



## Breakdown of the Tax Provisions in the Bailout Package

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The primary purpose of the recently enacted Emergency Economic Stabilization Act of 2008, popularly known as the bailout package, was to authorize the Secretary of the Treasury to purchase certain troubled assets, primarily commercial and residential mortgages and securities related to such mortgages. However, the Act also contains several tax provisions, many of which will impact middle-class taxpayers. This article will identify and provide a brief summary of the key tax provisions in the Act.

### Treatment of gain or loss from the Sale or Exchange of Preferred Stock

The Act provides that that gains and losses from the sale or exchange of preferred stock in Fannie Mae or Freddie Mac by “applicable financial institutions” will be treated as ordinary gains and losses for federal income tax purposes. Under the tax rules, capital losses may be used to offset capital gains (including capital gains realized in prior years), but not ordinary income (such as income from most banking operations). As a result of the Act, a loss recognized by an applicable financial institution on the preferred stock will be treated as an ordinary loss. This means that the applicable financial institution can use the loss against its ordinary income for the current tax year, and if the institution has a net operating loss for the current year, the loss could be carried back to the two preceding tax years in order to obtain a refund of taxes paid in those years (subject to certain limitations).

Individuals and other entities will not be entitled to

this special treatment, and thus their losses on Fannie Mae and Freddie Mac preferred stock generally will be treated as capital losses.

### Special Rules for Tax Treatment of Executive Compensation of Employers Participating in the Troubled Assets Relief Program

Any financial institution that sells troubled assets to the Treasury Department is subject to new executive compensation requirements that apply to its most highly paid executives. The executive compensation requirements differ depending upon whether the acquisition of troubled assets is characterized as a “direct purchase” or an “auction sale”. A “direct purchase” occurs when the Treasury Department acquires assets from an individual financial institution without a bidding process or where market prices are available. An “auction sale” occurs, as its name implies, when auction purchases of troubled assets are possible. Compensation limitations apply to auction purchases only where such purchases, plus direct purchases, from a financial institution exceed \$300,000,000 in the aggregate.

With respect to a direct purchase, the Act will (1) prohibit the financial institution from making any golden parachute payment to senior executive officers during the period that the Treasury Department holds an equity or debt position; and (2) provide a clawback for financial institutions to recover bonuses and incentives to executives that were based on earnings, gains or other data that prove to be materially inaccurate. With respect to an auction sale, the Act will (1) cap tax deductions on compensation and

bonuses to certain senior executives in excess of \$500,000; (2) prohibit financial institutions from including golden parachutes provisions in new employment agreements with top executives in the case of involuntary termination, bankruptcy filing, insolvency, or receivership; and (3) impose a 20% excise tax on any golden parachute payments made to a top executives in the case of involuntary termination, bankruptcy filing, insolvency, or receivership.

### **Relief for Homeowners**

The Act extends a temporary provision allowing taxpayers to exclude mortgage-debt forgiveness from taxable income. When a lender forecloses on property, sells the home for less than the borrower's outstanding mortgage and forgives all or part of the excess mortgage debt, the tax code treats the cancelled debt as taxable income to the homeowner. The Mortgage Forgiveness Debt Relief Act, enacted in late 2007, excludes from federal tax those discharges involving up to \$2 million of indebtedness (\$1 million for a married taxpayer filing a separate return) secured by a principal residence and incurred in the acquisition, construction or substantial improvement of the residence. The Act extends this treatment through the end of 2012.

### **AMT Patch**

The AMT exemption for individuals will be raised in 2008 to \$46,200 and to \$69,950 for married couples filing jointly. The Act also allows taxpayers to use certain personal credits against their AMT liability. The largest group of beneficiaries in the tax portion of the financial rescue bill is about 20 million mainly upper-middle income taxpayers who would likely have faced an average tax increase of \$2,000 each without this relief.

### **Tax-Free Distributions from IRA's for Charitable Purposes**

The Act extended a provision allowing taxpayers 70½ or older to transfer as much as \$100,000 a year directly from an individual retirement account (IRA) to charity without owing income tax on the money transferred. This provision is particularly important because the amount transferred applies toward the taxpayer's required minimum distribution for the year but is not included in the taxpayer's adjusted gross income, which would otherwise cause taxpayers to lose certain itemized deductions and personal exemption amounts.

### **Tuition and Fees Deduction**

The Act extended through 2009 a provision allowing a special deduction for higher-education tuition and fees. The maximum deduction is \$4,000 but the amount of the allowable deduction depends on your income.

### **State and Local Sales Tax Deduction**

The American Jobs Creation Act of 2004 and subsequent legislation allowed individuals to deduct state and local general sales taxes in lieu of state and local income taxes. This deduction expired at the end of 2007. The Act makes the deduction retroactive for 2008 and extends it for two years through December 31, 2009.

### **Relief for Teachers**

The Act extended a provision allowing elementary and secondary school teachers who pay for classroom supplies out of their own pockets to deduct as much as \$250 a year. ■

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