

February 17, 2009



Tax Provisions of the Stimulus Bill

On Friday, February 13, 2009, Congress passed the American Recovery and Reinvestment Act of 2009 (the “Act”), which was signed into law by the President on Tuesday, February 17, 2009. The Act provides a package of tax provisions that affect public welfare, infrastructure, energy, business, housing, and the automotive industry. Some of the more significant tax provisions include the following:

Business-Related Provisions:

- *Repeal of Notice 2008-83.* In late September 2008, the Internal Revenue Service issued Notice 2008-83 to encourage acquisitions of troubled financial institutions. Notice 2008-83 relaxed the rules under Section 382 of the Internal Revenue Code (the “Code”), which are designed to prevent the trafficking of built-in losses, by effectively excluding built-in loan losses of a troubled bank from the reach of Section 382 and related provisions. The apparent policy behind Notice 2008-83 was to encourage acquisitions of troubled banks by stronger financial institutions. For example, it is widely speculated that Notice 2008-83 contributed to the change in the value of Wachovia as a target last year, when three days after the issuance of Notice 2008-83, Wells Fargo announced that it would acquire Wachovia for approximately \$15 billion, outbidding Citi’s \$2 billion bid announced the day before Notice 2008-83 was issued. See <http://www.mofo.com/news/updates/files/081219TaxTalk.pdf> and <http://www.mofo.com/news/updates/files/14544.html> for our prior coverage of Notice 2008-83. Notice 2008-83 was controversial and some members of Congress believed that the Treasury overstepped its legal authority to issue the Notice. The Act nullifies Notice 2008-83 effective after January 16, 2009, stating that the Notice is “inconsistent with the congressional intent” and the legal authority to issue the Notice is “doubtful.”
- *Treatment of Certain Ownership Changes Under Section 382.* The Act provides that Section 382 of the Code will not apply in the case of an ownership change which is (i) pursuant to a restructuring plan which is required under a loan agreement or a commitment for a line of credit entered into with the Treasury under the Economic Stabilization Act of 2008 and (ii) intended to result in rationalization of the costs, capitalization, and capacity with respect to the manufacturing workforce of, and suppliers to, the taxpayer and its subsidiaries. However, the exception does not apply if, in general, any person owns 50% or more of the stock of the new loss corporation by vote or value after the ownership change. This provision appears aimed at, for example, General Motors, which may be required to restructure its debt under the terms of the loan it received from the Treasury late last year.
- *Cancellation of Indebtedness Income.* Taxpayers with outstanding debt are often subject to tax on cancellation of indebtedness (“COD”) income when all or a portion of such debt has been economically cancelled, whether through repurchase (including through a related party), modification or otherwise. At the election of the taxpayer, the Act defers the recognition of COD income in connection with certain repurchases, modifications, and exchanges (referred to as “reacquisitions”) of debt instruments after

December 31, 2008 and before January 1, 2011. For reacquisitions in 2009, the deferral is five years; for reacquisitions in 2010, the deferral is four years. At the end of the deferral period, the taxpayer must include the COD income ratably over the next five years. Among other things, the deferral applies to business debts only. Original issue discount on certain new debt instruments issued as part of, or in connection with, the reacquisition will not be deductible during the deferral period. The death of, liquidation of, or other similar event with respect to a taxpayer will accelerate deferred COD income. If a taxpayer elects deferral, other possible exceptions to COD income in the Code may be unavailable. Special rules apply to pass through entities. While the new provision defers rather than eliminates recognition of COD income, it should be expected to make it significantly more attractive for issuers to reacquire or restructure their existing indebtedness.

- *Temporary Suspension of AHYDO Rules.* For corporations that issue certain high-yield obligations with significant original issue discount (“AHYDOs”), a portion of such discount is treated as a nondeductible dividend under section 163(e)(5) of the Code, while the remaining discount may not be deducted until actually paid. The Act suspends these rules for AHYDOs issued in exchange for non-AHYDOs of the same corporation between August 31, 2008 and January 1, 2010. The Act grants the Treasury the authority to extend the suspension and also expands the Treasury’s ability to adjust the base rates used to determine whether an instrument is an AHYDO. Generally, these provisions should make the refinancing and restructuring of existing corporate debt, especially by distressed issuers, more attractive. The suspension does not apply to certain obligations with contingent interest determined, among other things, by reference to the income, value or dividends of the debtor (or a related person), nor does the suspension apply to obligations issued to related persons.
- *Modification of the Rules for Tax-Exempt Interest Expenses Relating to Financial Institutions.* Under current law, financial institutions may not deduct the portion of their interest expense allocable to their investments in tax-exempt bonds. In determining the portion of the interest expense allocable to investments in tax-exempt municipal bonds, the Act would exclude investments in tax-exempt bonds issued during 2009 and 2010 to the extent these investments constitute less than two percent of the average adjusted bases of all the assets of the financial institution. Presently, bonds issued by “qualified small issuers” are also not taken into account for purposes of the rules described above. The Act expands the definition of qualified small issuers by increasing the annual limit of obligations that may be issued from \$10 million to \$30 million for 2009 and 2010. The small issuer exception would apply to an issue if all the ultimate borrowers in such issue would separately qualify.
- *Five-Year Carryback of Net Operating Losses for Small Businesses.* In general, net operating losses (“NOLs”) can be carried back to offset taxable income for the two years prior to the taxable year in which they are generated and carried forward to offset taxable income in the subsequent 20 years. The Act extends carrybacks of NOLs of eligible small businesses to five years for NOLs arising in the 2008 and 2009 taxable years. An eligible small business is a business that averages \$15 million or less in annual gross receipts.
- *Small Business Capital Gains.* To encourage investment in small businesses, existing law allows noncorporate investors to exclude up to 50% of gain realized on the disposition of certain small business stock if held for more than five years. The Act increases the exclusion from 50% to 75%.
- *Temporary Reduction of S Corporation Built-In Gains Holding Period.* Under existing law, if a C corporation converts into an S corporation, the conversion itself is not a taxable event. However, to avoid tax on any unrecognized built-in gains of the corporation that existed at the time of conversion, the corporation is required to hold its assets for a period of ten years. The Act temporarily reduces this holding period from ten years to seven years for sales occurring in 2009 and 2010.
- *Accelerated Depreciation.* Last year, Congress temporarily allowed the recovery of costs of capital expenditures made in 2008 at an accelerated rate by allowing a business to immediately write off 50% of the cost of depreciable property acquired in 2008 for use in the U.S. The Act generally extends this temporary benefit for one additional year.

- *Pass Through of Credits from Tax Credit Bonds.* The Act allows a regulated investment company to elect to pass through the tax credits from certain tax credit bonds to its shareholders. A tax credit bond includes, for example, a qualified forestry conservation bond, a new clean renewable energy bond, a qualified energy conservation bond, a qualified zone academy bond, and a build America bond.

Housing and Automotive-Related Provisions:

- *First-Time Homebuyer Credit.* The Housing and Economic Recovery Act of 2008 provides that a taxpayer who purchases a principal residence in the U.S. after April 8, 2008, and before July 1, 2009, could qualify for a refundable income tax credit of up to \$7,500, if the taxpayer was a “first-time homebuyer” (meaning, generally, that the purchaser had no present ownership interest in a principal residence for three years prior to the date of purchase of the new home). The credit was subject to a phase-out for higher-income taxpayers and was subject to recapture during a fifteen-year recapture period and, in effect, was economically equivalent to an interest-free loan. The Act modifies this credit for purchases after December 31, 2008, by (i) increasing the amount of the credit up to \$8,000, (ii) extending the deadline to purchase a home to November 31, 2009, and (iii) waiving recapture unless the taxpayer sells the newly purchased home within three years of purchase.
- *Additional Standard Deduction for State Sales Tax and Excise Tax on the Purchase of Certain Motor Vehicles.* The Act allows as a deduction for the taxable year “qualified motor vehicle taxes,” which generally means any State or local sales or excise tax imposed on the purchase of a “qualified motor vehicle.” A qualified motor vehicle generally includes new purchases of standard passenger cars, light trucks, and motorcycles, and certain other vehicles. The deduction expires for purchases of qualified motor vehicles after December 31, 2009, is subject to an income phase-out, and is limited to the portion attributable to the first \$49,500 of the purchase price of the vehicle.

General Benefit Provisions:

- *Suspension of Tax on Portion of Unemployment Compensation.* Under previous law, all federal unemployment benefits were subject to taxation. The Act exempts the first \$2,400 of unemployment compensation from federal income taxes.
- *Temporary Increase of Refundable Portion of Child Credit.* The Act will increase eligibility for the refundable child tax credit in 2009 and 2010 by reducing the floor from which the amount of the credit is calculated from \$8,500 to \$3,000 for 2009 and 2010.
- *Computers as Qualified Education Expenses in 529 Education Plans.* The Act provides that computers and computer technology qualify as qualified education expenses under a 529 Education Plan. A 529 Education Plan is a tax-preferred savings plan designed to help families save funds for future college costs, which include tuition, room and board, mandatory fees, and books.
- *American Opportunity Education Tax Credit.* The Act will provide a tax credit of up to \$2,500 of the cost of tuition and related expenses during a taxable year to assist individuals seeking a college education. Forty percent of the credit will be refundable. The credit will be subject to a phase-out for high income earners.

Infrastructure-Related Provisions:

- *Recovery Zone Bonds.* The Act authorizes \$10 billion in recovery zone economic development bonds and \$15 billion in recovery zone facility bonds, which are tax-favored bonds that municipalities can use to invest in infrastructure, job training, education, and economic development in areas that have significant poverty, unemployment, or home foreclosures.
- *Qualified School Construction Bonds.* The Act creates a tax credit bond for the purchase of land for, or construction, rehabilitation, or repair of, public school facilities.

Energy:

- *Advanced Energy Investment Credit.* The Act creates a 30% investment tax credit for facilities engaged in the manufacture of advanced energy property. Advanced energy property generally includes technology for the production of renewable energy, energy storage, energy conservation, efficient transmission and distribution of electricity, and carbon capture and sequestration. The Act authorizes up to \$2.3 billion of advanced energy tax credits. Credits are available only for projects certified by the Secretary of the Treasury.
- *Extension and Modification of Renewable Energy Production Tax Credit.* The Act extends the placed-in-service date for wind facilities through December 31, 2012, and certain other facilities through December 31, 2013.
- *Election of Investment Credit in Lieu of Production Credit.* The Act allows a taxpayer, if certain requirements are met, to make an irrevocable election to claim a 30% investment tax credit in lieu of a production tax credit for wind or certain other facilities placed into service after December 31, 2008.
- *Tax Credits for Energy-Efficient Improvements to Existing Homes.* The Act extends and increases tax credits for energy-efficient home improvements.
- *Temporary Increase in Credit for Alternative Refueling Property.* The Act temporarily increases tax credits for businesses that install alternative fuel pumps.
- *Plug-in Electric Drive Vehicle Credit.* The Act modifies and increases a tax credit for qualified plug-in electric drive vehicles placed in service during the taxable year.
- *Addition of Permanent Sequestration Requirement to CO₂ Capture Tax Credit.* The Act requires any taxpayer claiming a \$10 credit per ton for carbon dioxide captured and transported for use in enhanced oil recovery to ensure such carbon dioxide is permanently stored in a geologic formation.
- *Clean Renewable Energy Bonds.* The Act authorizes an additional \$1.6 billion of new clean renewable energy bonds to finance facilities that generate electricity from certain renewable resources.
- *Qualified Energy Conservation Bonds.* The Act authorizes an additional \$2.4 billion of qualified energy conservation bonds to finance State, municipal and tribal government programs and initiatives designed to reduce greenhouse gas emissions.

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