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House Passes Legislation to Tax AIG (and Other TARP) Bonuses

The House of Representatives overwhelmingly passed legislation (H.R. 1586) that would impose a 90% tax on those bonuses. The House, under a suspension of the rules and by a vote of 328 to 93, imposed the tax on the “TARP bonus” received by a taxpayer after December 31, 2008.

Background

For purposes of this legislation, the term “**TARP bonus**” means the lesser of:

1. The amount of the “disqualified bonus payment” received during the year; or
2. The excess of the adjusted gross income of the taxpayer over \$250,000 (\$125,000 if married filing a separate return). The term “disqualified bonus payment” means any retention payment, incentive payment or other bonus which is in addition to any amount payable for services performed at a regular, hourly, daily, weekly, monthly or similar periodic rate. The term does not include commissions, welfare or fringe benefits or expense reimbursements. The bill also provides that if the employee irrevocably waives entitlement to the payment or returns the amount to the employer before the close of the taxable year, the tax does not apply. net federal emergency economic assistance in excess of \$100 million.

The TARP bonus rule applies only if the employer (i) received capital infusions under the Emergency Economic Stabilization Act of 2008 (EESA), which in aggregate exceeds \$5 billion or (ii) is either the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Association (Freddie Mac) or an affiliated group or partnership relating to those organizations.

Under this bill, starting in 2009 any employee who received a TARP bonus payment from an appropriate employer and had income above \$250,000 would be subject to the 90% income tax rate on that bonus instead

of the normal 35% rate. Since the bonus is also subject to FICA tax, the employee would also pay 1.45% (as would the employer) medicare tax on top of that. The employee would be subject to state income taxes on these amounts as well. It is therefore possible, depending on the state involved, that the total tax burden on such an employee could exceed 100% of the bonus received.

A number of commentators have begun to question the constitutionality of such a provision. There are, however, other instances in the Internal Revenue Code that impose 100% tax rates (for example, prohibited transactions) and in the 1960s, the top marginal income rate actually was as high as 92%. If Congress does enact such a tax, it is quite possible that litigation may ensue over the constitutionality of such a tax.

In the meantime, the Senate is expressing similar outrage over the AIG bonuses and Senators Max Baucus (D-MT) and Charles Grassley (R-IA) (Chairman and Ranking Member of the Senate Finance Committee) have announced that they plan to introduce legislation imposing a 35% excise tax on excessive compensation. It would also be designed to apply to these TARP bonuses. The combination of that 35% excise tax plus the 35% income tax would yield a 70% total tax rate. (We understand that the Baucus/Grassley bill will **also include a \$1 million annual limitation on deferred compensation for employees of companies receiving TARP funds**, with very severe penalties for failure to comply with the limitation.) Details of that legislation are still being worked on and the bill has not yet been introduced in the Senate.

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