

March 2, 2009

## American Recovery & Reinvestment Act of 2009

On February 17, 2009, President Obama signed the American Recovery and Reinvestment Act of 2009 (ARRA or "the Act") into law. The Act includes several provisions intended to provide immediate tax benefits to businesses and individuals. Most of the provisions build upon existing law by extending, and in some cases expanding, current incentives.

### BUSINESSES

#### Net Operating Losses

Net Operating Loss (NOL) carryback and carryforward periods have varied over the years with changes in the economy. Small businesses with less than \$15 million in average annual gross receipts (three-tax-year period or shorter period of existence) that had an NOL in a tax year beginning or ending in 2008 may elect a carryback period of three, four or five years instead of the normal two years. The carryforward period remains 20 years.

This longer carryback is designed to benefit taxpayers with taxable income in recent years. Suppose that a company has a 2008 NOL of \$3 million and taxable income in 2003 through 2007 of \$500,000 per year. The \$3 million NOL could be first applied to each of the last five years and the remaining \$500,000 would be carried forward to 2009 and beyond. Assuming a 34% tax rate, the \$2.5 million carryback would produce a tax refund of \$850,000. Under prior law, only \$1 million of the NOL could have been carried back (yielding a \$340,000 tax refund) with the remaining \$2 million available as a carryforward. The enhanced carryback applies for alternative minimum tax (AMT) purposes as well.

#### Bonus Depreciation

Under prior law, a 50% bonus deduction was allowed for qualifying MACRS property, generally new property with a recovery period of 20 years or less. The provision was due to expire at the end of 2008, but now has been extended to include property placed in service before January 1, 2010. Additionally, certain property with long production periods and transportation property, including certain aircraft, will qualify if placed in service before January 1, 2011. Bonus depreciation also applies to qualified leasehold improvements. The deduction is allowed in full for AMT purposes.

To illustrate the benefits of bonus depreciation, assume that a taxpayer purchases and places in service computers (five-year property) in 2009, costing \$2 million. Absent bonus depreciation, the depreciation deduction would be \$400,000. With the bonus, the deduction would increase to \$1,200,000, or 60% of the cost of the property.

#### Election to Forego Bonus Depreciation Deductions in Exchange for Current Allowance of Refundable Credits

The election to convert unused AMT and research credits into refundable credits has also been extended for one year. A corporation may elect to forego bonus depreciation in favor of utilizing these credits. The election allows certain taxpayers to monetize accumulated R&D and AMT credits in lieu of bonus depreciation which may not result in any current tax benefit. An electing corporation may not take bonus depreciation in any later year.

An electing corporation takes MACRS straight line depreciation on eligible property instead of bonus and accelerated MACRS depreciation. In exchange for a lower depreciation deduction, the company is entitled to increased limits on the use of R&D and AMT credits attributable to tax years before 2006. Eligible property is the same as that for bonus depreciation purposes.

The enhanced credit is equivalent to the bonus depreciation amount, namely 20% of the difference in depreciation as calculated with and without bonus depreciation. Further, the bonus depreciation amount is limited to the lesser of (1) \$30 million or (2) 6% of the pre-2006 credits.

## BUSINESSES

(continued)

### **Section 179 Expense Election**

Section 179 of the tax code allows an election to deduct the cost of certain property instead of capitalizing and depreciating it. Under prior law, the amount of annual expense was limited to \$250,000 and was reduced dollar for dollar for the amount of Section 179 property placed in service in excess of \$800,000. The allowed expense amount and the investment limitation of \$250,000 and \$800,000, respectively, only applied to tax years beginning in 2008, but the Act extended these amounts to tax years beginning in 2009 as well. Without further extension, the applied expense and investment limitations will fall in 2010 to \$125,000 and \$500,000, respectively.

The expense election is calculated prior to, and in addition to, bonus depreciation. For example, the combined expense deduction and bonus depreciation deduction amount to 80% for a \$500,000 eligible five-year asset placed in service in 2009.

### **Built-in Gains Tax Holding Period for S Corporations**

S corporations that converted from C corporations or acquired assets from C corporations in a nontaxable carryover basis transfer are generally subject to a corporate level tax (at a top rate of 35%) on the built-in gains when those assets are sold. This built-in gains tax generally applies for a recognition period of ten years from the date the C corporation converted to S corporation status. The Act reduces the recognition period to seven years for asset sales subject to the built-in gains tax in tax years beginning in 2009 and 2010.

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## INDIVIDUALS

### **FOR WORKING AMERICANS**

#### **Making Work Pay Credit**

This is President Obama's signature provision of tax relief for joint and single taxpayers for 2009 and 2010. The credit is calculated as 6.2% of earned income up to \$12,904 for joint taxpayers (or \$6,452 for single taxpayers), resulting in a refundable tax credit of up to \$800 for joint taxpayers (\$400 for single taxpayers). It is equivalent to a partial refund of Social Security taxes withheld from an employee's salary. Withholding tables will be adjusted to put more money in the paycheck of eligible taxpayers, or the credit can be claimed on the taxpayer's tax return. The credit is phased out for joint taxpayers with AGI from \$150,000 to \$190,000 (or \$75,000 to \$95,000 for single taxpayers). Taxpayers must have a valid Social Security number in order to claim this credit. The credit is not available for dependents or nonresident aliens.

#### **Small Business 90% Estimated Tax Safe Harbor**

Small business owners have a reduced estimated tax requirement for 2009. Generally, quarterly estimated taxes must be paid in 2009 based on 90% of the current year tax liability, or 100% of the prior year tax liability (110% for high income taxpayers). The estimated tax requirement is reduced to 90% of the prior year tax for eligible taxpayers. Taxpayers are eligible if their prior year adjusted gross income was (1) under \$500,000, and (2) was at least 50% from a small trade or business (defined as employing an average of 500 or fewer people).

### **AMT PROVISIONS**

#### **AMT Patch**

The Act addresses the Alternative Minimum Tax with another one year "patch." This patch will prevent over 26 million taxpayers from otherwise being subject to the AMT, saving taxpayers almost \$70 billion in taxes. The AMT exemption for joint taxpayers is \$70,950 and \$46,700 for single individuals. These amounts are slightly higher than the patched exemptions for 2008. The AMT exemption gets phased-out at the same amount of Alternative Minimum Taxable Income (AMTI) for joint taxpayers of \$150,000 (or \$112,500 for single taxpayers), as in previous years.

#### **AMT Exemption for Interest on Certain Municipal Private Activity Bonds**

The interest on certain Private Activity Bonds will not be subject to the Alternative Minimum Tax in 2009 and 2010 (municipal bond interest is never subject to regular federal income tax). The bonds must be issued in 2009 or 2010, for a new "private activity" (e.g., airports, or some housing), or to refinance private activity bonds issued during 2004 through 2008. This provision helps state and local government raise cash to fund construction work. It also helps investors by lowering their Alternative Minimum Tax. The new law provision also applies for the corporate Adjusted Current Earnings adjustment.

**FOR RETIRED AMERICANS****\$250 Economic Recovery Payment**

Separate one-time direct payments of \$250 will be sent out to recipients of Social Security, SSI, or other similar government "qualifying program." There are no AGI phase-outs, but this 2009 benefit offsets a taxpayer's Making Work Pay Credit (see above). The specifics of the payout have not yet been determined.

**FOR HOME AND CAR BUYERS****Revised First Time Home Buyer Credit**

Existing law (enacted only last fall) is adjusted to increase the First Time Home Buyer Credit on purchases between January 1, 2009 and November 30, 2009. The credit is 10% of the cost of the home, up to \$8,000 for joint or single taxpayers. The previous credit was only \$7,500. This credit is refundable, which means that it will be paid to you even if you have no tax liability. It will NOT have to be repaid over a period of 15 years as with the prior credit (unless the home is sold or is no longer your primary residence within 36 months from date of purchase). The credit is phased out for joint taxpayers with AGI over \$150,000 (or \$75,000 for single taxpayers). The old law still applies to purchases made between April 9, 2008 and December 31, 2008, including the old repayment provisions. Taxpayers may elect to claim the credit for a 2009 purchase on their 2008 tax return.

**New Deduction for Sales Tax Paid for Purchase of New Car**

Current law allows taxpayers to deduct state and local income taxes paid, or sales taxes paid (which ever is higher) if the taxpayers itemize their deductions. This new provision allows taxpayers to deduct the sales tax paid on new car (SUV, light truck, motorcycle, or motor home under 8,500 pounds) purchases through 2009. The deduction is limited to sales tax attributable to the first \$49,500 of the vehicle's purchase price and is phased-out for joint taxpayers with modified AGI between \$250,000 and \$260,000 (or \$125,000 to \$135,000 for single taxpayers). The deduction is also allowed for AMT purposes. The deduction is not allowed for taxpayers who elect to deduct state and local sales taxes in lieu of income taxes.

**FOR CHILDREN'S (AND GRANDCHILDREN'S) EDUCATION****Enhanced Education Credits**

The American Opportunities Tax Credit (previously called the HOPE credit) has been increased for 2009 and 2010 to \$2,500 (up from \$1,800). The credit is 100% of the first \$2,000 and 25% of the next \$2,000 of eligible expenses. Eligible expenses are extended beyond tuition and fees to include course materials. (Room and board are still not eligible expenses). The credit is now available for four years of post-secondary education, instead of the previous first two year limitation. The credit is now 40% refundable (for taxpayers not subject to the "kiddie tax"), and is a credit against AMT. The credit is phased out for joint taxpayers with AGI from \$160,000 to \$180,000 (or \$80,000 to \$90,000 for single taxpayers).

**Expansion of the Use of 529 Plan Funds**

Funds withdrawn from 529 plans in 2009 and 2010 may now be used for computer purchases, including software, peripheral equipment and internet access (even if shared with the plan beneficiary's family). Previously, funds were to be used for higher education tuition, fees, most room and board, supplies, textbooks and other required equipment only.

**FOR THE UNEMPLOYED****Unemployment Compensation**

The first \$2,400 of unemployment compensation received in 2009 is not taxable. Any additional amounts received continue to remain fully taxable.

**COBRA**

For individuals who are involuntarily terminated between September 1, 2008 and January 1, 2010, the federal government will subsidize 65% of his/her COBRA payments. Eligible individuals who pay 35% of the required COBRA payment will be considered to have made the payment in full. The 65% COBRA payment reduction will NOT be considered income to the individual. Income and other limits apply to this provision.

**FOR INVESTORS**

**Exclusion for Qualified Small Business Stock Gain**

To encourage certain investments in small businesses, the tax code allows a taxpayer to exclude some of the gain on the ultimate sale of the investment. Under prior law, individuals could exclude 50% of the gain on the sale of Qualified Small Business Stock (QSBS) held at least five years. The gain is taxed at a maximum regular tax rate of 28% and 7% of the excluded gain is an AMT preference. The amount of gain eligible for the exclusion is limited to the greater of (1) ten times basis or (2) \$10 million (\$5 million if married filing separately).

The Act increases the exclusion from 50% to 75% for stock acquired after February 17, 2009 and before January 1, 2011. In addition to the five-year holding period requirement for Qualified Small Business Stock, certain other requirements must be met with respect to the investment.

- Must be a C corporation acquired at original issuance;
- Corporation’s assets cannot exceed \$50 million at time of issuance; and
- Corporation must be engaged in the active conduct of a qualified trade or business (generally excludes services, financing, hotel and restaurant businesses).

The extensive impact of this provision can be illustrated in the following example where a taxpayer acquires QSBS in 2010 and sells it in 2016:

	Tax on Gain (\$)	
	prior tax rules	with provision
Initial Investment	1,000,000	1,000,000
Proceeds of Sale	5,000,000	5,000,000
Gain	4,000,000	4,000,000
Exclusion Percentage	50%	75%
Excluded Gain	2,000,000	3,000,000
Taxable Gain	2,000,000	1,000,000
Capital Gain Tax Rate	28%	28%
Tax	560,000	280,000

Accordingly, the rate of tax for regular purposes is 7%. The tax rate for AMT purposes equates to 12.88%.

**DEBTOR RELIEF**

**Debt Forgiveness Income**

Taxpayers can elect to defer recognition of Cancellation of Indebtedness (COD) Income upon the repurchase of its debt at a discount. Generally, when a debtor (or related person) repurchases its debt for an amount less than the adjusted issue price of the debt, the excess over the repurchase price generates COD income. Taxpayers may now elect to defer income recognition until year 2014. At such time, the COD income would then be reported ratably over a five-year period.

The new law applies to debt instruments repurchased in 2009 and 2010. The taxpayer need not reduce any of its tax attributes. A repurchase includes the following:

- Purchase for cash
- Debt exchange
- Exchange of debt for corporate stock or a partnership interest
- Contribution to capital
- Complete forgiveness

Once made, the election is irrevocable. For pass-throughs, the election would be made at the entity level. Any COD applicable exclusion (such as for Title 11 bankruptcies and insolvencies) will not apply for the tax year of election or any subsequent year. The issuer’s deduction for the Original Issue Discount (OID) will generally conform to that of the new deferral provision. Acceleration of the deferral would occur in certain situations, including death, cessation of business, or a sale of substantially all the taxpayer’s assets.

### **Applicable High-Yield Discount Obligation (AHYDO)**

If the AHYDO provisions apply, deductions are deferred until the OID is paid in cash, and a certain portion may be disallowed permanently to the extent that the yield to maturity exceeds an enumerated threshold. An AHYDO exists if all of the following three factors are present:

1. A term of more than five years from issue
2. Yield to maturity of more than 5% of the Applicable Federal Rate
3. Significant OID - Essentially payment of more than one year's worth of interest expense in kind (PIK interest) during the initial five-year term of the debt instrument

The new law suspends the AHYDO deduction restriction for certain obligations issued in a debt-for-debt exchange. A significant modification of a debt instrument would be considered as an exchange for this purpose. Only debt issued after August 31, 2008 and prior to January 1, 2010 for debt that is not considered as AHYDO would qualify for the suspension of the deduction restriction. This relaxation of the rules acknowledges the need for refinancing in recognition of the distressed conditions in the debt capital markets. The new law also empowers the IRS to apply the suspension rule subsequent to 2009, if deemed appropriate.

## **BAILOUT of BANKS**

### **Restructuring**

Section 382 essentially limits post ownership change annual utilization of the target loss corporation's NOL carryforward to an amount calculated by reference to the target's value (as multiplied by the long-term tax exempt rate) at the time of the ownership change. An ownership change generally occurs when there is a more than 50% increase in ownership by one or more five-percent (or greater) shareholders during a three-year test period.

The new law provides that the Section 382 limitation will not apply to certain ownership changes occurring after February 17, 2009. Only transactions occurring pursuant to a restructuring plan under the Emergency Economic Stabilization Act of 2008 (in which the U.S. government had loaned funds to certain banks and auto-makers) would qualify for this exception. A further requirement regarding the intended result of rationalization of costs and other items of the manufacturing workforce of the taxpayer and its subsidiaries would need to be satisfied.

### **Loss Limitations**

Section 382 generally imposes limitations on the utilization of a target's NOL upon the occurrence of an ownership change. In 2008, the IRS had released a controversial notice (Notice 2008-83, 2008-42) that banks' portfolio losses would no longer be subject to Section 382. The new law repeals prospective application of the Notice for transactions occurring after January 16, 2009. Binding contract transitional relief would apply.

### **Executive Compensation**

Effective February 17, 2009, each Troubled Assets Relief Program (TARP) recipient becomes subject to a \$500,000 compensation deduction limitation for covered employees for the period in which any TARP obligation remains outstanding.

**ENERGY INCENTIVES**

The new law contains numerous energy related incentive provisions including the following:

- The Production Tax Credit as pertaining to certain electricity is extended for three years.
- A 30% investment tax credit for qualified property of certain qualified facilities treated as energy property is included, applicable only to qualified facilities placed in service after December 31, 2008.
- The former \$4,000 cap on the 30% business energy credit is eliminated for periods subsequent to December 31, 2008 as pertaining to qualified small wind property.
- The plug-in electric motor vehicle credit is expanded. For vehicles purchased after the date of enactment and prior to January 1, 2012, there is a 10% nonrefundable credit (\$2,500 maximum credit per vehicle). The credit applies to electric drive low-speed vehicles (including motorcycles). The credit is a personal credit allowable for alternative minimum tax purposes.
- Similarly, there is a new 10% credit of up to \$4,000 for converting a motor vehicle into a plug-in electric drive motor vehicle, with the same effective dates as above.
- The current plug-in electric drive motor vehicle credit which limits the maximum credit to \$7,500 regardless of vehicle weight is no longer subject to a termination date. In addition, the Act reduces the 250,000 manufacturer vehicle limitation to 200,000 vehicles.
- The 10% credit for individuals of the amount paid during the year for qualified energy efficiency improvements is increased to 30% and extended for one year, expiring after 2010. The per person cap is increased to \$1,500. Qualified energy efficiency improvements include insulation, exterior windows, and doors meeting specific certification standards.
- There is a new manufacturing investment tax credit for up to 30% of qualified investment with respect to qualified energy projects. <sup>Ⓜ</sup>

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