TECHNICAL EXPLANATION OF TITLE III (TAX PROVISIONS) OF DIVISION A OF H.R. 1424, THE "EMERGENCY ECONOMIC STABILIZATION ACT OF 2008"

SCHEDULED FOR CONSIDERATION BY THE SENATE ON OCTOBER 1, 2008

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of Title III (Tax Provisions) of Division A of H.R. 1424, the "Emergency Economic Stabilization Act of 2008," scheduled for consideration by the Senate on October 1, 2008.

[1] This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of Title III (Tax Provisions) of Division A of H.R. 1424, the "Emergency Economic Stabilization Act of 2008"* (JCX-79-08), October 1, 2008. This document can also be found on our website at www.jct.gov.

A. Treat Gain or Loss from Sale or Exchange of Certain Preferred Stock by Applicable Financial Institutions as Ordinary Income or Loss (sec. 301 of the bill)

Present Law

Under section 582(c)(1),[2] the sale or exchange of a bond, debenture, note, or certificate or other evidence of indebtedness by a financial institution described in section 582(c)(2) is not considered a sale or exchange of a capital asset. The financial institutions described in section 582(c)(2) are (i) any bank (including any corporation which would be a bank except for the fact that it is a foreign corporation), (ii) any financial institution referred to in section 591, which includes mutual savings banks, cooperative banks, domestic building and loan associations, and other savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law, (iii) any small business investment company operating under the Small Business Investment Act of 1958, and (iv) any business development corporation, defined as a corporation which was created by or pursuant to an act of a State legislature for purposes of promoting, maintaining, and assisting the economy and industry within such State on a regional or statewide basis by making loans to be used in trades and businesses which would generally not be made by banks within such region or State in the ordinary course of their business (except on the basis of a partial participation) and which is operated primarily for such purposes. In the case of a foreign corporation, section 582(c)(1) applies only with respect to gains or losses that are effectively connected with the conduct of a banking business in the United States.

Preferred stock issued by the Federal National Mortgage Corporation ("Fannie Mae") or the Federal Home Loan Mortgage Corporation ("Freddie Mac") is not treated as indebtedness for Federal income tax purposes, and therefore is not treated as an asset to which section 582(c)(1) applies. Accordingly, a financial institution described in section 582(c)(2) that holds Fannie Mae or Freddie Mac preferred stock as a capital asset generally will recognize capital gain or loss upon the sale or taxable exchange of that stock. Section 1211 provides that, in the case of a corporation, losses from sales or exchanges of capital assets are allowed only to the extent of gains from such sales or exchanges.[3] Thus, in taxable years in which a corporation does not recognize gain from the sale of capital assets, its capital losses do not reduce its income.

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[2] Unless otherwise specified, all section references herein are to sections of the Internal Revenue Code of 1986, as amended.

[3] In general, corporations (other than S corporations) may carry capital losses back to each of the three taxable years preceding the loss year and forward to each of the five taxable years succeeding the loss year. Sec. 1212(a). In the case of an S corporation, net capital losses flow through to the corporation's shareholders. Banks hold a wide range of financial assets in the ordinary course of their banking business. For convenience, those assets often are described as "loans" or "investments," but both serve the same overall purpose (to earn a return on the bank's capital and borrowings consistent with prudent banking practices). A bank's investments are subject to the same regulatory capital adequacy supervision as are its loans, and a bank may acquire only certain types of financial assets as permitted investments. Banks determine how much of their assets to hold as loans or as investments based on the exercise of their commercial and financial judgment, taking into account such factors as return on the

Explanation of Provision

Under the provision, gain or loss recognized by an "applicable financial institution" from the sale or exchange of "applicable preferred stock" is treated as ordinary income or loss. An applicable financial institution is a financial institution referred to in section 582(c)(2) or a depository institution holding company (as defined in section 3(w)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(w)(1)). Applicable preferred stock is preferred stock of Fannie Mae or Freddie Mac that was (i) held by the applicable financial institution on September 6, 2008, or (ii) was sold or exchanged by the applicable financial institution on or after January 1, 2008, and before September 7, 2008.[4]

In the case of a sale or exchange of applicable preferred stock on or after January 1, 2008, and before September 7, 2008, the provision applies only to taxpayers that were applicable financial institutions at the time of such sale or exchange. In the case of a sale or exchange of applicable preferred stock after September 6, 2008, by a taxpayer that held such preferred stock on September 6, 2008, the provision applies only where the taxpayer was an applicable financial institution at all times during the period beginning on September 6, 2008, and ending on the date of the sale or exchange of the applicable preferred stock. Thus, the provision is generally inapplicable to any Fannie Mae or Freddie Mac preferred stock held by a taxpayer that was not an applicable financial institution on September 6, 2008 (even if such taxpayer subsequently became an applicable financial institution).

The provision grants the Secretary authority to extend the provision to cases in which gain or loss is recognized on the sale or exchange of applicable preferred stock acquired in a carryover basis transaction by an applicable financial institution after September 6, 2008. For example, if after September 6, 2008, Bank A, an entity that was an applicable financial

asset, relative liquidity, and diversification objectives. As a result, for Federal income tax purposes, gains and losses on a bank's investment portfolio ordinarily would be considered an integral part of the business operations of the bank, and ordinary losses that pass through to the shareholder of a bank that is an S corporation therefore could comprise part of such shareholder's net operating loss for the year attributable to that banking business.

Section 1366(d) provides that losses that flow through to an S corporation shareholder are limited to the sum of (i) the shareholder's adjusted basis in his S corporation stock and (ii) the shareholder's adjusted basis in any indebtedness of the S corporation to the shareholder; losses in excess of basis are suspended (and allowed to the extent of basis in subsequent years). An S corporation shareholder's ability to utilize any flow-through capital loss is subject to all limitations otherwise imposed by the Code on such shareholder. In general, under section 1211, an individual (including an individual S corporation shareholder) may deduct capital losses only against capital gains plus up to $3,000 of ordinary income; in addition, an individual may carry excess capital losses forward but not back.

[4] On September 7, 2008, the Federal Housing Finance Agency ("FHFA") placed both Fannie Mae and Freddie Mac in a conservatorship. Also on September 7, 2008, FHFA and the Treasury Department entered into Preferred Stock Purchase Agreements, contractual agreements between the Treasury and the conserved entities. Under these agreements, the Treasury Department received senior preferred stock in the two companies and warrants to buy 79.9% of the common stock of such companies.

institution at all times during the period beginning on September 6, 2008, acquired assets of Bank T, an entity that also was an applicable financial institution at all times during the period beginning on September 6, 2008, in a transaction in which no gain or loss was recognized under section 368(a)(1), regulations could provide that Fannie Mae and Freddie Mac stock that was applicable preferred stock in the hands of Bank T will continue to be applicable preferred stock in the hands of Bank A.

In addition, the Secretary may, through regulations, extend the provision to cases in which the applicable financial institution is a partner in a partnership that (i) held preferred stock of Fannie Mae or Freddie Mac on September 6, 2008, and later sold or exchanged such stock, or (ii) sold or exchanged such preferred stock on or after January 1, 2008, and before September 7, 2008. It is intended that Treasury guidance will provide that loss (or gain) attributable to Fannie Mae or Freddie Mac preferred stock of a partnership is characterized as ordinary in the hands of a partner only if the partner is an applicable financial institution, and only if the institution would have been eligible for ordinary treatment under section 301 of the bill had the institution held the underlying preferred stock directly for the time period during which both (i) the partnership holds the preferred stock and (ii) the institution holds substantially the same partnership interest.

In particular, substantial amounts of the preferred stock of Fannie Mae and Freddie Mac are held through “pass-through trusts” analyzed as partnerships for Federal income tax purposes. Substantially all the assets of such a pass-through trust comprise Fannie Mae or Freddie Mac preferred stock, and the trust in turn passes through dividends received on such stock to its two outstanding classes of certificates (partnership interests): an auction-rate class, where the share of the underlying preferred stock dividend is determined by periodic auctions, and a residual class, which receives the remainder of any dividends received on the underlying stock. The bill’s delegation of authority to the Secretary anticipates that regulations will promptly be issued confirming in general that losses recognized by such a trust on or after January 1, 2008, in respect of the preferred stock of Fannie Mae or Freddie Mac that it acquired before September 6, 2008, will be characterized as ordinary loss in the hands of a certificate holder that is an applicable financial institution and that would be eligible for the relief contemplated by this provision if the applicable financial institution had held the underlying preferred stock directly for the same period that it held the pass-through certificate. In light of the substantial amount of such pass-through certificates in the marketplace, and the importance of the prompt resolution of the character of any resulting losses allocated to certificate holders that are applicable financial institutions for purposes of their regulatory and investor financial statement filings, unnecessary disruptions to the marketplace could best be avoided if the Secretary were to exercise the regulatory authority granted under the provision to address this case as soon as possible and, in any event, by October 31, 2008.

Effective Date

This provision applies to sales or exchanges occurring after December 31, 2007, in taxable years ending after such date.

B. Special Rules for Tax Treatment of Executive Compensation of Employers Participating in the Troubled Assets Relief Program (sec. 302 of the bill and secs. 162(m) and 280G of the Code)

Present Law

In general

An employer generally may deduct reasonable compensation for personal services as an ordinary and necessary business expense. Sections 162(m) and 280G provide explicit limitations on the deductibility of compensation expenses in the case of corporate employers.

Section 162(m)

In general

The otherwise allowable deduction for compensation paid or accrued with respect to a covered employee of a publicly held corporation[5] is limited to no more than $1 million per year.[6] The deduction limitation applies when the deduction would otherwise be taken. Thus, for example, in the case of compensation resulting from a transfer of property in connection with the performance of services, such compensation is taken into account in applying the deduction limitation for the year for which the compensation is deductible under section 83 (i.e., generally the year in which the employee's right to the property is no longer subject to a substantial risk of forfeiture).

Covered employees

Section 162(m) defines a covered employee as (1) the chief executive officer of the corporation (or an individual acting in such capacity) as of the close of the taxable year and (2) the four most highly compensated officers for the taxable year (other than the chief executive officer). Treasury regulations under section 162(m) provide that whether an employee is the chief executive officer or among the four most highly compensated officers should be determined pursuant to the executive compensation disclosure rules promulgated under the Securities Exchange Act of 1934 ("Exchange Act").

In 2006, the Securities and Exchange Commission amended certain rules relating to executive compensation, including which executive officers' compensation must be disclosed under the Exchange Act. Under the new rules, such officers consist of (1) the principal executive officer (or an individual acting in such capacity), (2) the principal financial officer (or an individual acting in such capacity), and (3) the three most highly compensated executive officers, other than the principal executive officer or financial officer.

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[5] A corporation is treated as publicly held if it has a class of common equity securities that is required to be registered under section 12 of the Securities Exchange Act of 1934.

[6] Sec. 162(m). This deduction limitation applies for purposes of the regular income tax and the alternative minimum tax.

In response to the Securities and Exchange Commission's new disclosure rules, the Internal Revenue Service issued updated guidance on identifying which employees are covered by section 162(m).[7] The new guidance provides that "covered employee" means any employee who is (1) the principal executive officer (or an individual acting in such capacity) defined in reference to the Exchange Act, or (2) among the three most highly compensated officers for the taxable year (other than the principal executive officer), again defined by reference to the Exchange Act. Thus, under current guidance, only four employees are covered under section 162(m) for any taxable year. Under Treasury regulations, the requirement that the individual meet the criteria as of the last day of the taxable year applies to both the principal executive officer and the three highest compensated officers.[8]

Compensation subject to the deduction limitation

In general.–Unless specifically excluded, the deduction limitation applies to all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash. If an individual is a covered employee for a taxable year, the deduction limitation applies to all compensation not explicitly excluded from the deduction limitation, regardless of whether the compensation is for services as a covered employee and regardless of when the compensation was earned. The $1 million cap is reduced by excess parachute payments (as defined in sec. 280G, discussed below) that are not deductible by the corporation.

Certain types of compensation are not subject to the deduction limit and are not taken into account in determining whether other compensation exceeds $1 million. The following types of compensation are not taken into account: (1) remuneration payable on a commission basis; (2) remuneration payable solely on account of the attainment of one or more performance goals if certain outside director and shareholder approval requirements are met ("performance-based compensation"); (3) payments to a tax-qualified retirement plan (including salary reduction contributions); (4) amounts that are excludable from the executive's gross income (such as employer-provided health benefits and miscellaneous fringe benefits (sec. 132)); and (5) any remuneration payable under a written binding contract which was in effect on February 17, 1993. In addition, remuneration does not include compensation for which a deduction is allowable after a covered employee ceases to be a covered employee. Thus, the deduction limitation often does not apply to deferred compensation that is otherwise subject to the deduction limitation (e.g., is not performance-based compensation) because the payment of compensation is deferred until after termination of employment.

Performance-based compensation.–Compensation qualifies for the exception for performance-based compensation only if (1) it is paid solely on account of the attainment of one or more performance goals, (2) the performance goals are established by a compensation

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[7] Notice 2007-49, 2007-25 I.R.B. 1429.

[8] Treas. Reg. sec. 1.162-27(c)(2).

committee consisting solely of two or more outside directors,[9] (3) the material terms under which the compensation is to be paid, including the performance goals, are disclosed to and approved by the shareholders in a separate vote prior to payment, and (4) prior to payment, the compensation committee certifies that the performance goals and any other material terms were in fact satisfied.

Compensation (other than stock options or other stock appreciation rights) is not treated as paid solely on account of the attainment of one or more performance goals unless the compensation is paid to the particular executive pursuant to a pre-established objective performance formula or standard that precludes discretion. Stock options or other stock appreciation rights generally are treated as meeting the exception for performance-based compensation, provided that the requirements for outside director and shareholder approval are met (without the need for certification that the performance standards have been met), because the amount of compensation attributable to the options or other rights received by the executive would be based solely on an increase in the corporation's stock price. Stock-based compensation is not treated as performance-based if it is dependent on factors other than corporate performance. For example, if a stock option is granted to an executive with an exercise price that is less than the current fair market value of the stock at the time of grant, then the executive would have the right to receive compensation on the exercise of the option even if the stock price decreases or stays the same. In contrast to options or other stock appreciation rights, grants of restricted stock are not inherently performance-based because the executive may receive compensation even if the stock price decreases or stays the same. Thus, a grant of restricted stock does not satisfy the definition of performance-based compensation unless the grant or vesting of the restricted stock is based upon the attainment of a performance goal and otherwise satisfies the standards for performance-based compensation.

Section 280G

In general

In some cases, a compensation agreement for a corporate executive may provide for payments to be made if there is a change in control of the executive's employer, even if the executive does not lose his or her job as part of the change in control. Such payments are sometimes referred to as "golden parachute payments." The Code contains limits on the amount of certain types of such payments, referred to as "excess parachute payments." Excess parachute

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[9] A director is considered an outside director if he or she is not a current employee of the corporation (or related entities), is not a former employee of the corporation (or related entities) who is receiving compensation for prior services (other than benefits under a tax-qualified retirement plan), was not an officer of the corporation (or related entities) at any time, and is not currently receiving compensation for personal services in any capacity (e.g., for services as a consultant) other than as a director.

payments are not deductible by a corporation.[10] In addition, an excise tax is imposed on the recipient of any excess parachute payment equal to 20 percent of the amount of such payment.[11]

Definition of parachute payment

A "parachute payment" is any payment in the nature of compensation to (or for the benefit of) a disqualified individual which is contingent on a change in the ownership or effective control of a corporation or on a change in the ownership of a substantial portion of the assets of a corporation ("acquired corporation"), if the aggregate present value of all such payments made or to be made to the disqualified individual equals or exceeds three times the individual's "base amount."

The individual's base amount is the average annual compensation payable by the acquired corporation and includible in the individual's gross income over the five-taxable years of such individual preceding the individual's taxable year in which the change in ownership or control occurs.

The term parachute payment also includes any payment in the nature of compensation to a disqualified individual if the payment is made pursuant to an agreement which violates any generally enforced securities laws or regulations.

Certain amounts are not considered parachute payments, including payments under a qualified retirement plan, and payments that are reasonable compensation for services rendered on or after the date of the change in control. In addition, the term parachute payment does not include any payment to a disqualified individual with respect to a small business corporation or a corporation no stock of which was readily tradable, if certain shareholder approval requirements are satisfied.

Disqualified individual

A disqualified individual is any individual who is an employee, independent contractor, or other person specified in Treasury regulations who performs personal services for the corporation and who is an officer, shareholder, or highly compensated individual of the corporation. Personal service corporations and similar entities generally are treated as individuals for this purpose. A highly compensated individual is defined for this purpose as an employee (or a former employee) who is among the highest-paid one percent of individuals performing services for the corporation (or an affiliated corporation) or the 250 highest paid individuals who perform services for a corporation (or affiliated group).

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[10] Sec. 280G.

[11] Sec. 4999.

Excess parachute payments

In general, excess parachute payments are any parachute payments in excess of the base amount allocated to the payment. The amount treated as an excess parachute payment is reduced by the portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered before the change in control.

Explanation of Provision

Section 162(m)

In general

Under the provision, the section 162(m) limit is reduced to $500,000 in the case of otherwise deductible compensation of a covered executive for any applicable taxable year of an applicable employer.

An applicable employer means any employer from which one or more troubled assets are acquired under the "troubled assets relief program" ("TARP") established by the bill if the aggregate amount of the assets so acquired for all taxable years (including assets acquired through a direct purchase by the Treasury Department, within the meaning of section 113(c) of Title I of the bill) exceeds $300,000,000. However, such term does not include any employer from which troubled assets are acquired by the Treasury Department solely through direct purchases (within the meaning of section 113(c) of Title I of the bill). For example, if a firm sells $250,000,000 in assets through an auction system managed by the Treasury Department, and $100,000,000 to the Treasury Department in direct purchases, then the firm is an applicable employer. Conversely, if all $350,000,000 in sales take the form of direct purchases, then the firm would not be an applicable employer.

Unlike section 162(m), an applicable employer under this provision is not limited to publicly held corporations (or even limited to corporations). For example, an applicable employer could be a partnership if the partnership is an employer from which a troubled asset is acquired. The aggregation rules of Code section 414(b) and (c) apply in determining whether an employer is an applicable employer. However, these rules are applied disregarding the rules for brother-sister controlled groups and combined groups in sections 1563(a)(2) and (3). Thus, this aggregation rule only applies to parent-subsidiary controlled groups. A similar controlled group rule applies for trades and businesses under common control.

The result of this aggregation rule is that all corporations in the same controlled group are treated as a single employer for purposes of identifying the covered executives of that employer and all compensation from all members of the controlled group are taken into account for purposes of applying the $500,000 deduction limit. Further, all sales of assets under the TARP from all members of the controlled group are considered in determining whether such sales exceed $300,000,000.

An applicable taxable year with respect to an applicable employer means the first taxable year which includes any portion of the period during which the authorities for the TARP established under the bill are in effect (the "authorities period") if the aggregate amount of troubled assets acquired from the employer under that authority during the taxable year (when added to the aggregate amount so acquired for all preceding taxable years) exceeds $300,000,000, and includes any subsequent taxable year which includes any portion of the authorities period.

A special rule applies in the case of compensation that relates to services that a covered executive performs during an applicable taxable year but that is not deductible until a later year ("deferred deduction executive remuneration"), such as nonqualified deferred compensation. Under the special rule, the unused portion (if any) of the $500,000 limit for the applicable tax year is carried forward until the year in which the compensation is otherwise deductible, and the remaining unused limit is then applied to the compensation.

For example, assume a covered executive is paid $400,000 in cash salary by an applicable employer in 2008 (assuming 2008 is an applicable taxable year) and the covered executive earns $100,000 in nonqualified deferred compensation (along with the right to future earnings credits) payable in 2020. Assume further that the $100,000 has grown to $300,000 in 2020. The full $400,000 in cash salary is deductible under the $500,000 limit in 2008. In 2020, the applicable employer's deduction with respect to the $300,000 will be limited to $100,000 (the lesser of the $300,000 in deductible compensation before considering the special limitation, and $500,000 less $400,000, which represents the unused portion of the $500,000 limit from 2008).

Deferred deduction executive remuneration that is properly deductible in an applicable taxable year (before application of the limitation under the provision) but is attributable to services performed in a prior applicable taxable year is subject to the special rule described above and is not double-counted. For example, assume the same facts as above, except that the nonqualified deferred compensation is deferred until 2009 and that 2009 is an applicable taxable year. The employer's deduction for the nonqualified deferred compensation for 2009 would be limited to $100,000 (as in the example above). The limit that would apply under the provision for executive remuneration that is in a form other than deferred deduction executive remuneration and that is otherwise deductible for 2009 is $500,000. For example, if the covered executive is paid $500,000 in cash compensation for 2009, all $500,000 of that cash compensation would be deductible in 2009 under the provision.

<u>Covered executive</u>

The term covered executive means any individual who is the chief executive officer or the chief financial officer of an applicable employer, or an individual acting in that capacity, at any time during a portion of the taxable year that includes the authorities period. It also includes any employee who is one of the three highest compensated officers of the applicable employer for the applicable taxable year (other than the chief executive officer or the chief financial officer and only taking into account employees employed during any portion of the taxable year that includes the authorities period).

The determination of the three highest compensated officers is made on the basis of the shareholder disclosure rules for compensation under the Exchange Act, except to the extent that the shareholder disclosure rules are inconsistent with the provision.[12] Such shareholder disclosure rules are applied without regard to whether those rules actually apply to the employer under the Exchange Act. If an employee is a covered executive with respect to an applicable employer for any applicable taxable year, the employee will be treated as a covered executive for all subsequent applicable taxable years (and will be treated as a covered executive for purposes of any subsequent taxable year for purposes of the special rule for deferred deduction executive remuneration).

Executive remuneration

The provision generally incorporates the present law definition of applicable employee remuneration. However, the present law exceptions for remuneration payable on commission and performance-based compensation do not apply for purposes of the new $500,000 limit. In addition, the new $500,000 limit only applies to executive remuneration which is attributable to services performed by a covered executive during an applicable taxable year. For example, assume the same facts as in the example above, except that the covered executive also receives in 2008 a payment of $300,000 in nonqualified deferred compensation that was attributable to services performed in 2006. Such payment is not treated as executive remuneration for purposes of the new $500,000 limit.

Other rules

The modification to section 162(m) provides the same coordination rules with disallowed parachute payment and stock compensation of insiders in expatriated corporations as exist under present law section 162(m). Thus, the $500,000 deduction limit under this section is reduced (but not below zero) by any parachute payments (including parachute payments under the expanded definition under this provision) paid during the authorities period and any payment of the excise tax under section 4985 for stock compensation of insiders in expatriated corporations.

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[12] For example, the shareholder disclosure rules require the reporting of the compensation of the three most highly compensated executive officers (other than the principal executive officer and the principal financial officer) who were serving as executive officers at the end of the last completed fiscal year and up to two additional individuals from whom disclosure would have been provided but for the fact that the individual was not serving as an executive officer at the end of the last completed fiscal year. 17 C.F.R. sec. 229.402(a)(3)(iii), (iv). For purposes of the provision, the term “officer” is intended to mean those “executive officers” whose compensation is subject to reporting under the Exchange Act. Under the provision, however, an individual’s status as one of the three most highly compensated officers takes into account only executive officers employed during the authorities period, regardless of whether the individual serves as an executive officer at year end. Additionally, the shareholder disclosure rules measure compensation for purposes of determining “high three” status by reference to total compensation for the last completed fiscal year, and compensation is measured without regard to whether the compensation is includible in an executive officer’s gross income. It is intended that this broad measurement of compensation apply for purposes of the provision; however, the measurement period for purposes of the provision is the applicable taxable year for which “high three” status is being determined.

The modification authorizes the Secretary of the Treasury to prescribe such guidance, rules, or regulations as are necessary to carry out the purposes of the $500,000 deduction limit, including the application of the limit in the case of any acquisition, merger, or reorganization of an applicable employer.

Section 280G

The provision also modifies section 280G by expanding the definition of parachute payment in the case of a covered executive of an applicable employer. For this purpose, the terms "covered executive," "applicable taxable year," and "applicable employer" have the same meaning as under the modifications to section 162(m) (described above).

Under the modification, a parachute payment means any payments in the nature of compensation to (or for the benefit of) a covered executive made during an applicable taxable year on account of an applicable severance from employment during the authorities period if the aggregate present value of such payments equals or exceeds an amount equal to three times the covered executive's base amount. An applicable severance from employment is any severance from employment of a covered executive (1) by reason of an involuntary termination of the executive by the employer or (2) in connection with a bankruptcy, liquidation, or receivership of the employer.

Whether a payment is on account of the employee's severance from employment is generally determined in the same manner as under present law. Thus, a payment is on account of the employee's severance from employment if the payment would not have been made at that time if the severance from employment had not occurred. Such payments include amounts that are payable upon severance from employment (or separation from service), vest or are no longer subject to a substantial risk of forfeiture on account of such a separation, or are accelerated on account of severance from employment. As under present law, the modified definition of parachute payment does not include amounts paid to a covered executive from certain tax qualified retirement plans.

A parachute payment during an applicable taxable year that is paid on account of a covered executive's applicable severance from employment is nondeductible on the part of the employer (and the covered executive is subject to the section 4999 excise tax) to the extent of the amount of the payment that is equal to the excess over the employee's base amount that is allocable to such payment. For example, assume that a covered executive's annualized includible compensation is $1 million and the covered executive's only parachute payment under the provision is a lump sum payment of $5 million. The covered executive's base amount is $1 million and the excess parachute payment is $4 million.

The modifications to section 280G do not apply in the case of a payment that is treated as a parachute payment under present law. The modifications further authorize the Secretary of Treasury to issue regulations to carry out the purposes of the provision, including the application of the provision in the case of a covered executive who receives payments some of which are treated as parachute payments under present law section 280G and others of which are treated as parachute payments on account of this provision, and the application of the provision in the event of any acquisition, merger, or reorganization of an applicable employer. The regulations shall also prevent the avoidance of the application of the provision through the mischaracterization of a severance from employment as other than an applicable severance from employment. It is intended that the regulations prevent the avoidance of the provision through the acceleration, delay, or other modification of payment dates with respect to existing compensation arrangements.

Effective Date

The provision is effective for taxable years ending on or after date of enactment, except that the modifications to section 280G are effective for payments with respect to severances occurring during the authorities period.

C. Exclude Discharges of Acquisition Indebtedness on Principal Residences from Gross Income (sec. 303 of the bill and sec. 108 of the Code)

Present Law

In general

Gross income includes income that is realized by a debtor from the discharge of indebtedness, subject to certain exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain student loans, certain farm indebtedness, and certain real property business indebtedness (secs. 61(a)(12) and 108).[13] In cases involving discharges of indebtedness that are excluded from gross income under the exceptions to the general rule, taxpayers generally reduce certain tax attributes, including basis in property, by the amount of the discharge of indebtedness.

The amount of discharge of indebtedness excluded from income by an insolvent debtor not in a Title 11 bankruptcy case cannot exceed the amount by which the debtor is insolvent. In the case of a discharge in bankruptcy or where the debtor is insolvent, any reduction in basis may not exceed the excess of the aggregate bases of properties held by the taxpayer immediately after the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge (sec. 1017).

For all taxpayers, the amount of discharge of indebtedness generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. These rules generally apply to the exchange of an old obligation for a new obligation, including a modification of indebtedness that is treated as an exchange (a debt-for-debt exchange).

Qualified principal residence indebtedness

An exclusion from gross income is provided for any discharge of indebtedness income by reason of a discharge (in whole or in part) of qualified principal residence indebtedness. Qualified principal residence indebtedness means acquisition indebtedness (within the meaning of section 163(h)(3)(B), except that the dollar limitation is $2,000,000) with respect to the taxpayer's principal residence. Acquisition indebtedness with respect to a principal residence generally means indebtedness which is incurred in the acquisition, construction, or substantial improvement of the principal residence of the individual and is secured by the residence. It also includes refinancing of such indebtedness to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness. For these purposes, the term "principal residence" has the same meaning as under section 121 of the Code.

If, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to so much of the amount

[13] A debt cancellation which constitutes a gift or bequest is not treated as income to the donee debtor (sec. 102).

discharged as exceeds the portion of the debt which is not qualified principal residence indebtedness. Thus, assume that a principal residence is secured by an indebtedness of $1 million, of which $800,000 is qualified principal residence indebtedness. If the residence is sold for $700,000 and $300,000 debt is discharged, then only $100,000 of the amount discharged may be excluded from gross income under the qualified principal residence indebtedness exclusion.

The basis of the individual's principal residence is reduced by the amount excluded from income under the provision.

The qualified principal residence indebtedness exclusion does not apply to a taxpayer in a Title 11 case; instead the general exclusion rules apply. In the case of an insolvent taxpayer not in a Title 11 case, the qualified principal residence indebtedness exclusion applies unless the taxpayer elects to have the general exclusion rules apply instead.

The exclusion does not apply to the discharge of a loan if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.

The exclusion for qualified principal residence indebtedness is effective for discharges of indebtedness before January 1, 2010.

Explanation of Provision

The provision extends for three additional years the exclusion from gross income for discharges of qualified principal residence indebtedness.

Effective Date

The provision is effective for discharges of indebtedness on or after January 1, 2010, and before January 1, 2013.