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Contacts

Alexander G. McGeoch
(214) 979-3041
amcgeoch@hunton.com

Jeffry M. Blair
(214) 468-3306
jblair@hunton.com

Cameron N. Cosby
(804) 788-8604
ccosby@hunton.com

Dallas Office
1445 Ross Avenue
Suite 3700
Dallas, TX 75202-2799

Richmond Office
Riverfront Plaza, East Tower
951 East Byrd Street
Richmond, VA 23219-4074

Business Tax Provisions Under the Stimulus Bill

The American Recovery and Reinvestment Act of 2009 (the "Act") was signed into law by President Barack Obama on February 17, 2009. Known informally as the "Stimulus Bill," the Act is intended to preserve and create jobs, stimulate investment in infrastructure and assist the unemployed. The main tax provisions of the Act that are expected to have the greatest impact on corporations and closely held businesses, excluding the energy incentives, are summarized below.[1]

Net Operating Loss Provisions

Net Operating Loss Carry back. Generally, a net operating loss ("NOL") is the amount by which a business's deductible expenses exceed its gross income. Under current law, a taxpayer may "carry back" an NOL to offset taxable income of the two taxable years immediately prior to the year the NOL is incurred. The taxpayer then may carry forward any remaining portion of that NOL up to 20 years to offset taxable income in those years. The Act amends these rules to permit an "eligible small business" to elect to carry back an "applicable 2008 NOL" for three, four or five years rather than the normal two-year carryback period. An "eligible small business" is generally a taxpayer that has gross annual receipts of $15,000,000 or less in the tax year in which the applicable 2008 NOL arose. For purposes of the increased carryback election, an "applicable 2008 NOL" is defined as the taxpayer's NOL for any taxable year either (i) ending in 2008 or (ii) at the taxpayer's election, beginning in 2008. The Act doesn't change the allowable carryforward period of up to 20 years for 2008 NOLs. An eligible small business that incurred an applicable 2008 NOL should follow the quick return procedure to claim refunds of taxes paid in the 2003 through 2007 tax years.

Special NOL Rule for Banks. On October 1, 2008, the Internal Revenue Service ("IRS") issued Notice 2008-83 providing that if a bank recognized a loss from the disposition of a loan or from taking a bad debt deduction after a change in ownership, then that loss or deduction would not be treated as a built-in loss attributable to the pre-acquisition period and would not be subject to limitation under Code Section 382. The Act repeals Notice 2008-83. Notice 2008-83 continues to have the force of law only for any ownership change (as defined in Code Section 382(g)) occurring on or before January 16, 2009, or occurring after January 16, 2009, provided that the change is pursuant to either a written binding contract entered into before that date or a written agreement described in a public announcement or filing with the

[1] All Section references are to the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

Securities and Exchange Commission on or before January 16, 2009.

Treatment of Certain Ownership Changes. Code Section 382 places a limit on how quickly a loss corporation may use its NOL carryforwards to offset its income after an ownership change. The Act amends these rules to provide that the Code Section 382 limitations will not apply to an ownership change that both: (i) occurs pursuant to a restructuring plan as required under a loan agreement or a commitment for a line of credit entered into with the Department of the Treasury under the Emergency Economic and Stabilization Act of 2008 (the "EESA") and (ii) is intended to result in a rationalization of the costs, capitalization and capacity with regard to the manufacturing, workforce of and suppliers to the taxpayer and its subsidiaries. This new rule does not apply to a subsequent ownership change that does not meet both of these requirements. In addition, this new rule will not apply to any ownership change if, immediately after the ownership change, any person (other than a voluntary employees' beneficiary association under Code Section 501(c)(9)) owns stock of the old 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 that corporation. For purposes of this exception, related persons are treated as a single person. A person is treated as related to another person if they bear a relationship to each other described in Code Section 267(b) or 707(b) or are members of a group acting in concert.

Compensation for TARP Recipients

In general, a publicly held corporation cannot deduct more than $1 million per year paid to "covered employees" under the rules of Code Section 162(m). Covered employees are generally defined as the CEO, CFO and the three highest-paid officers other than the CEO and CFO. In addition, a corporation's ability to deduct compensation paid as a result of a change in ownership can be limited by the golden parachute rules of Code Section 280G.

In October 2008, the EESA expanded these rules by providing a $500,000 compensation deduction limitation for covered employees under Code Section 162(m)(5). This limit applied to financial institutions (including those not publicly held or not incorporated) from which troubled assets were acquired under the Troubled Asset Relief Program ("TARP") established by the EESA, if the aggregate amount of acquired assets exceeded $300 million. In October 2008, the Department of the Treasury announced that the Code Section 165(m)(5) $500,000 compensation deduction limitation applies to participants in the Capital Purchase Program ("CPP"). The EESA also expanded the golden parachute rules under Code Section 280G to apply to severance payments to this same group of five covered employees (as defined under Code Section 162(m)) regardless of whether there was a change of control.

The Act expands the rules established by the EESA and establishes additional compensation deduction restrictions. The Act provides that each "TARP recipient" is subject to the $500,000 compensation deduction limit of Code Section 162(m)(5) during the period in which any obligation arising from financial assistance provided under TARP remains outstanding. "TARP recipient" means "any entity that has received or will receive financial assistance under the financial assistance provided under the TARP." The period in which any obligation arising from financial assistance provided under TARP remains outstanding does not include any period during which the federal government holds only warrants to purchase the TARP recipient's common stock. Thus, the Act expands the scope of the $500,000 compensation deduction limit in the following ways:

- The limit applies to "any entity," and is not restricted to financial institutions.
- The limit applies to any "entity that has received or will receive financial assistance" under TARP and is not restricted to institutions from which more than $300 million of troubled assets were acquired. There is no exception for institutions from which all acquisitions were direct purchases.
- The limit applies to the entire period in which any obligation arising from financial assistance provided under TARP (other than solely warrants issued to the federal government) remains outstanding and is not restricted to any specific tax years of the employer.

The Act makes other non-tax modifications to the TARP executive compensation rules, including:

- Expanding the requirement to recover any bonus, retention award or incentive compensation paid to a senior executive officer ("SEO") based on statements of earnings, revenues, gains or other criteria that are found to be materially inaccurate to the next 20 most highly compensated employees of a TARP recipient after the SEOs. Therefore, this requirement will now apply to the 25 employees of the TARP recipient with the highest compensation.

- Expanding the prohibition on the payment of any "golden parachute payment" to include the next five most highly compensated employees of the TARP recipient after the SEOs. For purposes of this provision, a "golden parachute payment" means any payment relating to the departure from a company for any reason (except for services performed or benefits rendered). Therefore, the prohibition on golden parachute payments now applies to the ten employees of the TARP recipient with the highest compensation.
- Prohibiting a TARP recipient from paying or accruing any bonus, retention award or incentive compensation to at least the 25 most highly compensated employees. The restriction is phased in by the amount of financial assistance received by the entity receiving TARP assistance. Compensation is permitted to be paid in the form of restricted stock.
- Prohibiting any compensation plan that would encourage manipulation of the reported earnings of the TARP recipient to enhance the compensation of any of its employees.

The Treasury Secretary is directed to review compensation paid to SEOs and the next 20 most highly compensated employees of an entity receiving TARP assistance before the date of enactment to determine whether the payments were inconsistent with the amended TARP compensation rules, TARP or public interest.

Furthermore, the Act provides for certain corporate governance rules relating to the compensation committees of TARP recipients, nonbinding shareholder votes on executive compensation payable by a TARP recipient, and the adoption by TARP recipients of policies regarding luxury expenditures such as entertainment, aviation and office renovation expenses.

Depreciation Provisions

Extended Bonus Depreciation. The Act extends the first-year "bonus" depreciation deduction for one year, generally through 2009 (2010 in the case of certain longer-lived and transportation property). This bonus depreciation allows a taxpayer to take a deduction equal to 50% of the adjusted basis of the qualified property for the year the property is placed in service. The extension of the additional first-year depreciation deduction is generally effective for qualified property that is placed in service after December 31, 2008. "Qualified property" is defined as (1) property to which the Modified Accelerated Cost Recovery System ("MACRS") applies with an applicable recovery period of 20 years or less, (2) computer software other than computer software covered by Code Section 197, (3) water utility property and (4) qualified leasehold improvement property. The Act also extends the temporary $8,000 increase in the Code Section 280F first-year depreciation deduction limitation for certain passenger automobiles that are qualified property, to include such vehicles acquired in tax years beginning in 2009. With this change, the total first-year depreciation deduction limitation for each such vehicle is limited to $10,560.

Election to Accelerate AMT/Research Credits in Lieu of Bonus Depreciation Extended for One Year. Prior to the Act, corporations were permitted to increase the research credit or minimum tax credit limitation on pre-2006 credits in lieu of taking bonus depreciation with respect to certain property placed in service in 2008 (2009 in the case of certain longer-lived and transportation property). The Act extends the election to cover property placed in service by December 31, 2009 (December 31, 2010, in the case of certain longer-lived and transportation property).

Extension of Enhanced Small Business Expensing. Pursuant to Code Section 179, certain small businesses may elect to expense the cost of "qualifying property" in the year of acquisition, as opposed to recovering the costs over time. Such election is limited to a maximum amount of $125,000. In addition, the deduction is reduced (but not below zero) by the amount by which the cost of the qualifying property exceeds $500,000. The Code Section 179 deduction limitation and phase-out threshold are indexed for inflation. In 2008, as part of the EESA, Congress amended Code Section 179 to provide for a temporary increase in both the write-off amount from $125,000 to $250,000 and the phase-out threshold amount from $500,000 to $800,000. The Act extends these temporary increases to taxable years beginning in 2009.

Other Business Provisions

Modification to S Corporation Built-In Gain Holding Period. Currently, when an existing C corporation elects to be taxed as an S corporation (or where an existing S corporation receives property from a C corporation in a nontaxable carryover basis transfer), any unrecognized gain in the assets of the corporation as of the date of the S corporation election (or, in the case of a carryover basis asset transfer, as of the transfer date) is preserved. This unrecognized gain is subject to corporate level tax under Code Section 1374, if and when the assets are disposed of during the ten-year period after the date of such election (or during the ten-year period after the date of the transfer). The Act amends Code Section 1374 to provide that for the 2009 and 2010 tax years, the holding period before such former C corporation assets can be sold without triggering corporate level tax is reduced from ten to seven years. In addition, the Act provides that the 2009 and 2010 seven-year holding period does not apply to distributions by thrift institutions that are deemed to be out of pre-1988 reserves, and the recognition period of such distributions continues to be unlimited.

Delayed Recognition of Certain Cancellation of Indebtedness Income. Generally, under Code Section 61(a)(12), a taxpayer must include in income the amount of any indebtedness of the taxpayer that is discharged during the taxable year. However, a discharge of indebtedness does not result in income recognition if it meets one of the exceptions of Code Section 108. These exceptions include a discharge that occurs in a Title 11 bankruptcy case or when the taxpayer is insolvent. When income recognition is excluded under Code Section 108, the taxpayer must generally reduce certain tax attributes, including NOLs and the tax basis in its property. The Act amends Code Section 108 to permit a taxpayer to elect to defer cancellation of indebtedness income arising from the reacquisition of an "applicable debt instrument" after December 31, 2008, and before January 1, 2011. Income deferred pursuant to this election must be included in the gross income of the taxpayer ratably in the five taxable years beginning with (1) for repurchases in 2009, the fifth taxable year following the taxable year in which the repurchase occurs or (2) for repurchases in 2010, the fourth taxable year following the taxable year in which the repurchase occurs. "Reacquisition" includes (i) an acquisition of a debt instrument for cash, (ii) the exchange of a debt instrument for another debt instrument (including a deemed exchange), (iii) the exchange of corporate stock or a partnership interest for a debt instrument, (iv) the contribution of a debt instrument to the capital of the issuer and (v) the complete forgiveness of a debt instrument by a holder. An "applicable debt instrument" is defined as any debt instrument issued by (a) a C corporation or (b) any other person in connection with the conduct of a trade or business by such person. A debt instrument is broadly defined to include any bond, debenture, note, certificate or other instrument or contractual arrangement constituting indebtedness (within the meaning of Code Section 1275(a)(1)). A taxpayer who meets the requirements to exclude the cancellation of indebtedness income under Code Section 108 but elects to defer the income is not required to reduce any tax attributes.

If the taxpayer makes the deferral election with respect to a debt-for-debt exchange, then any otherwise allocable deduction for original issue discount ("OID") with respect to the newly issued debt instrument that (i) accrued before the first year of the five-taxable-year period in which the related, deferred discharge of indebtedness income is included in the gross income of the taxpayer and (ii) does not exceed such related, deferred discharge of indebtedness income, is deferred and allowed as a deduction ratably over the same five-taxable-year period in which the deferred discharge of indebtedness income is included in gross income.

In general, cancellation of indebtedness income and any related deduction for OID that is deferred by an electing taxpayer will be accelerated and taken into income in the taxable year in which the taxpayer: (i) dies, (ii) liquidates or sells substantially all of its assets (including in a title 11 or similar case), (iii) ceases to do business or (iv) is in similar circumstances.

Under the Act, special rules apply for partnerships. In the case of a partnership, any income deferred under the amendment is allocated to the partners in the partnership immediately before the discharge of indebtedness in the manner such amounts would have been included in the distributive shares of such partners under Code Section 704 if such income were recognized at the time of the discharge. Any decrease in a partner's share of liabilities as a result of the discharge is not taken into account for the purposes of Code Section 752, to the extent the deemed distribution under Code Section 752 would cause the partner to recognize gain under Code Section 731. Thus, the deemed distribution under Code Section 752 is deferred for a partner to the extent it exceeds the partner's basis. Any deferred decrease in partnership liabilities will be taken into account at the same time, and to the same extent, as the deferred income is recognized by the partner.

Modification of Rules for OID on Certain High Yield Obligations. OID on obligations such as bonds, notes, debentures, certificates and other evidences of indebtedness is generally deductible by the issuer as interest. The discount must be amortized over the life of the obligation on a constant yield basis. Pursuant to Code Section 163(e)(5), in the case of an applicable high yield discount obligation ("AHYDO"), the issuer gets no deduction for the disqualified portion of the OID, and the remainder of the OID isn't deductible until paid. The Act temporarily suspends the interest deduction limitations of Code Section 163(e)(5) for debt-for-debt exchanges in which an AHYDO issued during the period beginning on September 1, 2008, and ending on December 31, 2009, is exchanged (including a deemed exchange as a result of a significant modification of the original debt instrument) for an obligation that is not an AHYDO and the issuer (or obligor) of which is the same as the issuer (or obligor) of such AHYDO. This exception does not apply to any obligation the interest on which there is contingent interest (as determined under Code Section 871(h)(4)) or to any obligation issued to a related party (within the meaning of Code Section 108(e)(4)). The Act also provides the Secretary of the Treasury with the authority (1) to apply this suspension rule to periods after December 31, 2009, if such application is appropriate in light of distressed conditions in the debt capital markets, and (2) to use a rate that is higher than the applicable federal rate for purposes of applying Code Section 163(e)(5) for obligations issued after December 31, 2009, if the Secretary determines that such higher rate is appropriate in light of distressed conditions in the debt capital markets.

Small Business Capital Gains. Noncorporate taxpayers can exclude 50% of any gain realized on the sale of "qualified small business stock" (as defined under Code Section 1202) held for more than five years. The Act increases from 50% to 75% the amount excluded from the gross income of an individual taxpayer under Section 1202 resulting from the sale or exchange of qualified small business stock held for more than five years. However, the increased exclusion amount applies only to small business stock issued after the enactment date and before 2011.

Small Business Estimated Tax Payment Relief. With respect to estimated tax payments made in 2009, the Act provides that the required annual estimated tax payments for certain qualifying small businesses is not greater than 90% of the tax liability shown on the tax return for the preceding tax year.

Hiring Tax Credits. Pursuant to Code Section 51, businesses are allowed a work opportunity tax credit ("WOTC") with respect to wages paid to individuals from one of nine targeted groups. Under the Act, a new targeted group of unemployed veterans and disconnected youth is added to Code Section 51, and employers may claim the WOTC for those individuals in the targeted group who begin work for the employer in 2009 or 2010.

Temporary Modification of AMT on Tax-Exempt Bonds. Currently, an alternative minimum tax ("AMT") is imposed on individuals and corporations. AMT is the amount by which the tentative minimum tax exceeds the regular income tax. AMT is computed by modifying a taxpayer's regular taxable income to take into account certain preferences and adjustments. One preference item is tax-exempt interest on certain tax-exempt bonds issued for private activities. Also, in the case of a corporation, an adjustment based on current earnings is determined, in part, by taking into account 75% of items, including tax-exempt interest, that are excluded from taxable income but included in the corporation's earnings and profits. The Act provides that tax-exempt interest on private activity bonds issued in 2009 and 2010 will not be a tax preference item for AMT purposes. In addition, the Act provides that tax-exempt interest on private activity bonds issued in 2009 and 2010 is not included in a corporation's adjustment based on current earnings. The Act also provides that tax-exempt interest on private activity bonds issued in 2009 and 2010 to currently refund a private activity bond issued after December 31, 2003, and before January 1, 2009, is not an item of tax preference for purposes of the AMT and that such interest is not included in the corporate adjustment based on current earnings.