PUBLICATION

The American Recovery and Reinvestment Act of 2009

February 17, 2009

President Obama signed the American Recovery and Reinvestment Act of 2009 (the Act) on February 17, 2009. The Act implements several broad economic stimulus, spending and related provisions, including various tax incentives for businesses and individuals. This Tax Alert summarizes some of the important tax provisions in the Act.

Tax Incentives and Related Provisions for Business

Increased net operating loss carryback period for small business. Certain small businesses may elect to carry back net operating losses (NOLs) incurred in 2008 for up to five years instead of the usual two years. A business is a small business for this purpose if the average annual gross receipts of the entity for the three-taxable-year period ending with such prior taxable year does not exceed $15,000,000.

Deferral of cancellation of indebtedness income. The Act permits certain taxpayers to spread recognition of cancellation of indebtedness income over five years for certain types of business debts reacquired between January 1, 2009 and December 31, 2010. Such income would be included ratably over a five-year period, with recognition beginning in the fifth or fourth taxable year after reacquisition of the debt (fifth year for debt acquired in 2009, fourth year for debt reacquired in 2010). The new provision applies to the reacquisition of a "debt instrument," which means a bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness within the meaning of Section 1275(a)(1) of the Internal Revenue Code (the Code). The provision applies to a debtor's or related party's reacquisition of debt by cash purchases, debt-for-debt exchanges, stock-for-debt exchanges, contributions of the debt to an entity's capital, as well as complete forgiveness of a debt by its holder. In the case of a debt-for-debt exchange covered by this new provision, any deduction for original issue discount is deferred to the same taxable periods described above.

One-year extension of bonus depreciation. The Act extends a provision enacted in 2008 stimulus legislation that allowed taxpayers to depreciate an additional 50% of the cost of an asset acquired and placed in service during the year. The Act extends the placed-in-service deadline for purchased assets by one year, through the end of calendar year 2009.

Extension of temporary increase in expensing limits. The Act also extends a pre-existing increase in elective expensing limits. Prior law increased for 2008 only the expensing limits to $250,000 and the phase-out to $800,000. The Act allows taxpayers to use the increased amounts for 2009 as well.

Expanded Work Opportunity Tax Credit. The Act adds, for 2009 and 2010, certain disconnected youth and unemployed veterans to the list of qualified target groups for the purposes of the Work Opportunity Tax Credit. For this purpose, an unemployed veteran is a veteran who has been discharged or released form the Armed Forces during the five-year period preceding the hiring date, and has collected unemployment compensation for at least four weeks out of the year preceding the hiring date. Disconnected youth includes only persons aged 16-25 who have not regularly attended school or been regularly employed within the six months preceding the hire date, and who are certified as not readily employable for lacking a sufficient number of basic skills.

Modification of OID rules for certain high-yield bonds. The Act allows taxpayers to deduct interest on bonds issued at a discount during the period from September 1, 2008 to December 31, 2009. The Act suspends the rules in Section 163(e)(5) for certain obligations issued in a debt-for-debt exchange, including an exchange resulting from a significant modification of a debt instrument issued during the applicable period. Ordinarily, in the case of an applicable high-yield discount obligation (AHYDO) issued by a corporate issuer, no deduction is allowed for the disqualified portion of the original issue discount on such obligation and the remainder of the original issue discount on any such obligation is not allowable as a deduction until paid by the issuer. The suspension provided in the Act does not apply to any newly issued debt instrument that is issued for an AHYDO. However, any newly issued debt instrument (including any debt instrument issued as a result of a significant modification of a debt instrument) for which the AHYDO rules are suspended under the provision is not treated as an AHYDO for purposes of a subsequent application of the suspension rule. Suspension also does not apply to certain contingent debt or to debt issued to a person related to the issuer.

Increased exclusions amount for small business capital gains. The Act increases the amount individuals may exclude on the sale of certain small business stock held for more than five years. The exclusion amount is increased from 50% to 75%. The change applies only to stock issued after the date of enactment and before January 1, 2011.

Temporarily reduced built-in gain recognition period for S corporations. The Act reduces the period after conversion to S status during which an S corporation must pay the built-in gains tax on disposed assets. Solely for gains on assets sold during a taxable year beginning in 2009 or 2010, the Act provides that taxpayers will not be treated as having net recognized built-in gain on assets sold after year 7 of the usual 10-year recognition period.

Repeal of IRS Notice addressing bank built-in losses under Section 382. The Act prospectively repeals Notice 2008-83, which provided banks some relief from the potential effects of Section 382 of the Code, which limits a corporation's ability to use its pre-existing losses, including built-in losses that it recognizes after an ownership change. The Notice provided that the IRS would not treat as recognized built-in losses subject to the Section 382 limitation any losses on loans or bad debts. The Act also explicitly states Congress' view that regulatory authority under Section 382(m) does not permit the Treasury to grant exemptions or special rules for particular industries or classes of taxpayers.

Relief on withholding requirement for government contractors. Under current law, government agencies are not required to withhold from payments made to contractors. Previously enacted legislation requires that a three percent withholding requirement will apply after December 31, 2010. The Act delays this withholding requirement for one year.

Strict new executive pay caps for employers that accepted TARP relief. Existing law had already provided that employers participating in the Troubled Assets Relief Program (TARP) were subject to certain standards for executive compensation under Section 162(m)(5) of the Code. The Act expands the standards significantly and provides that these standards apply in any period during which an obligation arising from TARP assistance is outstanding. Congress directed Treasury to establish additional standards that exclude incentives for senior executive officers to take unnecessary and excessive risks that threaten the value of the TARP recipient during the period of financial assistance. Congress also directed Treasury to provide for the recovery by a TARP recipient of any bonus, retention award, or incentive compensation paid to a senior executive officer and any of the next 20 most highly-compensated employees of the TARP recipient based on statements of earnings, revenues, gains or other criteria that are later found to be materially inaccurate. Additional Treasury guidance will provide that a TARP recipient cannot make any golden parachute payment to a senior executive officer or any of the next five most highly-compensated employees of the TARP recipient during the period of financial assistance. Treasury guidance will also include a prohibition on a TARP recipient paying or accruing any

bonus, retention award or incentive compensation (excluding certain long-term restricted stock) during the period an obligation arising from TARP assistance is outstanding. This restriction is prospective only, and will not apply to employment contracts entered into before February 11, 2009. The number of employees to whom this last restriction applies varies greatly by the amount of TARP assistance that a company has received. The Act also requires each TARP recipient to establish a Board Compensation Committee, comprised entirely of independent directors, for the purpose of reviewing employee compensation plans and establishing a company-wide policy regarding excessive or luxury expenditures. Finally, each TARP recipient must submit executive compensation to an annual, non-binding shareholder vote during the period of TARP assistance.

Assistance for Individuals and Families

Making Work Pay Credit. The Act adds Section 36A to the Code, which allows a credit against tax on the earned income of eligible individuals in an amount equal to the lesser of 6.2% of the taxpayer's earned income, or $400 ($800 for married couples filing jointly). The credit is reduced, but not below zero, by 2% for so much of a taxpayer's modified adjusted gross income that exceeds $75,000 ($150,000 for married couples filing jointly). The credit is further reduced, but not below zero, for any payments or credits received by the taxpayer pursuant to Section 2201 (economic recovery payments to recipients of social security, supplemental security income, railroad retirement benefits, and veterans' disability compensation or pension) and Section 2202 (special credit for certain government retirees) of the Act.

Eligible individuals include individuals other than nonresident aliens, individuals who may be claimed as dependents under Section 151 of the Code, and estates or trusts. The credit will apply for the 2009 and 2010 tax years and it will be administered thorough the payroll withholding system.

Temporary increase in the earned income tax credit (EITC). The Act increases the EITC for the 2009 and 2010 tax years by boosting the credit percentage from 40% to 45% for a taxpayer with three or more qualifying children. The Act also increases the marriage penalty phase-out from $3,000 to $5,000 for the 2009 and 2010 tax years, with the amount being adjusted for inflation in 2010.

Temporary increase in refundable portion of child credit. The Act increases the refundable portion of the child tax credit by reducing the current earned income level for claiming the credit from $8,500 to $3,000.

American Opportunity Tax Credit. The Act revises many aspects of the Hope Scholarship Credit and renames the credit the "American Opportunity Tax Credit." Specifically, the Act increases the maximum credit from $1,800 to $2,500, expands the credit to include course materials in addition to tuition and fees, increases the years covered by the credit from the first two years of post-secondary education to the first four years of post-secondary education, and increases the phase-out provisions to $80,000 ($160,000 for married couples filing jointly). In addition to the increases and expansion in scope, the credit will also be partially refundable up to 40%.

Computer technology and equipment allowed as a qualified education expense for Section 529 accounts in 2009 and 2010. The Act provides that certain computer technology and equipment expenses paid or incurred in 2009 or 2010 shall be considered qualified higher education expenses for Section 529 accounts. Computer technology and equipment includes computers, computer software (other than software designed for sports, games, or hobbies unless the software is predominantly educational in nature), and fiber optic cables. The Act also includes Internet access and related services as qualified higher education expenses for Section 529 accounts.

Suspension of tax on portion of unemployment compensation. The Act excludes the first $2,400 of unemployment compensation from gross income for the 2009 tax year.

First-time homebuyers credit. The Act amends Section 36 to increase the amount of the credit to $4,000 for individual taxpayers ($8,000 for married couples filing jointly). The Act also extends the credit for homes purchased prior to December 1, 2009, and the Act waives the credit recapture provision for homes purchased after December 31, 2008 and prior to December 1, 2009, except for certain dispositions within 36 months from the date of purchase. The Act further removes the prohibition on financing by mortgage revenue bonds under Section 103 of the Code.

AMT Patch. As part of the economic stimulus package, Congress increased the exemption amounts that taxpayers may apply in determining the alternative minimum tax (AMT). This patch is similar in form to the temporary patches enacted by Congress in 2007 and 2008. For tax years beginning in 2009, the AMT exemptions are as follows:

- 70,950 for couples filing jointly or surviving spouses (increased from $69,950 in 2008);
- $46,700 for single individuals (increased from $46,200 in 2008); and
- $34,975 for married individuals filing separately (the same as the 2008 tax year).

The stimulus package also provides for an extension of all otherwise allowable nonrefundable personal credits to offset AMT, which includes, among others, the child and dependent care credit, credit for the elderly and disabled, child tax credit, and the Hope and Lifetime Learning Credits.

Coordination of low-income housing credit and low-income housing grant. The Act amends Section 42 of the Code to reduce the state housing credit ceiling for low income housing grants received in 2009.

New car above-the-line deduction. The Act provides an above-the-line deduction for state and local sales taxes or excise taxes paid on new motor vehicles in 2009. The sales tax and excise tax deductions are available only to the extent of the first $49,500 of the car's purchase price. The deduction applies for passenger vehicles up to 8,500 pounds, as well as motorcycles and new motor homes. The sales tax and interest deductions begin to phase-out for taxpayers with an adjusted gross income of $125,000 ($250,000, if married and filing jointly).

Recovery for State and Local Governments

De minimis safe harbor exception for tax-exempt interest expense for financial institutions. With exceptions for certain small governmental and charitable issuers, financial institutions since 1986 have not been allowed to take a deduction for the portion of interest expense that is allocable to investments in tax-exempt municipal bonds. In practical terms, this prevented financial institutions from investing in virtually all tax-exempt bonds.

The Act excludes from the limitation those investments by a financial institution in tax-exempt municipal bonds issued in 2009 and 2010 to the extent that these investments constitute less than 2% of the average adjusted bases of all assets of the financial institution. The exclusion lasts for the life of the bonds, regardless of by whom held. The exclusion also extends to refundings.

This provision extends to financial institutions a safe harbor that has long been in place for individuals.

Modification of small issuer exception to tax exempt interest expense allocation rules for financial institutions. As noted above, there is an exception for small issuers. Under current law, a small issuer is one that reasonably anticipates that the amount of its tax-exempt obligations (other then certain private activity bonds) will not exceed $10,000,000. The Act increases this limit to $30,000,000 when determining whether a

tax-exempt obligation issued in 2009 and 2010 qualifies for the small issuer exception. This exemption also extends to refundings.

The above two measures will substantially increase the market for tax-exempt bonds and decrease issuance expenses.

Eliminate costs imposed on state and local governments by the AMT. Under current law, interest on most tax-exempt private activity bonds (i.e., bonds issued for the purpose of financing other than purely governmental activities) is subject to AMT. The Act excludes the remaining categories of private activity bonds from AMT if the bonds are issued in 2009 and 2010. This provision would also extend to refundings.

Temporary expansion of availability of industrial development bonds to facilities creating intangible property and other modifications. For bonds issued after date of enactment and before 2011, proceeds of qualified small issue bonds may be used for facilities engaged in creating intangible property. In addition, the "related and subordinate" requirement is substantially liberalized.

Qualified school construction bonds. The Code presently authorizes the issuance of several types of state and local obligations that do not pay interest, but entitle the holder to a credit in computing federal income tax. The presently authorized types of tax credit bonds are: new clean renewable energy bonds, qualified energy conservation bonds and qualified zone academy bonds. The amount of the credit is set by the Secretary of the Treasury to be the rate that will allow new bonds to be issued at par.

The Act adds a new category. Qualified school construction bonds must meet three requirements: (1) 100% of the available proceeds must be used for the acquisition of real property on which a school is to be constructed or for the construction, rehabilitation or repair of a public school facility; (2) the bonds must be issued by a governmental unit within which the school will be located; and (3) the issuer must so designate the issue. There is a national limitation on the amount of qualified school construction bonds that may be issued by state and local governments, which is $11 billion for both 2009 and 2010.

Qualified Zone Academy Bonds. As indicated above, qualified zone academy bonds are a category of tax credit bonds. In general, to qualify, the school must be in a depressed area and must apply for designation as such. To qualify, the school must be designed to enhance the academic curriculum and increase graduation and employment rates. The program has been seldom used. The Act adds an additional $1.4 billion issuing authority to state and local governments in 2009 and 2010, which can be used to finance renovations and equipment purchases, develop course materials, and train teachers and personnel.

Recovery Zone Bonds. The Act creates a new category of tax credit bonds for investment in economic recovery zones, consisting of $10 billion in recovery zone economic development bonds and $15 billion in recovery zone facility bonds. These bonds could be issued in 2009 and 2010. Each state would receive a share of the national allocation based on that state's job losses as a percentage of national job losses in 2008. That allocation would be sub-allocated to local municipalities. Municipalities receiving an allocation of these bonds would be permitted to use these funds to invest in infrastructure, job training, education and economic development within the boundaries of a city or county that has significant poverty, unemployment or home foreclosures.

Build America Bonds. The Act permits state and local government issuers to elect that interest on its bonds issued at any time will be taxable. The holder of any such bonds is entitled to a nonrefundable credit of 35% of the amount of interest received on such bonds. A subcategory of Build America bonds are taxable governmental bonds issued in 2009 and 2010 if all of the available proceeds are used for capital expenditures.

The holder receives interest at the market taxable rate and the governmental issuer receives a payment from the Treasury equal to 35% of the interest paid to the holder.

Pass-through of bond tax credits for RICs. In lieu of interest, holders of qualified tax credit bonds receive a tax credit that accrues quarterly. The credit is treated as interest that is includible in gross income. Qualified tax credit bonds include qualified forestry conservation bonds, new clean renewable energy bonds, qualified conservation bonds and qualified zone academy bonds. The Code has long provided that in the case of a tax credit bonds held by a regulated investment company (e.g., a mutual fund) the credit is allowed to the shareholders and the income associated therewith is passed through. The Act provides a procedure for passing these items through.

Energy Tax Provisions

Extensions and modifications of existing renewable energy incentives for individuals. The Act includes extensions and modifications of a number of energy tax credits primarily available to individuals. Energy tax credits being extended and/or modified include:

- **Credit for residential energy property.** Expenses for qualified energy-related improvements may qualify for the Code Section 25C residential energy property tax credit. The credit was reinstated for expenses incurred after December 31, 2008 by the Emergency Economic Stabilization Act (EESA). This Act increases the credit from 10% to 30%, raises the maximum to $1,500 for 2009 and 2010 installations, eliminates the $500 lifetime cap, and makes some other minor modifications. The changes are for eligible property placed in service after December 31, 2008, and before January 1, 2011. Improvements eligible for this credit include insulation materials, exterior windows including skylights, exterior doors, central air conditioners, natural gas, propane or oil water heaters and furnaces, hot water boilers, electric heap pump water heaters, certain metal roofs, stoves using renewable plant-derived fuel, and advanced main air circulating fans.
- **Credit for residential energy efficient property.** The Act removes the credit caps under Code Section 25D for solar hot water property, geothermal heat pumps and wind energy property.

Extensions and modifications of existing energy incentives for businesses. The Act also includes extensions of a number of energy tax credits primarily available to businesses. Energy tax credits being extended and/or modified include:

- **Qualified plug-in electric drive motor vehicle credit.** The Act modifies and increases the qualified plug-in electric vehicle credit. The base amount of the credit is $2,500. If the qualified plug-in vehicle draws propulsion from a battery with at least five kilowatt hours of capacity, the credit is increased by $417, plus another $417 for each kilowatt hour of battery capacity in excess of five kilowatt hours, up to 16 kilowatt hours. A taxpayer may claim the full amount of the allowable credit up to the end of the first calendar quarter in which the manufacturer records its 200,000th sale of a plug-in electric drive vehicle. The credit is reduced in the following quarters. The Act also restores and updates the credit for low-speed vehicles and other vehicles that would not qualify for the larger plug-in electric drive vehicle credit and provides a tax credit for plug-in electric drive conversion kits.
- **Carbon Dioxide Sequestration Credit.** The Act modifies the newly created carbon dioxide sequestration credit by providing that carbon dioxide used as a tertiary injectant would need to be disposed of by the taxpayer in a secure geological storage.
- **Clean Renewable Energy Bonds.** The EESA established the category of qualified tax credit bonds for state and local governments, state utilities, and cooperative electric companies used for capital expenditures for qualified renewable energy facilities. This Act authorizes an additional $1.6 billion of clean renewable energy bonds to finance facilities producing energy from renewable sources.

- **Qualified Energy Conservation Bonds.** The EESA also established the category of tax credit energy conservation bonds for state and local government projects focused on reducing energy consumption in publicly-owned buildings, implementing green community programs, rural development involving electricity from renewable energy sources, and other qualified projects to reduce greenhouse gas emissions. This Act authorizes an additional $2.4 billion of energy conservation bonds.
- **Renewable energy production credit.** The Act extends the placed-in-service date for qualified wind facilities from January 1, 2010, to January 1, 2013 pursuant to Code Section 45. For the majority of other qualified facilities, the placed-in-service date is extended from January 1, 2011, to January 1, 2014.
- **Energy investment credit.** The EESA extended the business energy credit under Code Section 48 for solar energy property, fuel cell property, and microturbine property through December 31, 2016. The EESA also added qualified small wind energy property as property eligible for the credit. The 30% credit is generally limited to $4,000 for each tax year and is allowed for property placed in service before January 1, 2017. This Act removes the $4,000 cap for qualified small wind energy property.
- **Investment credit election.** Code Section 45 provides a credit for the production of electricity from alternative sources of energy at qualified facilities. This Act permits taxpayers to treat certain qualified alternative energy facilities as energy property eligible for a 30% investment credit under Code Section 48. The facility must be placed in service in 2009 or 2010.
- **Alternative fuel pump tax credit.** This Act increases the credit for 2009 and 2010 for alternative fuel vehicle refueling property for businesses such as a commercial or retail refueling station. The credit is currently set at 30% of the cost of property placed in service at each location during the tax years, but is limited to $30,000. The credit is now increased from 30% to 50% and is capped at $50,000 for property placed in service for 2009 and 2010. For individuals, the credit is increased to 50% and is capped at $2,000.

Changes to COBRA

The Act provides subsidized health coverage to individuals who have lost their jobs as a result of the economic downturn. Accordingly, any individual who was involuntarily terminated on or after September 1, 2008 and before January 1, 2010 is eligible to pay only 35% of his or her regular COBRA premiums. The individual's former employer must cover the additional 65% of the individual's COBRA premiums. Of the 18 months that the individual is eligible for COBRA, only nine months may be subsidized.

The subsidized premiums are subject to an income threshold after which an individual must begin to repay, through income tax payments, the subsidized amounts once his or her adjusted gross income exceeds $125,000 if single or married filing separately, or $250,000 for those who are married filing jointly. As income increases above these amounts, the individual must repay larger portions of the premiums. When income reaches $145,000 and $290,000 respectively, the individual must repay the entire subsidized portion of the premiums. If an individual determines that they will surpass these limits, he or she may elect to waive the right to subsidized premium coverage.

Employers are eligible for reimbursement of the COBRA component they are required to pay. As such, the amount they pay is treated as a credit against wage withholdings and payroll taxes. If an employer's claims for the COBRA subsidy payments exceed the amount of wage withholdings or the FICA payroll taxes that the employer reports, the employer is entitled to direct reimbursement by the Treasury for the excess amount.

For any individual who has not previously elected COBRA, the individual, along with his or her qualified beneficiaries, have an additional 60 days from the date the former employer provides notice of the eligibility of

subsidized coverage to elect COBRA and be eligible for the subsidy. Additionally, an individual may elect any health plan option that the former employer offers to any of its employees so long as the premium of the option the individual elects is the same or lower than the individual's premium for the health coverage the individual had when he or she was employed.

Caveat about State Tax Law Conformity

The Act provides a number of beneficial federal tax incentives for businesses and individuals. Although many states conform their tax treatment to the federal tax laws, the threat to state tax revenue often causes states to decouple their treatment from the federal laws. For instance, a few dozen states chose not to follow the federal law's provisions for bonus depreciation the last time Congress granted this federal incentive. It is likely that state fiscal pressures will again result in state decoupling from certain of the provisions described in this Alert.