Business Tax Provisions in American Recovery and Reinvestment Act of 2009

On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (the "Act"). A substantial portion of the Act consists of tax provisions that are intended, along with a massive government spending program, to stimulate the U.S. economy. This memorandum provides a summary of the most significant business-related provisions of the Act, including those designed to encourage renewable energy projects.

NON-ENERGY BUSINESS TAX RELIEF

The Act extends or expands a number of existing tax benefits that are available to businesses and provides new elections relating to (i) debt relief that results in cancellation of indebtedness income and (ii) the utilization of net operating losses.

Extension of Bonus Depreciation. Businesses generally are allowed to recover the cost of capital expenditures over time according to a depreciation schedule. In 2008 (and in several prior years), Congress permitted businesses to claim so-called "bonus depreciation," thereby obtaining an immediate write-off for a certain percentage (generally 50%) of the cost of certain new "qualified property" in the first year such property is placed in service. Such property included, among other depreciable property, wind turbines, solar panels, aircraft and computers. This bonus depreciation is taken in addition to regular depreciation deductions claimed for the year.

The Act extends this 50% bonus depreciation for property that is placed in service in 2009 (and 2010 for certain property with a recovery period of ten years or longer and certain transportation property, including aircraft).

Bonus depreciation provides a significant tax incentive for businesses to acquire new depreciable property. It is also valuable to lessees of equipment as the additional tax benefits that are available to owner/lessors should be reflected in lower lease rates to lessees.

Extension of Enhanced Small Business (Section 179) Expensing. In order to help small businesses quickly recover the cost of certain capital expenses, small business taxpayers can elect to write off the cost of these expenses in the year of acquisition, in lieu of recovering these costs over time through depreciation deductions. Unlike bonus depreciation, this expensing provision is available for both new and used property. The amount that small businesses could write off for capital expenditures incurred in 2008 was temporarily increased to $250,000, subject to a phase-out once annual capital expenditures exceed $800,000. The Act extends these temporary increases for capital expenditures incurred in 2009.

Five-Year Carryback of Net Operating Losses for Small Businesses. A net operating loss (an "NOL") is the excess of certain business deductions over gross income in any taxable year. NOLs generally can be carried back to the two taxable years before the year in which the loss arises, and carried forward to each of the succeeding 20 taxable years after the year of the loss. For taxable years ending in 2008 (or, if the taxpayer elects, for years beginning in 2008), the Act extends the maximum NOL carryback period from two years to five years for small businesses with gross receipts of $15 million or less. **This provision of the Act will provide an immediate cash flow benefit to certain small businesses that have current NOLs that can be carried back to profitable years, enabling receipt of tax refunds.**

Delayed Recognition of Certain Cancellation of Debt Income. Gross income generally includes income realized by a debtor from the discharge of its debt (so-called "cancellation of debt" or "COD" income), subject to certain exceptions for insolvent debtors and for debtors in bankruptcy. A debtor generally recognizes COD income where the debtor (or a related party) cancels or repurchases its debt for an amount less than its adjusted issue price. The amount of this COD income is the excess of the debt's adjusted issue price over the repurchase price.

Under the Act, certain businesses will be allowed irrevocably to elect to defer recognition of COD income for specified types of business debt repurchased by the business (or a related party) during 2009 and 2010. For debt repurchased in 2009, COD income will be deferred for five taxable years, and recognized ratably over the following five taxable years. For debt repurchased in 2010, COD income will be deferred for four taxable years, and recognized ratably over the following five taxable years. Thus, in either case, the COD will be included in income ratably over the five tax year period from 2014 to 2018. Debt instruments covered by this provision include bonds, debentures, notes, certificates, or any other instruments constituting indebtedness issued by a C corporation or any other person in connection with the conduct of a trade or business by such person. Debt can be "repurchased" for cash, in exchange for another debt instrument (including an exchange resulting from a modification of a debt instrument), in exchange for corporate stock or a partnership interest, as a contribution to capital, or by complete forgiveness.

In the case of a partnership debtor, deferred COD income is allocated to the partners in the partnership immediately before the repurchase, in the manner that such income would have been allocated had such income been recognized at the time of the repurchase. In addition, any deemed distribution resulting from a decrease in a partner's share of the partnership's liabilities as a consequence of the repurchase, to the extent it exceeds such partner's basis, generally is deferred over the same time period as the deferral of the COD income.

If a debt instrument is repurchased in exchange for another debt instrument having so-called original issue discount ("OID") (or repurchased using the proceeds of the issuance of an OID debt instrument), the debtor will be required to defer deductions for such OID (to the extent they do not exceed the COD income from the debt instrument being repurchased), generally over the same time period as the deferral for the COD income.

Deferred COD income would be accelerated in certain circumstances, such as the death of the taxpayer, the liquidation or sale of substantially all of the assets of the taxpayer or the cessation of business by the taxpayer. In addition, if a taxpayer elects to defer COD income from the repurchase of a debt instrument, none of the other exceptions for COD income will apply to such income for the taxable year of the election or for any subsequent taxable year.

The ability to use NOLs in years 2009 – 2013, without any reduction in the amount of NOLs due to COD income, may provide a significant cash flow benefit to many financially-distressed businesses. Taxpayers that are debtors in a bankruptcy proceeding (or that are insolvent), however, will have to determine whether this deferral election is beneficial.

Modifications of Rules for Certain High Yield Obligations. Issuers of debt instruments with OID generally are permitted to deduct any OID accruing during the taxable year. However, in the case of an applicable high-yield discount obligation (an "AHYDO") issued by a corporation, a certain portion of the deductions for OID are deferred until paid, and the remainder is disallowed entirely. An AHYDO is any debt instrument with a term of more than five years if the yield exceeds a certain specified rate and the instrument has a significant amount of OID.

The Act suspends the AHYDO rules for certain newly-issued debt instruments issued in debt-for-debt exchanges (including exchanges resulting from a modification of debt instruments) between September 2008 and December 2009. However, the suspension does not apply to any newly-issued debt instrument that is issued in exchange for an existing AHYDO. In addition, the suspension does not apply to certain newly-issued debt instruments with contingent interest, or to debt instruments issued to a person related to the issuer.

The combination of the new deferral of COD income and the suspension of the AHYDO rules may provide a significant opportunity for tax indifferent lenders (*e.g.*, non U.S. lenders and U.S. tax exempt organizations) to participate in the restructuring of the debt of financially-distressed U.S. debtors in a manner that will increase the present value return to the lenders and reduce current cash flow obligations of the U.S. borrower. This may provide a major taxplanning opportunity for certain creditors and financially-distressed debtors.

Temporary Reduction of S Corporation Built-In Gains Holding Period From Ten Years to Seven Years. Certain taxable C corporations are permitted to convert into S corporations. Unlike C corporations, S corporations generally pay no corporate-level tax. Instead, items of income and loss of an S corporation pass through to its shareholders, under rules similar to those for partnerships. If a C corporation converts into an S corporation, the conversion itself is not a taxable event. However, following such conversion, an S corporation must hold its assets for ten years in order to avoid a "built-in gains tax" on any appreciation that exists at the time of the conversion. The built-in gains tax is designed to prevent C corporations from avoiding corporate level tax on the sale of appreciated assets by first converting into an S corporation.

The Act temporarily reduces this holding period from ten years to seven years for sales occurring in 2009 and 2010. Therefore, no built-in gains tax will apply to a sale by an S corporation in 2009 and 2010 if the sale occurs more than seven taxable years following conversion from a C corporation.

This provision of the Act will permit sellers of some S corporations to agree to either (i) sell the assets of such corporations or (ii) sell the stock of such corporations and agree with the purchaser to make a joint election under Internal Revenue Code (the "Code") Section 338(h)(10), in either case avoiding a corporate level tax that would otherwise have been imposed. These transactions generally provide the purchaser with a step up in the tax basis of each of the S corporation's assets and should result in tax savings to the purchaser and a greater purchase price for the sellers.

Repeal of Treasury Section 382 Notice and Clarification of the Application of Section 382 to Certain Ownership Changes. Section 382 of the Code limits the extent to which a corporation with an NOL (or, in certain cases, net unrealized built-in loss) that experiences certain changes in ownership may utilize losses that are attributable to tax periods prior to the ownership change.

In conjunction with the bank bailout legislation passed in October 2008 (the Emergency Economic Stabilization Act of 2008), the Treasury Department issued Notice 2008-83, which liberalized certain rules under Section 382 for corporations acquiring a financially-strapped bank. In particular, this Notice provided that a deduction properly-allowed after an ownership change to a bank was not treated as attributable to tax periods prior to the ownership change. Under this Notice, banks were allowed to deduct an unlimited amount of losses on loans or bad debts that were held by another bank in a merger or acquisition. Many lawmakers had criticized the IRS for issuing Notice 2008-83, claiming that the agency over-stepped its authority without giving proper deference to Congress.

The Act repeals Notice 2008-83, effective for ownership changes after the date of enactment, with respect to which there was no written agreement before that date. This provision will increase the net cost of acquiring a financially-strapped bank, making such an acquisition less attractive.

RENEWABLE ENERGY TAX PROVISIONS

The Act will have a significant impact in the areas of renewable energy production, creation of a "smart" grid, the transmission of energy, the utilization of advanced vehicles and numerous other aspects of "green technology." The provisions discussed below provide tax benefits in the renewable energy area that are in addition to the other business tax benefits discussed above (such as the extension of "bonus depreciation"). Also, it should be noted that, apart from tax benefits, renewable energy and energy-efficient programs will benefit from billions of dollars of direct government spending, including funds that will be provided to modernize the nation's electricity grid with "smart" technology, support research and development projects in the energy area and grants for the manufacture of advanced batteries and components.

Extension of the Renewable Energy Production Tax Credit. An income tax credit (1.5 cents per kilowatt-hour produced, indexed for inflation), called the production tax credit ("PTC"), is allowed for the production of electricity from qualified energy resources at "qualified facilities" for the first ten years from the date the facility is placed into service. Qualified energy resources include wind, closed loop biomass, open loop biomass, geothermal energy, small irrigation, hydropower, landfill gas, waste to energy and marine renewable facilities that produce electricity. Generally, prior to the Act, a facility was treated as a "qualified facility" only if it was placed in service before 2011 (before 2010 in the case of wind energy facilities).

The Act extends the placed in service date requirement for three years — *i.e.*, until the end of 2013 (for two years, *i.e.*, to the end of 2012, for wind energy facilities).

This extension provides developers of, and investors in, such facilities the certainty of knowing that proposed facilities (especially in the wind power area) will qualify for PTC benefits and thus enable developers to be able to proceed with plans to build such facilities.

Energy Investment Tax Credit Available for All Renewable Energy in Lieu of Production Tax Credits. A nonrefundable, business energy credit ("investment tax credit" or "ITC") is allowed for the cost of qualifying energy property. Qualifying energy property includes certain fuel cell property, solar property, geothermal power production property, small wind energy property, combined heat and power system property, microturbine property, and geothermal heat pump property. The investment tax credit, unlike a production tax credit, is a component of the general business credit. Moreover, unlike the production tax credit discussed above, the investment tax credit is based on the cost that is incurred to construct or acquire the equipment (subject to certain limitations), rather than the amount of energy that it produces.

Although the energy investment tax credit generally is 10%, the credit for certain projects, notably solar energy property, placed in service prior to 2017, is 30%.

The Act extends the 30% ITC to certain projects that were previously eligible only for the renewable electricity PTC. Thus, developers of wind, geothermal, biomass and certain other projects will be permitted to make an irrevocable election to have certain qualified facilities that are placed in service in the years 2009 through 2013 (through 2012, for wind facilities) treated as energy property eligible for a 30% investment tax credit, provided such facility has not claimed the production tax credit.

Thus, a taxpayer who constructs or acquires a qualified facility could receive a 30% investment tax credit for the year in which the qualifying property is placed in service, rather than obtaining production tax credits over ten years. This provision will enable many renewable energy projects to obtain financing because potential investors in such projects will not need to consider whether they will be able to utilize PTCs in future years.

Repeal of Limitation on ITC Due to Subsidized Energy Financing. The Act allows businesses and individuals to qualify for the full amount of available ITC with respect to energy property regardless of whether the construction or acquisition of the property is financed with industrial development bonds or other subsidized financing.

Department of Treasury Grants in Lieu of Tax Benefits. Although this memorandum generally does not summarize government grants, in the energy area, one grant is specifically related to the tax provisions of the Act discussed above. The Act provides that owners of renewable electricity qualifying properties may elect to receive grants from the Department of Treasury in lieu of claiming either production tax credits or electing to claim investment tax credits (as discussed above) for projects placed in service in 2009 and 2010.

The amount of the grant generally would be equal to the amount of the investment tax credit for which the owner of the project would otherwise have been eligible (*i.e.*, generally 30% of the qualified cost of the project). This is a very important provision for project developers, as it would provide an immediate source of funds. The grants would function in a manner similar to a refundable tax credit, and would not be includible in the gross income of the taxpayer. The advantage of a grant over a nonrefundable tax credit, such as the energy tax credit, is that a taxpayer that does not have current taxable income can benefit from a grant, whereas an energy investment tax credit only has value when applied against a taxpayer's tax liability. This will enable developers to fund portions of their investments, and to obtain funds from equity participants who are more interested in cash returns and the future appreciation of the project than in obtaining tax credits and other tax benefits.

Advanced Energy Manufacturing Facility Credits. The Act provides a 30% energy related manufacturing facility investment tax credit (up to a national limit of $2.3 billion) for projects designed to reduce greenhouse gas emissions, including, among others, projects that re equip, expand or establish manufacturing facilities for the production of (i) property designed to be used to generate renewable energy, (ii) fuel cells, microturbines or energy storage systems for use with electric or hybrid electric cars, (iii) electric grids to support the transmission of renewable energy and (iv) equipment for carbon dioxide capture and storage. A taxpayer may not claim this 30% credit with respect to any property for which it also claims the 30% energy investment tax credit (discussed above).

Expand New Clean Renewable Energy Bonds. New clean renewable energy bonds (new "CREBS") are bonds that can be issued by qualified issuers to finance the cost of qualified renewable energy facilities (those which qualify for the production tax credit and are owned by a public power provider, governmental body or cooperative electric company). Previously, these were capped at $800 million nationally. The Act provides for $1.6 billion of additional new CREBs.

Expand Qualified Energy Conservation Bonds. Qualified energy conservation bonds are available to finance programs by state or local governments for "qualified conservation purposes" (*e.g.*, to reduce energy consumption or greenhouse gas emissions). The Act authorizes issuance of an additional $2.4 billion worth of bonds.

Tax Credits for Alternative Fuel Pumps. Taxpayers can claim a credit for the cost of installing qualified clean fuel vehicle refueling property that is used in the trade or business of the taxpayer (*e.g.*, at gas stations). The Act, covering property placed in service in 2009 and 2010, increases the maximum credit from $30,000 to $200,000 (for hydrogen refueling property) or $50,000 (all other qualifying property). It also increases the credit rate from 30% to 50%, except for hydrogen refueling property.

Addition of Permanent Sequestration Requirement to CO2 Capture Tax Credit. Under current law, there is a $10 tax credit per ton for the first 75 million metric tons of carbon dioxide captured and transported from an industrial source for use in enhanced oil recovery. The Act introduces a requirement that the credit may be claimed only if the carbon dioxide is permanently sequestered in a geological formation.

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