The Business Tax Changes of the Recovery Act: Loan Workouts, Tax Incentives for Small Businesses, and Ownership Changes of Banks

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The American Recovery and Reinvestment Act of 2009 (the "Recovery Act") was signed into law by President Obama on February 17, 2009. The Recovery Act contains several helpful business tax changes, including: (i) provisions making it easier for taxpayers to "workout" or restructure outstanding debt, (ii) provisions providing various incentives for small businesses and their owners, and (iii) a provision prospectively repealing the Treasury notice issued last year preserving tax losses of banks.

I. Restructuring of Debt Made Easier

A. Deferral of Taxable Income From Certain Debt Workouts

The Recovery Act contains a provision pursuant to which businesses with taxable income resulting from restructured debt will be able to defer taxable income for up to 5 years, and then pay taxes on that taxable income over another 5 year increment.

By way of background, the proceeds of borrowing are not taxable income, as the borrower has an obligation to pay back such debt, so that the taxpayer has not "ascended to wealth." However, when debt is cancelled, or retired at a discount, so that the taxpayer no longer has an obligation to pay back the face amount, there is resulting taxable income. Generally, if a taxpayer acquires or retires its debt at a discount to the face amount (whether through an exchange of cash or new debt for old debt, or indirectly by a modification of the old debt's terms), the taxpayer has taxable income equal to the discount.

Under the Recovery Act, some relief is provided to taxpayers relating to taxable income resulting from the acquisition of debt or a modification of debt. A taxpayer may elect to defer cancellation of debt ("COD") income arising from an acquisition by the taxpayer or certain related persons during calendar years 2009 and 2010, of a debt instrument issued by either a C corporation or any other person in connection with the conduct of a trade or business. The income is deferred for roughly a 5 year period. The income deferred must be included in the gross income of the taxpayer ratably in the 5 taxable years beginning with the 5th taxable year following the year of repurchase (and for repurchases in 2010, the 4th taxable year following the year of repurchase).

The Recovery Act further addresses the mismatch between certain interest deductions and COD income that would have occurred under current law unless addressed. Debt issued

that has a stated redemption price at maturity (generally, face amount) in excess of its "issue price" has "original issue discount", or "OID".[1] Debt issued in exchange for outstanding debt can often have an issue price less than its stated redemption price at maturity, and thus have OID. This deduction for OID may fall to a great extent in the years in which the COD income was deferred. Under the Recovery Act, however, if a taxpayer makes the election to defer COD income in connection with a debt-for-debt exchange in which the newly issued debt instrument has OID, then any deduction for interest in connection with the OID that accrues in the deferral period up to the amount of the COD, is deferred and allowed as a deduction ratably over the 5 year period in which the COD income is recognized.

Solvent as well as insolvent taxpayers may defer the taxable income pursuant to this provision. Further if COD income is deferred pursuant to this election, there is no associated requirement for a taxpayer to reduce its tax attributes such as NOLs (as would be required if a taxpayer excluded COD income based on an exclusion such as that based on the taxpayer's insolvency). Electing debtors are ineligible for other Section 108 exclusions from income.

B. Limitations on Deductibility of Interest on High-yield Debt Instruments Eased Where Instrument Issued in Connection with Workout of Existing Loan

The Recovery Act encourages debt-for-debt exchanges in which the old debt is exchanged for new debt with a high-yield, by suspending some current limitations on the deductibility of interest on the new high-yield debt. Absent this provision, many taxpayers would have COD income resulting from a debt restructuring, and yet not be able to offset that COD income by interest deductions associated with the new or modified debt.

Ordinarily, the issuer of a debt instrument with OID may deduct the portion of such OID equal to the aggregate daily portions for the OID for the days in the taxable year. However, this is not so in the case of a debt instrument that is an applicable high yield debt obligation ("AHYDO"). A debt instrument is an AHYDO if it is long term (maturity date of greater than 5 years), and there is OID on the debt, and the yield to maturity is very high. If a debt instrument is an AHYDO, then the deduction for interest with respect to it is deferred, or wholly denied.

The Recovery Act suspends the limitations on such deductibility for certain obligations issued in a debt-for-debt exchange, including a deemed exchange resulting from a modification, after August 31, 2008 and during calendar year 2009. The suspension applies to debt instruments issued in exchange for a debt instrument (including any debt instrument deemed issued as a result of a significant modification of a debt instrument). However, the suspension does not apply to any newly issued debt instrument (including any debt instrument issued as a

[1] The issue price of debt exchanged for other debt is the trading price if either the new debt or the old debt is publicly traded. If neither is publicly traded, the issue price will generally be the stated principal amount of the new debt so long as it bears "adequate stated interest" (the applicable federal rate, published monthly by the IRS). If neither debt is publicly traded and there is no adequately stated interest, then the issue price is the imputed principal amount of the debt (the amount derived by discounting all payments of principal and interest using the applicable federal rate).

result of a significant modification of a debt instrument) that is issued for an AHYDO. The IRS is given the authority to apply the suspension rule to periods after 2009 where it determines that such application is appropriate in light of distressed conditions in the debt capital markets.

II. Tax Incentives Related to Small Businesses

A. Small Businesses May Carryback NOLs For Up To 5 years

Businesses with annual gross receipts of $15 million may carryback NOLs for up to 5 years to obtain refunds of taxes.

A net operating loss ("NOL") generally means the amount by which a taxpayer's business deductions exceed its gross income. NOLs are valuable tax attributes as they reduce the amount of tax otherwise payable. Many taxpayers have no current taxable income against which they can use the NOLs, and furthermore do not expect to have taxable income in near future years against which they can use the NOLs. A lot of these taxpayers have, however, had taxable income in the previous few years, so that if they were permitted to carryback NOLs to those years, they would get a taxable refund. (Under current law, NOLs may be carried back 2 years, and forward 20 years to offset taxable income in such years.)

The Recovery Act provides a measure of relief for small businesses. Eligible small businesses (those generally with average annual gross receipts of $15 million or less) have an election to increase the carryback period for NOLs for the taxable year ending in 2008 (or at the taxpayer's election for any taxable year beginning in 2008) from the current 2 years to any whole number of years from 2 to 5. The election may be made only with respect to one taxable year.

Both the House and Senate bills had provisions that would have allowed for a 5 year carryback of NOLs without imposing a limit on the size of revenues of the business. Many business groups were reportedly unpleasantly surprised by the limited amount of relief in the Recovery Act, saying that an expanded provision would have been one of the most proven ways of helping struggling companies, creating jobs, and stimulating the economy.

B. Significantly Reduced Tax Rate on Gain From Sale of Small Businesses

Gain from the sale of qualified small business stock is subject to an effective regular tax rate of 7%.

Under current law, individuals may exclude 50% of the gain from the sale of certain small business stock acquired at original issue and held for at least 5 years. The portion of the gain includible in taxable income is taxed at a maximum rate of 28%. Thus, the gain from the sale of qualified small business stock is taxed at effective rates of 14% under the regular tax. The amount of gain eligible for the exclusion by an individual with respect to any corporation is the greater of (1) 10 times the taxpayer's basis in the stock or (2) $10 million. In order to qualify as a small business, when the stock is issued, the gross assets of the corporation may not

exceed $50 million. The corporation must also meet certain active trade or business requirements.

The percentage exclusion for qualified small business stock sold by an individual is increased from 50% to 75% by the Recovery Act. As a result, gain from the sale of qualified small business stock is taxed at the effective rate of 7% under the regular tax. The provision is effective for stock issued after the date of enactment and by the end of calendar year 2010.

C. Recently Converted S Corporations Have Shorter Holding Period for Avoiding Corporate Tax on Sale of Assets

C corporations that converted to S status over 6 years ago can avoid corporate tax on actual or deemed sale of assets, despite the fact that 10 years have not passed since conversion.

Under current law, if a taxable "C corporation" converts to an "S corporation" (which generally does not pay an income tax), the conversion is not a taxable event. However, following such a conversion, an S corporation must hold its assets for 10 years in order to avoid a tax on any built-in gains that existed at the time of the conversion. The Recovery Act reduces this holding period from 10 years to 7 years for sales occurring in 2009 and 2010.

D. Increase In Limitations on Expensing of Certain Depreciable Business Assets

Last year, Congress temporarily increased the amount of costs for certain depreciable business assets small businesses could "write-off" or immediately expense rather than depreciate over time to $250,000 and increased the phase-out threshold for 2008 to $800,000. Without the Recovery Act, the amount that could have been expensed in 2009 would be $133,000. The Recovery Act allows certain small business taxpayers to elect to immediately expense $250,000 with the investment ceiling of $800,000 again. These amounts are not indexed for inflation. The increase in limits is applicable for 2009, after which time the limits will fall back to $125,000 and $500,000 (adjusted for inflation) for 2010, and then to $25,000 and $200,000 for 2011 and afterwards.

Small businesses, as well as many medium sized businesses will benefit from this provision, which makes the effective cost of business machinery and equipment significantly lower than it otherwise would be.

E. One-Year Extension for 50% First Year Depreciation Deduction

Although this provision is discussed under the section relating to small businesses, many medium and large businesses will benefit from this provision as well, as again, it would significantly reduce the effective cost for them of acquiring depreciable property.

Last year, Congress temporarily allowed businesses to deduct the costs of capital expenditures made in 2008 faster than the otherwise applicable depreciation schedule would allow by permitting these businesses to immediately deduct 50% of the cost of depreciable

property acquired in 2008 for use in the United States. The Recovery Act extends this temporary benefit for costs incurred in 2009.

F. Temporary Small Business Estimated Tax Payment Relief

The Recovery Act reduces the 2009 required estimated tax payments for small business owners.

III. Notice Preserving Tax Losses of Banks; General Motors

A. Prospective Repeal of Treasury Bank Loss Notice

The Recovery Act repeals Notice 2008-83, with Congress finding Treasury's legal authority to issue the notice "doubtful."

This is the Notice issued by Treasury in September 2008, prior to the enactment of the Emergency Economic Stabilization Act on October 3, 2008 ("Bailout Bill"). By way of background, if a corporation with NOLs undergoes a sufficient enough ownership change, then its NOLs become subject to a limitation. If this corporation had losses in its assets that had not yet been triggered for tax purposes (so called net unrealized built-in losses ("NUBILs"), then such NUBILs would also be subject to a limit. (Distressed banks likely would have NUBILs with respect to loans, particularly ones they've written down for book purposes, but not for the tax purposes.) This notice said that any deduction allowed after an ownership change to a bank with respect to losses on loans or bad debts would not be treated as a built-in loss or deduction that is attributable to periods before the change. Thus, the notice allowed banks to save significant amounts of NOLs from limitations that would otherwise have been imposed on their use. This notice received a lot of attention in the press, as it reportedly enabled Wells Fargo to make a superior bid for the purchase of Wachovia of approximately $15 billion. As a result of the notice, a reported $74 million of Wachovia losses could be triggered post-purchase and used to shelter taxable income without limits, with some estimating that the value of these NOLs to Wells Fargo could be greater than the purchase price of $15 billion.

While the notice was repealed, it is allowed to have the force and effect of law with respect to (I) any ownership change occurring on or before January 16, 2009, and (II) those occurring after January 16, 2009 but pursuant to a written binding contract entered into on or before January 16, 2009 (or agreements that were described on or before January 16, 2009 in a public announcement or in a filing with the SEC required by reason of such ownership change).

B. Relaxation of Limits on Use of NOLs for Certain Corporations Receiving Funds from Treasury under Bailout Bill

At the same time, the Recovery Act provides an exception from the limitations on NOLs triggered by an ownership change of certain corporations.

Pursuant to the Recovery Act, the loss limitation that would otherwise arise as a result of an ownership change will not apply in the case of an ownership change that occurs pursuant to a restructuring plan of a taxpayer which is required under a loan agreement or commitment for a line of credit entered into with the Department of the Treasury under the Bailout Bill, and is intended to result in a rationalization of the costs, capitalization, and capacity with respect to the manufacturing workforce of, and suppliers to, the taxpayer and its subsidiaries. An ownership change that would otherwise be excepted from the Section 382 limitation under the provision will instead remain subject to the Section 382 limitation if, immediately after such ownership change, any person owns stock of the new loss corporation possessing 50% or more of the total combined voting power of all classes of stock entitled to vote or of the total value of the stock of such corporation.

It is speculated that this provision likely would apply only to General Motors.