

Alert

Tax Provisions in Stimulus Act for Businesses and Individuals

The recently enacted American Recovery and Reinvestment Act of 2009 (the "Stimulus Act") includes a number of new tax breaks, both large and small, and extends several existing tax breaks for businesses and individuals. Although some provisions are not as generous as originally hoped, there are still plenty of opportunities for individuals and businesses alike. Following are some highlights of the new legislation.

Tax Incentives for Businesses

Deferral of Cancellation of Debt Income. Under current law, when a taxpayer's existing debt is discharged or reduced, the taxpayer generally has cancellation of debt (COD) income equal to the difference between the old debt's adjusted issue price and the amount paid or deemed paid by the taxpayer to discharge the old indebtedness. In the simplest case, any reduction in the amount of principal owed is treated as ordinary taxable income (although the old debt's adjusted issue price is not always the same as its stated principal amount). There are exceptions to this general rule under which COD income may be excluded from a taxpayer's gross income (for example, in the case of bankruptcy, insolvency and qualified real *property* business indebtedness).

The Stimulus Act allows taxpayers to defer recognition of COD income arising from the "reacquisition" in 2009 or 2010 of debt instruments (including bonds, notes, debentures and certain other contractual arrangements constituting indebtedness) either (a) issued by a C corporation, or (b) issued by any other person (such as a partnership, S corporation or individual) in connection with the conduct by such other person of a trade or business. The provision applies to reacquisitions of indebtedness by the borrower/issuer/obligor (or certain related persons). Reacquisitions include (1) the acquisition of the old debt instrument for cash, (2) the exchange of the old debt instrument for a new debt instrument (including a renegotiation or modification of the old debt instrument), (3) the issuance of corporate stock or a partnership interest in exchange for the old debt instrument, (4) certain contributions of a debt instrument to the capital of a corporate issuer, and (5) the partial or complete forgiveness of a debt instrument by its holder. COD income generated in 2009 or 2010 that otherwise would be recognized currently is deferred outright for five or four years respectively under this provision and then spread out ratably and taken into income in 20% installments over the following five years. Thus, for example, a calendar year taxpayer with eligible COD income in 2009 or 2010 would defer the COD income until 2014 and include 20% in gross income each year from 2014 until 2018. The deferral ends if the taxpayer dies or sells the investment or underlying business, among other events.

Note that in the case of a debt exchange, if the new debt issued (or deemed issued) in exchange for the old debt has original issue discount, certain limitations apply.

Bonus Depreciation. Tax legislation enacted last year allowed businesses to accelerate the normal cost recovery schedules for depreciable property by allowing a first year write off of half the cost of qualified depreciable property (e.g., computers, equipment, certain land and tenant space improvements, etc.) purchased and placed into service in 2008. The other 50% of a qualified item would be depreciated according to its normal depreciation schedule, resulting in well over half the cost being written off for tax purposes in the year of purchase. The Stimulus Act extends the 50% bonus depreciation to property purchased and placed into service in 2009.

Election to Accelerate Recognition of Historic Research/AMT Credits (in Lieu of Bonus Depreciation). Corporations may elect to accelerate the recognition of their historic alternative minimum tax (AMT) or research credits in lieu of bonus depreciation. Generally, a corporation's credits for research expenditures and AMT liabilities are subject to annual limitations, resulting in carryovers of unused credits from prior years. Under the Stimulus Act, corporations may increase the research credit limitation or the AMT credit limitation by 20% of the amount by which the aggregate amount of depreciation that would be allowable for eligible qualified property (purchased and placed into service in 2009) if first-year bonus depreciation were applied, over the aggregate amount of "regular" depreciation that would be allowable if first year depreciation did not apply. Increasing the annual credit limitations allows corporations to accelerate their "historic" credits carried over from prior tax years (before 2006) that otherwise would go unused in the current year. The amount accelerated is capped at the lesser of 6% of historic AMT and research credits or \$30 million.

Small Business Expensing. Prior to the Stimulus Act, eligible businesses could expense (or write off) up to \$125,000 (indexed for inflation) in equipment each year until 2010, but this amount was phased out to the extent that total capital expenditures for qualifying property exceeded \$500,000 (also indexed). In 2008, businesses were allowed to expense up to \$250,000 of equipment (subject to an \$800,000 phase-out threshold). The 2008 thresholds have been extended through 2009.

5-Year Carryback of 2008 Net Operating Losses. Generally, a net operating loss may be carried back only two years. However, the Stimulus Act allows "eligible small businesses" with annual gross receipts of \$15 million or less to extend the carryback period for 2008 losses up to five years. Eligible taxpayers may make the net operating loss carryback election for any year beginning or ending in 2008.

Small Business Capital Gains. Prior to the Stimulus Act, individuals could exclude 50% of the gain from the sale of eligible small business stock held for more than five years, up to a maximum of ten times the taxpayer's basis in the stock or \$10 million gain from the sale, whichever is greater. The Stimulus Act has increased the exclusion to 75% for stock acquired after the date of enactment (February 17, 2009) and before January 1, 2011. The legislative history to the Stimulus Act estimates that gain from the sale of qualified small business stock to which the provision applies would be taxed at effective rates of 7% under the regular tax and 12.88% under the AMT.

S Corporation Built-In Gains Tax Relief. The Stimulus Act includes a provision for corporations that elected S status more than seven years ago, but which are still within the ten year holding period for built-in gains under current law. Generally, when a C corporation elects S status, its income is no longer taxed at the corporate level; rather, its income and loss flows through to its shareholders. However, the corporation's "built-in gains" are subject to a special built-in gains tax if the S corporation recognizes gain on the disposition of such assets within the first ten taxable years after the S election.

Tax Provisions in Stimulus Bill for Businesses and Individuals

The basic idea is that unrealized gains on appreciated property held by the C corporation at the time it elected S status should be taxed in roughly the same manner as if the corporation were still a C corporation. Accordingly, while overall gains on the disposition of property held by the S corporation generally flow through to its shareholders, an additional corporate-level tax is imposed on any built-in gains of a former C corporation if the property is sold during the ten-year holding period. After the holding period has passed, the S corporation may sell the appreciated assets without triggering the built-in-gains tax. The Stimulus Act reduces the asset holding period from ten years to seven years for asset sales occurring in 2009 and 2010. This provision helps corporations that elected S status more than seven years ago (and less than ten years ago) that wish to sell assets with significant built-in gains in 2009 or 2010.

Tax Incentives for Individuals

"Making Work Pay" Tax Credit. The Stimulus Act provides a refundable tax credit based on earned income of up to \$400 for individuals and \$800 for married couples filing joint returns. The credit phases out at a rate of 2% of adjusted gross income ("AGI") for individuals with AGI above \$75,000 and married couples (filing jointly) with AGI above \$150,000.

AMT Patch. The Stimulus Act extends the existing AMT "patch" to taxable years beginning in 2009 and increases the AMT exemption amount to \$70,950 for joint returns and \$46,700 for individuals. Taxpayers may offset both their regular tax liability and their AMT liability with their "nonrefundable personal credits" (such as the dependent care credit, the adoption credit, the credit for plug-in electric cars, the Hope/American Opportunity credit, etc.).

Refundable Credit for First-Time Homebuyers. Under last year's stimulus legislation, first-time homebuyers were given a refundable credit equal to the lesser of \$7,500 or 10% of the purchase price of a principal residence purchased after April 8, 2008 and before July 1, 2009 (subject to phase-outs beginning at modified AGI of \$75,000 for individuals and \$150,000 for joint filers). The credit would be recaptured ratably over a fifteen year period. The Stimulus Act extends the existing credit to cover eligible home purchases before December 1, 2009, increases the maximum credit amount to \$8,000 and waives the fifteen year credit recapture requirement if the taxpayer uses the home as a principal residence for at least 36 months. However, the credit remains limited to first-time buyers.

American Opportunity Tax Credit. For taxable years beginning in 2009 and 2010, the Stimulus Act replaces the existing Hope credit for qualified tuition expenses with the "American Opportunity" tax credit, increasing the maximum credit amount each year from \$1,800 to \$2,500 of qualified tuition expenses per eligible student and making the credit 40% refundable. The credit now covers 100% of the first \$2,000 of qualified tuition expenses and 25% of the next \$2,000. It also applies to the first four years of post-secondary education (only the first two years were eligible under the Hope credit). The AGI threshold at which the phase-out begins is increased from \$50,000 to \$80,000 for individuals and from \$100,000 to \$160,000 for married couples filing joint returns.

Deduction for Sales Taxes on New Car Purchases. Individuals can deduct state and local sales taxes on up to \$49,500 of the purchase price of cars, motorcycles, motor homes or certain light trucks purchased after February 17, 2009 and before January 1, 2010. The deduction phases out for individuals with modified AGI above \$125,000 and married couples (filing jointly) with modified AGI above \$250,000.

Exclusion for Unemployment Benefits. Taxpayers may exclude the first \$2,400 of unemployment insurance benefits received in 2009 from gross income.

Child-Related Credits. The Stimulus Act temporarily increases the earned income tax credit for families with three or more children and expands eligibility for the refundable portion of the child tax credit in 2009 and 2010 by reducing the earned income floor from \$8,500 to \$3,000.

Energy-Related Incentives. The Stimulus Act includes a wide range of renewable energy and manufacturing credits, including a three-year extension of the Section 45 Renewable Energy Production Tax Credit and various credits for large-scale producers, as well as a number of provisions applicable to individuals and small businesses. This includes, among other things, 30% credits for the purchase of qualifying energy-efficient property for existing homes (subject to a lifetime cap of \$1,500), increases in the credits available for the purchase of plug-in electric vehicles and 30% credits (without caps) for the purchase of qualified solar hot water, geothermal, and wind property.

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These are just some of the many tax provisions in the Stimulus Act, which includes numerous other provisions targeted at different groups and industries. Other provisions may be of particular relevance, depending on your circumstances.

This alert is provided for general informational purposes only and should not be construed as specific legal advice.

Please contact any of the attorneys listed below if we can provide assistance regarding the matters discussed herein.

Henry P. Bubel	212-336-2615	hpbubel@pbwt.com
Dahlia B. Doumar	212-336-2988	dbdoumar@pbwt.com
Melissa E. Lewin	212-336-2017	melewin@pbwt.com
Jenny L. Longman	212-336-2409	jlongman@pbwt.com
Carl A. Merino	212-336-2067	cmerino@pbwt.com
Richard R. Upton	212-336-2020	rrupton@pbwt.com

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