitimacy of these two bills and whether the resulting law could withstand judicial scrutiny. Treasury and Congress had ample opportunity before investing TARP funds to require TARP recipients, as a condition of receipt, to limit future bonus payouts to executives and employees. Congress and Treasury not only failed to obtain such concessions before investing taxpayer dollars, but explicitly provided a loophole allowing certain bonuses to be paid. These actions created a general expectation, by both the TARP funds corporate recipients and their employees, that certain existing bonus-related contractual arrangements would not be impacted by government action. As a result, courts are unlikely to allow targeted, after-the-fact changes to the contractually-grounded compensation arrangements, particularly to the extent any company or employee reasonably relied on the prior government action (or inaction). Ironically, while perhaps the most egregious fact situations caused Congress to pass the legislation, the least egregious fact situations likely will lead to the legislation (or certain applications of the legislation) being stricken by the courts.

Grounds for potentially challenging the legislation include those based in contract law and various constitutional bases. The challenges based on contract law are numerous, but also fact-specific.

With respect to constitutional frailties, there is a range of colorable arguments that the proposed tax provisions are unconstitutional; some of these arguments are stronger than others. One such argument is that these provisions constitute an unconstitutional Bill of Attainder, under Article I Section 9 of the Constitution, which prohibits the passing of any law that singles out an individual or group for punishment. Supporters of the bills will argue that the legislation is generally applicable and regulatory, not punitive, in nature, and therefore, not a Bill of Attainder. Those opposing the bills will likely cite the severe tax provisions as clearly punitive and focused on a relatively small, select group of individuals. It is difficult to predict how the courts would assess this argument, since the actual number of affected parties is likely to be in the hundreds, and may even exceed a thousand. Because the House bill is more narrowly tailored, it is more vulnerable to this argument than the Senate version.

Any legislation will also be challenged as an *ex post facto* law, proscribed by Article I Section 9 of the Constitution, because the proposals apply retroactively to bonuses

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paid on or after January 1, 2009. Under this constitutional argument, the law cannot change the legal consequences of an act or action after such act or action has occurred. However, this argument is highly unlikely to succeed based on judicial precedent to date.

Any legislation also may face a Fifth Amendment Takings Clause attack, based on the argument that there has been a taking of private property for public use without just compensation. Such an attack also would be unlikely to succeed based on judicial precedent to date—generally tax legislation has not been successfully challenged on takings grounds. One reason, however, why this argument may get some traction here is because of the government’s past actions relating to TARP, which arguably caused both TARP corporate recipients and employees to conclude that past contractual arrangements would not be disturbed. Thus, for example, an affected employee would be able to claim that, had he known that the existing contractual arrangements would be disturbed by governmental action, he would have left the company that received TARP funds. This argument, and the facts upon which it is based, closely resemble the situation found in the *Winstar* line of cases, in which the government was held liable under the Takings Clause for inducing companies and individuals to buy S&L institutions, based upon a certain accounting treatment of their good will for the purposes of satisfying the relevant capitalization requirements, only to later change this regulatory posture, to the disadvantage of the private parties involved.

The strongest Constitutional basis on which to challenge this legislation would be challenges by individual employees as a violation of the Fifth Amendment’s Equal Protection Clause

The strongest Constitutional basis on which to challenge this legislation would be challenges by individual employees as a violation of the Fifth Amendment’s Equal Protection Clause which requires the government to treat similarly situated parties in a like fashion. In this regard, while the bills in issue use the fact that a given company has received TARP monies as a triggering event, the parties being taxed include the employees. Significantly, there is no meaningful difference, sufficient to satisfy the Equal Protection Clause’s requirements, between an employee who may earn a bonus at a corporation that has received TARP funds and an employee who earns a bonus at an employer that has not received TARP funds.

Most of the employees were not in a position to participate in corporate decisions on whether or not to seek TARP funding; arguably, even the most senior employees, up to and including the CEO level, may have been pressured by the government to accept TARP funds. (There were many media stories recounting how even some of the largest financial institutions did not wish to accept TARP funding but responded to pressure by the Treasury Department and the Federal Reserve.) Just as it would be unconstitutional for Congress to tax employees of a green energy company at a lower tax rate and employees of a coal-fired electric utility at a higher tax rate, the legislation, as proposed, may not pass constitutional muster to the extent it would tax employees working at different banks differently.

Significantly, unlike the case with the Takings, Bill of Attainder and *ex post facto* arguments, the fact that Congress and Treasury, had they thought about it, could have imposed conditions on TARP recipients regarding permissible bonuses does not change the Equal Protection analysis. Employees have a constitutional right to be taxed similarly to others on similar income under any circumstances, and irrespective of whether the tax is being imposed prospectively or retrospectively, and whether it covers a large or small number of employees.

If the legislation passes in any of its current forms, it is sure to face severe scrutiny and create a torrent of litigation as its provisions begin to be applied in specific cases. It is not too late for Congress to significantly amend the proposed legislation or to send Treasury back to the negotiating table with these companies to work out fair resolutions on a case-by-case basis.

If you have any questions about these issues, please contact [Jeff Paravano](#), [David Rivkin Jr.](#), [Ray Malone](#) or your Baker Hostetler attorney.

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