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Tax Law
ALERT
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Tax Provisions Of American Recovery And Reinvestment Act Of 2009

On February 17, 2009, President Barack Obama signed into law the American Recovery and Reinvestment Act of 2009 (H.R. 1). A significant part of the economic stimulus provided by the legislation is in the form of tax cuts and other tax benefits and incentives. These are contained in a part of the legislation called the American Recovery and Reinvestment Tax Act of 2009 (the "Act").

Many of the tax provisions are in the form of credits to low and middle income taxpayers to stimulate consumer spending. These types of credits are phased out at various levels of adjusted gross income and are generally not relevant to high income taxpayers. Once again, Congress has acted to keep millions of middle income taxpayers from being subjected to the alternative minimum tax by further increasing the exemption amount at an estimated cost to the government of more than $70 billion.

In addition to these provisions which benefit low and middle income taxpayers, the Act also contains several provisions that are of interest to high income taxpayers or their families and numerous additional provisions that are relevant to businesses. In this client alert, we will summarize these provisions.

Individual Tax Provisions

Temporary expansion of permitted uses for funds in Section 529 plans. Section 529 education savings plans may be used to pay qualified higher education expenses which to date have included tuition, certain room and board, books, supplies and required equipment. The Act provides that during 2009 and 2010, these accounts may also be used to pay for the purchase of computer technology or equipment and internet access and related services, if such items are used by the beneficiary or his family during years in which he is enrolled at an eligible educational institution. Computer technology or equipment includes software, computers, computer peripherals and fiber optic cable related to computer use.

Extension of first time homebuyer tax credit. The first time home buyer credit may be applicable to your children or grandchildren. The credit is equal to 10% of the cost of the home with a maximum credit of $7,500, and was originally applicable for first time home purchases between January 1 and June 30 of 2009. The Act increases the maximum credit amount to $8,000 and extends the credit for first time purchases through November 30, 2009. Previously, the credit was recaptured over a period of 15 years or sooner, if the taxpayer disposed of the home. Under the Act, there is no recapture if the taxpayer owns the home and uses it as his principal residence for at least 36 months.

Deduction of sales taxes on certain motor vehicle purchases. The Act permits sales or excise taxes paid on new passenger vehicles (including motorcycles) purchased by December 31, 2009, to be deducted to the extent the tax is attributable to the first $49,500 of the vehicle's purchase price. This deduction is not useful for high income taxpayers because it is phased out for those with adjusted gross income in excess of $125,000. However, this deduction may benefit children and grandchildren who need to purchase a vehicle, as they may take this deduction even if they do not otherwise itemize deductions on their income tax return.

Increased tax benefit upon sale of Qualified Small Business Stock. If a taxpayer sells Qualified Small Business Stock that he held for more than five years, he is permitted to exclude from his taxable income 50% of the gain realized on the sale. There is a limit of the greater of ten times the taxpayer's basis in the stock or $10,000,000 of gain per issuer to which the 50% exclusion can be applied. In order to be Qualified Small Business Stock, the taxpayer must have acquired the stock upon its original issuance by a C corporation that is engaged in the active conduct of a trade or business and which has gross assets of $50,000,000 or less.

Under the Act, for Qualified Small Business Stock acquired after February 17, 2009, and before January 1, 2011, 75% of such gain upon sale may be excluded from the taxpayer's taxable income. The five year holding period rule still applies, with the result that stock purchased during 2009 will have to be held past the corresponding date in 2014 for the 75% exclusion to apply.

Business Tax Provisions

Bonus depreciation extended for property purchased in 2009. The special 50% bonus first year depreciation on certain kinds of new property, including aircraft, was originally applicable only to property purchased by December 31, 2008. The bonus depreciation is applicable for both the regular income tax and the alternative minimum tax. The Act extends the 50% bonus depreciation to qualifying property purchased during 2009 as well. Most kinds of equipment and other tangible personal property qualify for the bonus depreciation, as do leasehold improvements that are placed in service more than three years after the building in which they are located was placed in service. Certain assets having a longer production period may be placed in service before January 1, 2011, and qualify for the bonus depreciation.

Increased limitation on amount of business property that can be expensed is extended through 2009. The Economic Stimulus Act of 2008 increased the amount of business property that could be expensed from $125,000 to $250,000 for property acquired during 2008. The Act extends the $250,000 limit through 2009.

Expanded carryback of net operating losses for small businesses. The normal period for which a net operating loss may be carried back and deducted against income from prior tax periods is two years. The Act increases the carryback period for small businesses for losses incurred during 2008. Those losses, at the election of the taxpayer, may also be carried back three, four or five years. Only small businesses are eligible for the extended carryback. A small business is one which, for the three taxable years prior to the loss year, had average gross receipts not exceeding $15,000,000. This is a significant disappointment as it was initially proposed that the expanded carryback apply to all taxpayers. In the first Conference Agreement, the average gross receipts was limited to $5,000,000 but applicable to both 2008 and 2009 losses. Further lobbying by business groups resulted in the limit being raised to $15,000,000 but limited to 2008 losses. The limitation was imposed to help contain the cost of the Act.

Expansion of Work Opportunity Credit. Employers are currently entitled to a tax credit equal to 40% of the first $6,000 of first year wages paid to new employees who are members of a "targeted group." One targeted group was veterans who were either disabled or they or their family qualified for nutrition assistance under the Food and Nutrition Act of 2008.

For hires during 2009 or 2010, the Act expands the group of veterans that qualify and adds a new class of eligible employees called "disconnected youth." During this period, a veteran need only have been discharged during the prior five years and be receiving unemployment compensation for at least four weeks during the one-year period ending on his hiring date. The definition of "disconnected youth" has nothing to do with whether the kid has internet access. A disconnected youth is one between the ages of 16 and 25 who has not attended school for six months prior to his hiring date, who has not been regularly employed for six months prior to his hiring date and who is not readily employable because he lacks a sufficient number of basic skills.

Deferral of income resulting from company's purchase of its outstanding debt at a discount. If a company is able to repurchase its own debt for less than its face amount, it realizes an economic benefit on which it must pay income tax. Such income is referred to as cancellation of indebtedness income or sometimes by the short-hand phrase "COD." As a result of current economic circumstances, there is a considerable amount of company debt trading at deep discounts to the debt's face value. Businesses have lobbied Congress extensively for some tax relief if they go into the market and buy back their debt at a discount.

Congress has responded with a deferral rather than a complete forgiveness of the COD income. If a company purchases its own debt during 2009 or 2010, it may elect to defer the COD income for a period of time and then recognize it ratably over five years. For debt re-purchased in 2009, the ratable inclusion does not begin for five years and for debt purchased in 2010, the ratable inclusion begins after four years.

The deferral provision applies solely to debt issued in connection with the conduct of a trade or business. The deferred income is accelerated and must be recognized in the year in which an individual taxpayer dies or the year in which a company is liquidated or goes out of business.

Suspension of rules prohibiting the deduction of disqualified yield on Applicable High Yield Discount Obligations. Where a corporation issues debt instruments and receives proceeds that are less than the principal amount due at maturity, the difference is referred to original issue discount ("OID") and may generally be deducted by the issuer over the term of the debt. On the other side, the holder is required to take the OID into income over the term of the debt. OID also results where debt is issued that does not require the interest to be paid in cash each year, such as "pay in kind" or "PIK" debt instruments. If the term of a debt instrument is more than five years, the yield to maturity exceeds the applicable federal rate by more than five percentage points, and the debt instrument has significant OID, the excess yield is not deductible and balance of the OID is deductible only when paid. Such a debt instrument is referred to as an "applicable high yield discount obligation" or "AHYDO."

The Act suspends these deduction restrictions for new debt issued between September 1, 2008, and December 31, 2009, that is issued to re-finance prior debt that was not an AHYDO. This is an apparent recognition that corporations may need to pay higher yields in order to re-finance outstanding indebtedness.

Built-in gains of S Corporations. If a C Corporation has unrealized gain in its assets at the time it elects to become an S Corporation, it must pay corporate level tax on such built-in gain if the assets are sold within the first ten years after the corporation becomes an S Corporation. The purpose of this provision is to prevent corporations from electing S Corporation status immediately before they sell their assets. The Act reduces the ten year period to seven years for sales of assets during 2009 or 2010.

AMT exemption for interest on certain municipal private activity bonds issued during 2009 and 2010. Interest on the bonds and other indebtedness issued by state and local governments is exempt from the regular federal income tax. However, where such bonds are issued for the purpose of financing private business activity, such as industrial development bonds, interest received on those bonds is included in income for purposes of the alternative minimum tax ("AMT").

The Act provides that in the case of private activity bonds issued by a state or local government during 2009 and 2010, interest from such bonds is not subject to the AMT. In addition, if new bonds are issued during 2009 or 2010 and the proceeds are used to refinance private activity bonds previously issued between January 1, 2004, and December 31, 2008, the interest paid on the new bonds is also exempt from AMT.

These favorable provisions may lead to increased issuance of industrial development bonds by municipalities during 2009 and 2010. The exemption from AMT makes these bonds more attractive for investors from a tax perspective, however these bonds' yields will likely be lower. The purpose of this provision is to lower the borrowing cost for state and local governments desiring to finance industrial facilities.

Election to claim investment tax credit instead of production tax credit for certain electricity production facilities. Facilities that produce electricity from solar energy receive a 30% investment tax credit under current law. Facilities that produce electricity from wind, biomass, geothermal, hydropower, landfill gas, waste-to-energy and marine renewable resources receive instead a production tax credit that is taken over ten years. In the hope of immediately stimulating new investment in these kinds of facilities, the Act provides an election to claim the 30% investment tax credit in the year the facility is placed in service in lieu of the taking the production tax credit over ten years. The election is available for wind energy facilities placed in service between 2009 and 2012 and other types of facilities listed above placed in service between 2009 and 2013.

Removal of dollar limitation for certain energy credits. Businesses are currently allowed a credit of 30% of the cost of qualified small wind energy property subject to a $4,000 cap. Qualified small wind energy property is a wind turbine that is used to generate electricity and has a capacity of one hundred kilowatts or less. The Act removes all of the dollar limitations so the credit is now available on the full cost of these items.

Expanded tax credit for plug-in electric vehicles. The number of cars in the United States qualifying for the tax credit for vehicles with a plug-in electric motor has been increased again. For taxable years beginning after 2009, the credit is between $2,500 and $7,500 per vehicle, depending on the vehicle's battery capacity and may offset the alternative minimum tax as well as the regular income tax. The weight of the vehicle no longer has any bearing on the amount of the credit. The expanded credit does not begin to be phased out until the second calendar quarter after a particular manufacturer has sold 200,000 of these vehicles for use in the United States after December 31, 2009.

Further compensation limitations for financial institutions receiving federal assistance under TARP program. Although not tax provisions, the legislation contains additional restrictions on executive compensation for financial institutions that have received assistance under the Treasury Department's Troubled Asset Relief Program ("TARP"). The most significant restriction prohibits a TARP recipient from paying or accruing any bonus or other incentive compensation to certain of the most highly compensated employees until the TARP funds have been repaid. There is an exception that permits a bonus in the form of restricted stock that does not vest until after the TARP funds have been repaid; provided that the bonus amount cannot be greater than one-third of the total compensation of the employee receiving the restricted stock. The number of employees subject to these restrictions depends on the amount of TARP funds received by the employer. If less than $25,000,000 was received, only the highest paid employee is subject to the restrictions. The number of employees subject to the restrictions increases to a maximum of the five highest paid executive officers and twenty highest paid employees in companies that received $500,000,000 or more of TARP funds. The restrictions do not apply to amounts payable under employment contracts executed on or before February 11, 2009.

Conclusions. This client alert contains only a very brief summary of those tax provisions most likely to be of interest to high income taxpayers, their families, and businesses. If you have questions about any of the provisions discussed above or would like more information about any aspect of the legislation, please feel free to contact any of the attorneys in our group.

For more information about any of the techniques and strategies discussed in this newsletter, or any other income or estate tax planning assistance, please feel free to contact any member of our High Net Worth Family Practice Group.

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