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Business Tax Highlights of the American Recovery and Reinvestment Act of 2009

The American Recovery and Reinvestment Act of 2009 (the "Act") was signed into law (P.L. 111-5) by the President on February 17, 2009. As part of the economic stimulus package, the Act amended several business tax provisions of the Internal Revenue Code (the "Code"). This Client Advisory highlights key changes below. (All section references are to the Code unless otherwise indicated.)

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Election to defer 2009 and 2010 discharge of indebtedness income from reacquisitions of business debt at a discount.

Under pre-Act law, the discharge of indebtedness income realized on the repurchase of a debt instrument had to be recognized in the year of repurchase. Under the Act, a taxpayer can elect to have discharge of indebtedness income from the reacquisition of an applicable debt instrument after December 31, 2008, and before January 1, 2011, be included in gross income ratably over five tax years, starting in 2014. Although all of the deferred debt discharge income will eventually be recognized, the taxpayer benefits from having the tax deferred to later years. The election is made on an instrument-by-instrument basis. For partnerships, S corporations, or other pass-through entities, the election is made by the partnership, corporation, or other entity involved, rather than by individual beneficial owners (in contrast to the determination of solvency which is made at the partner level). If a taxpayer elects to defer debt discharge income from a reacquisition of an applicable debt instrument, the exclusions for bankruptcy, insolvency, and qualified real property business indebtedness will not apply to the debt discharge income for the tax year of the election or any later tax year. Deductions for original issue discount ("OID") on the modified debt are suspended during the deferral, but is deductible ratably over the five tax year recognition period. In the case of the taxpayer's death or the liquidation or sale of substantially all assets of a business, the cessation of business, or similar circumstances, any item of deferred income or deduction is taken into account in the tax year in which that event occurs.

Suspension of AHYDO rules for obligations issued from September 1, 2008 to December 31, 2009 and beyond at IRS's discretion.

Current rules give special treatment to OID deductions for applicable high yield discount obligations ("AHYDOs"). In certain situations, the issuer's interest deductions may be deferred or disallowed. The disqualified portion of OID is generally the portion of the total return on the obligation that bears the same ratio to the total return as the disqualified yield bears to the total yield to maturity. The disqualified yield is the portion of the yield that exceeds the applicable federal rate ("AFR") for the month in which the obligation is issued plus six percentage points. If the yield to maturity exceeds the AFR plus six percentage points, the disqualified portion is the entire amount of the OID. The Act suspends these rules for AHYDOs issued in a debt-for-debt exchange, including an exchange resulting from a significant modification of a debt instrument, from September 1, 2008 to December 31, 2009. The IRS has the authority to continue to suspend the rules if it determines that continued distressed conditions in the debt capital markets necessitate suspension of the rules after December 31, 2009.

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IRS may apply a higher rate to determine whether an obligation issued after 2009 is an AHYDO.

Under the Act, the IRS is given the authority, starting in 2010, to use a rate higher than the AFR for determining whether a debt obligation is an AHYDO, if it determines that the selected rate is appropriate in light of distressed conditions in the debt capital markets.

Revocation of IRS Notice 2008-83 exempting banks from loss limitation rules following an ownership change.

Under IRS Notice 2008-83, an acquiring bank was allowed an unlimited deduction of an acquired bank's losses on loans, bad debts or additions to bad debt reserves. Issued during the bank bailouts of October 2008, this guidance facilitated the acquisitions and mergers of numerous troubled banks. The Act provides that the IRS is not authorized to provide exemptions or special rules that are restricted to particular industries or classes of taxpayers, and that IRS Notice 2008-83 is inconsistent with the Congressional intent in enacting Section 382, which limits the rate at which losses may be used to offset income generated after a corporate ownership change. Notice 2008-83 will have no effect for ownership changes after January 16, 2009, except for ownership changes that were made under a written binding contract entered into on or before Jan 16, 2009, or under a written agreement entered into and described on or before January 16, 2009, in a public announcement or in a filing with the SEC required by reason of the ownership change.

Election for small businesses to increase carryback period for 2008 net operating losses up to five years.

In general, net operating losses ("NOLs") may be carried back two years and forward 20 years. The Act allows eligible small businesses to elect a three-, four-, or five-year carryback period for 2008 NOLs. This increase in the NOL carryback period essentially provides taxpayers refunds of income taxes paid in earlier years. An "eligible small business" is any trade or business whose average annual gross receipts for the three-tax-year period ending in 2008 are $15 million or less. This election may only be applied for NOLs for tax years ending in 2008 or, if the taxpayer so elects, NOLs for tax years beginning in 2008. Corporate income tax returns generally must be filed on or before the 15th day of the third month after the end of the tax year. Thus, for calendar year corporations, the 2008 NOL carryback increase election must be made by March 15, 2009, subject to filing extensions.

Estimated tax payments reduced starting in 2009 for certain small businesses

Under pre-Act law, the required annual payment for estimated income tax for individuals is the lesser of (i) 90% of the tax shown on the return for the tax year or (ii) 100% of the tax shown on the return of the individual for the preceding tax year. The Act provides that annual estimated tax payments for "qualified individuals" for tax years beginning in 2009 shall not be greater than 90 percent of the tax liability shown on the tax return for the preceding tax year. A "qualified individual" is an individual with adjusted gross income for the preceding tax year of less than $500,000 ($250,000 if married filing separately) with at least 50 percent of such income derived from a small trade or business. A "small trade or business" is a trade or business with fewer than 500 employees for the calendar year ending with or within the preceding tax year of the individual. This will benefit small business owners operating, or treated as operating, as sole proprietorships, LLCs, S-corporations and partnerships

One year extension of 50% bonus depreciation and AMT depreciation relief.

Under Section 168(k), "qualified property" is allowed 50% depreciation in the year that the property is placed in service, is exempt from the alternative minimum tax ("AMT") depreciation adjustment which requires that certain property depreciated on the 200% declining balance method for regular income tax purposes must be depreciated on the 150% declining balance method for AMT purposes, and is allowed an $8,000 increase in the otherwise-applicable dollar limit on first-year depreciation for passenger cars. The Act extends these benefits to "qualified property" placed in service before January 1, 2010 (before January 1, 2011 for aircraft and long-production-period property) and after December 31, 2008.

One year extension of Section 179 deduction limit of $250,000 and phaseout threshold amount of $800,000.

For tax years beginning in 2008, the Section 179 deduction, allowing taxpayers to expense the cost of certain qualifying personal property used in the active conduct of a trade or business purchased and placed in service during the tax year, was limited to a maximum expense of $250,000 and was phased out starting at a total cost of property placed in service of $800,000. Under pre-Act law for tax years beginning in 2009, the Section 179 deduction limit was reduced to $133,000 and the phaseout threshold was reduced to $530,000. The Act extends the $250,000 limitation and $800,000 phase-out amounts to tax years beginning in 2009.

Exclusion of 75% of gain on the sale or exchange of qualified small business stock acquired between the date of enactment and the end of 2010 and held for more than 5 years.

The Act provides that 75% of the gain from the sale or exchange by an individual of "qualified small business stock" ("QSBS") held for more than five years may be excluded in determining the regular tax. The excluded amount is included in calculating the alternative minimum tax. The gain from the sale of QSBS is therefore taxed at the effective rates of 7% under the regular tax and 12.88% under the AMT. QSBS is stock in a domestic C corporation with gross assets of $50,000,000 or less at all times since 1993.

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S Corporation built-in gain recognition period shortened for 2009 and 2010.

Under pre-Act law, where a C corporation elects to become an S corporation and where an S corporation receives property from a C corporation in a nontaxable carryover basis transfer, the S corporation was taxed at the highest corporate rate on all built-in gains existing at the date of conversion or acquisition and recognized in a disposition occurring at any time during the following ten years from the date of conversion or acquisition. The Act provides for the 2009 and 2010 tax years a reduced recognition period of seven years. Therefore, the recognition period for an S corporation election made in 2002 will end at the beginning of the 2009 tax year and the recognition period for an S corporation election made in 2003 will end at the beginning of the 2010 tax year. For property acquired from C corporations in carryover basis transactions, the recognition period is reduced to seven years from the date the property was acquired.

Extension of tax credit for electricity produced from certain renewable resources.

The Act generally extends the Section 45 production tax credit through 2013 (2012 for qualified wind facilities). The credit equals 2.1 cents per KWhr in 2008 for electricity produced from qualified wind, closed-loop and open-loop biomass, geothermal, solar, hydropower, small irrigation power, municipal solid waste landfill gas, and marine and hydrokinetic facilities. The credit may be claimed against both regular and AMT tax liability over a 10-year period (5-year period for qualified wind facilities).

Election of investment credit in lieu of production credit and repeal of certain limitations on credit for renewable energy property.

The Act generally allows the Section 48 investment credit for facilities covered by the Section 45 production credit. A taxpayer is not allowed a credit for both the Section 45 production credit and Section 48 investment credit. The investment credit equals 30% of the basis in qualified investment credit facilities, including fuel cell and solar energy equipment generating electricity to heat, cool or illuminate a structure, and small wind facilities. The $4,000 per tax year limitation for small wind energy property, with a capacity of 100KW or less, and basis reduction for tax-exempt and subsidized financing are repealed. In lieu of tax credits, the Act also authorizes the award of reimbursement grants for energy property placed in service or under construction in 2009 or 2010, that is either (1) an electricity production facility otherwise eligible for the production credit or (2) qualifying property otherwise eligible for the investment credit.

New Section 48C Advanced Energy Project Credit in the amount of 30% of qualified investment in manufacturing facilities.

The Act provides a new Section 46 investment credit for investments in qualifying advanced energy projects. The credit amount is 30% of the basis of eligible property that is part of a qualifying advanced energy project. A qualifying advanced energy project is a project certified by the IRS under Section 48C which re-equips, expands, or establishes a manufacturing facility for the production of: (1) property designed to be used to produce energy from the sun, wind, geothermal deposits or other renewable resources; (2) fuel cells, microturbines, or an energy storage system for use with electric or hybrid-electric motor vehicles; (3) electric grids to support the transmission of intermittent sources of renewable energy, including storage of that energy; (4) property designed to capture and sequester carbon dioxide emissions; (5) property designed to refine or blend renewable fuels, other than fossil fuels, to produce energy conservation technologies (including energy-conserving lighting technologies and smart grid technologies), (6) new qualified plug-in electric drive motor vehicles, qualified plug-in electric vehicles, or components which are designed specifically for use with those vehicles, including electric motors, generators, and power control units, or (7) other advanced energy property designed to reduce greenhouse gas emissions as may be determined by the IRS. The IRS may award up to $2.3 billion in credits to qualified advanced energy projects. Each applicant will have one year from the date the IRS accepts the application during which to provide to the IRS evidence that the requirements of the certification have been met, and has three years from the date of issuance of the certification to place the project in service.

Low Income Housing Tax Credit Exchange Program authorized for 2009 State allocations.

The Act allows states to elect to receive federal grants in lieu of their 2009 federal allocation of Low Income Housing Tax Credits ("LIHTCs"). States may elect to receive up to 40% of their 2009 housing credit ceiling as a federal housing grant, priced at $0.85 per dollar of credit, which would be used to award subgrants to finance the construction or acquisition and rehabilitation of qualified low-income buildings. States may also elect to receive 100% of their 2008 unused and 2009 returned housing credit as a grant, on similar terms. These awards may be made to projects with or without an existing LIHTC allocation. Those projects with existing LIHTC allocations are required to demonstrate good faith efforts to obtain investment commitments for such credits before the agency makes subawards. For projects using the grants in conjunction with LIHTC, the Act provides that the basis of a qualified low-income building shall not be reduced by the amount of any grant. Projects receiving these grants would be subject to LIHTC restrictions and compliance requirements. State allocating agencies are required to perform asset management functions to ensure compliance

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and the long-term viability of buildings under Section 42. Projects will also be restricted by recapture provisions to assure all buildings that are funded remain qualified low-income buildings during the compliance period. Any recapture of the grant financing may be enforced by liens on the property made by the IRS.

New markets tax credit annual national limit is raised to $5 billion for 2008 and 2009.

Section 45D provides a new markets tax credit ("NMTC") for qualified equity investments in a qualified community development entity ("CDE"). A qualified equity investment is any equity investment in a CDE for which the CDE has received an allocation from the IRS if, among other requirements, the CDE uses substantially all of the cash from the investment to make qualified low-income community investments. The Act raises the maximum amount of qualified equity investments by $1.5 billion for a total of $5 billion for both 2008 and 2009. The 2008 increased amount is to be allocated to CDEs which have submitted unfunded or underfunded allocation applications for calendar year 2008.

Note that this Client Advisory highlights only a few of the changes that may affect your business planning. If you have any questions regarding the tax law changes summarized in this Advisory or other provisions of the Act, and how these changes and provisions may affect your business, please contact one of the members of our Tax Department listed below.

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