THE AMERICAN RECOVERY AND REINVESTMENT TAX ACT OF 2009 ─ KEY BUSINESS PROVISIONS AND IMPLICATIONS TO M&A TRANSACTIONS

On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Tax Act of 2009 (the "Recovery Act"). This legislation provides individuals and families with tax relief in several significant areas such as home ownership, automobile purchases, alternative minimum tax, earned income tax credit and unemployment compensation. The Recovery Act addresses an issue that has received heightened public scrutiny over the past several months ─ executive compensation paid by certain financial institutions which have received funds under the Troubled Assets Relief Program ("TARP"). The Recovery Act applies both to financial institutions which have already received TARP funds as well as future first-time TARP recipients. Finally, the Recovery Act also contains several tax incentives for businesses.

The purpose of this summary is to highlight certain business tax provisions contained in the Recovery Act which may impact M&A transactions.

Cancellation of Indebtedness Income ("COD Income")

The Recovery Act allows a taxpayer to elect to defer COD Income realized on the reacquisition of a debt instrument for a short period and then recognize it ratably over five (5) years. The election only applies to COD Income arising from the reacquisition of an applicable debt instrument in 2009 and 2010. The election is made on an instrument-by-instrument basis and is irrevocable. The deferral lasts until 2014, which means that the taxpayer will have to recognize 20% of the COD Income in each of the five tax years from 2014 to 2018.

If a debtor makes a deferral election under the Recovery Act, then certain other COD Income exclusion provisions under the Code[1] (e.g., Section 108(a)(1) exclusions when the debtor is insolvent or in a title 11 bankruptcy case) will not apply. Accordingly, an insolvent or bankrupt taxpayer may decide to make the election to defer recognition of COD Income rather than excluding such income and reducing its tax attributes.

An "applicable debt instrument" is any debt instrument that was issued by a C corporation or any other person in connection with the conduct of a trade or business by that person. The reacquisition of the debt instrument must be made by either the debtor that issued (or obligor under) the debt instrument or a related person to such debtor.

Where a debt instrument is reacquired in exchange for a new debt instrument having original issue discount ("OID"), the issuer's interest deduction on the new debt's OID is deferred until 2014 and then is deductible ratably over the next five tax years to match the COD income inclusion on the reacquired debt instrument.

The OID deduction deferral rule also applies to the related-person acquisition rules of Section 108(e)(4) as illustrated by the following example:

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

Corporation ("C") has outstanding debt owed to a financial institution with a face value and stated redemption price at maturity of $500,000. In 2010, C's majority shareholder ("MS") purchases C's debt from the financial institution for $350,000 in cash. The following tax treatment applies:

1. C realizes $150,000 (an amount equal to the acquisition discount) taxable COD Income in 2010 (the taxable year of MS's purchase of the debt). However, under the 2009 Recovery Act, C does not recognize the COD Income in 2009. Instead, C recognizes $30,000 of COD Income ($150,000 divided by 5) in each of the five (5) tax years from 2014 to 2018, inclusive.
2. New debt is deemed to be issued by C to MS with an issue price equal to the purchase price of the debt. Therefore, new indebtedness is treated as having been issued to MS with an issue price of $350,000. This new debt has $150,000 of OID (the excess of the stated redemption price at maturity of the debt ($500,000) over its issue price ($350,000)).
3. Under general tax law principles, the issuer of a debt instrument with OID can generally deduct a portion of the OID as interest in each tax year over the remaining term of the debt. However, under the 2009 Recovery Act, C's $150,000 in OID deductions is deferred to match its deferred COD Income inclusion (discussed in step #1 above). Therefore, C takes $30,000 of OID deductions ($150,000 divided by 5) in each of the five (5) tax years from 2014 to 2018, inclusive.
4. $150,000 OID income will be recognized by MS as such OID Income accrues over the remaining term of the debt. However, the issuer's corresponding OID deductions are deferred for 5 years Thus the Recovery Act creates a mismatch in the timing of the issuer's OID deductions and the holder's OID income inclusion.

Recognition of COD Income deferred pursuant to an election is accelerated in the case of the taxpayer's death, the liquidation or sale of substantially all the assets of the taxpayer (including in a bankruptcy case), or cessation of business by the taxpayer, and must be recognized in the taxable year in which such event occurs (or in the case of a bankruptcy proceeding, the day before the petition is filed). The acceleration of COD Income recognition also applies in the case of the sale or exchange or redemption of an interest in a partnership, S corporation, or other pass-thru entity by a partner, shareholder, or other person holding an ownership interest in such entity.

In the case of a partnership, any COD Income deferred pursuant to an election is allocated to the partners in the partnership immediately before the debt discharge in the manner such amounts would have been included in the distributive shares of such partners under Section 704 if such income were recognized at such time. Any decrease in a partner's share of partnership liabilities as a result of the debt discharge is not taken into account for purposes of the Section 752 partnership liability rules to the extent it would cause the partner to recognize gain under Section 731. Any decrease in partnership liabilities not taken into account under this rule will be taken into account by the partner at the same time, and to the same extent, as the deferred COD Income is recognized.

It is imperative that Purchasers in M&A transactions perform additional due diligence as a result of the 2009 Recovery Act's COD Income provisions. Purchasers must ascertain whether a target previously has made any elections to defer COD Income from a reacquisition of an applicable debt instrument. Additionally, Purchasers should include in their acquisition agreements specific representations from the sellers and target with respect to COD Income deferral elections, and should also obtain indemnification from the sellers for taxes incurred in post-closing periods arising from COD Income recognition that is attributable to a deferral election.

Suspension of OID Rules for Certain High-Yield Obligations

The Recovery Act suspends the applicable high yield discount obligation ("AHYDO") rules under Section 163(e)(5) with respect to any AHYDO issued during the period beginning on September 1, 2008 and ending on December 31, 2009 in exchange (including an exchange resulting from a modification of the debt instrument) for an obligation which is not an AHYDO and the issuer (or obligor) of which is the same as the issuer (or obligor) of such AHYDO. Therefore, the Recovery Act suspends the AHYDO rules for certain obligations issued in a debt-for-debt exchange, including an exchange resulting from a significant modification of a debt instrument, beginning September 1, 2008 and ending December 31, 2009.

However, the AHYDO rules will continue to apply to any new debt issued for an existing AHYDO, and will also apply to new debt that is contingent debt or is issued to a person related to the issuer.

Finally, the Recovery Act grants the IRS the authority to use a rate that is higher than the AFR with respect to the AHYDO rules for debt issued after December 31, 2009 if it deems necessary in light of distressed conditions in the debt capital markets.

Three, Four or Five Year Carryback Period for 2008 NOLs by Eligible Small Business

The 2009 Recovery Act increases from two years the net operating loss ("NOL") carryback period with respect to certain NOLs incurred in 2008 by an electing "eligible small business." An eligible small business is a corporation, partnership or sole proprietorship whose average annual gross receipts for the three-year tax period ending with the tax year in which the loss arose are $15 million or less. An eligible small business may make an irrevocable election to carryback an applicable 2008 NOL for a period of three, four or five years, instead of the general two-year carryback period. With respect to a group of corporations filing a consolidated return, the 2008 NOL carryback election is made by the parent corporation and is binding on all members of the group.

An applicable 2008 NOL generally is the taxpayer's NOL for the tax year ending in 2008. A fiscal year taxpayer may elect as the applicable 2008 NOL the NOL for the tax year beginning in 2008, in which case the increased carryback period will apply to the NOL for the tax year ending in 2009. The election must be made by the due date (including extensions) for filing the taxpayer's return for the tax year of the NOL. Thus in absence of an extension, a corporation with a calendar taxable year would have to make the election for a 2008 NOL by March 15, 2009.

A purchaser of an eligible small business with a 2008 NOL may make the election to increase the carryback period with respect to the 2008 NOL to obtain refunds of income taxes paid in earlier years by offsetting income in such earlier year on which taxes have already been paid. Purchaser's in M&A transactions should make sure their acquisition agreements specifically provide that the purchaser may elect to carryback losses from post-closing periods to pre-closing periods and in such case the refunds attributable to such carryback shall be for the account of the Purchaser.

S Corporations – Temporary Reduction in Recognition Period for Built-In Gains Tax

Under Section 1374, a built-in gains tax may apply to an S corporation with a prior history as a C corporation. If an S corporation sells its assets within 10 years after its S corporation election became effective, then the S corporation is subject to a corporate level tax (at the current rate of 35%) on the built-in gain in its assets that existed at the time of its S corporation election. Moreover, the built-in gain rules of Section 1374 also apply to assets acquired by an S corporation from a C corporation in a carryover basis transaction.

The 2009 Recovery Act shortens the 10 year recognition period for any built-in gains of an S corporation that was previously a C corporation. For S corporation tax years beginning in 2009 and 2010, no tax is imposed under the Recovery Act on the net unrecognized built-in gain of an S corporation if the seventh tax year in the recognition period preceded the 2009 and 2010 tax years. Accordingly, the 10-year recognition period is reduced to 7 years for the 2009 and 2010 tax years. For example, the Section 1374 recognition period will end at the start of the 2009 tax year if the S corporation election was made for the 2002 tax year or end at the start of the 2010 tax year if the S corporation election was made for the 2003 tax year.

In many cases, purchasers of target S corporations are forced by significant built in gains taxes to buy the shares, as opposed to assets, of the S corporations (without Section 338(h)(10) elections). As such, the buyers do not "step up" the tax bases in the assets to their fair market value for depreciation/amortization purposes. However, purchasers of S corporations in 2009 and 2010 may find the costs associated with an asset sale or Section 338(h)(10) election significantly reduced under this provision.

Special Rules Applicable to Qualified Small Business Stock for 2009 and 2010

Generally, Section 1202 allows noncorporate taxpayers to exclude from gross income 50% of any gain from the sale or exchange of qualified small business stock held for more than 5 years. "Qualified small business stock" means any stock in a C corporation which is acquired by the taxpayer at original issuance and is issued by a corporation which meets certain active business requirements and has aggregate gross assets of less than $50 million.

The Recovery Act modifies Section 1202 by increasing the gain exclusion on the sale of qualified small business stock from 50% to 75% for stock issued after the date of the enactment of the Recovery Act and before January 1, 2011 and held for more than 5 years. Thus for qualified small business stock acquired by an individual or pass-thru entity after the enactment of the Recovery Act and before January 1, 2011 and held for more than 5 years, such individual (or

individual holder of an interest in such pass-thru entity) may exclude 75% of the gain from the sale or exchange of the stock.

Temporary Increase in Limitations on Expensing of Certain Depreciable Business Assets

The Recovery Act extends to taxable years beginning in 2009 an increase in the deduction limitations with respect to certain depreciable business assets acquired by purchase for use in the active conduct of a trade or business and placed into service in 2009. Under Section 179, a taxpayer may elect to treat the cost of depreciable business assets as an expense which is not chargeable to capital account, and, therefore, is allowed a deduction for the tax year in which such property is placed into service.

Section 179(b)(7) provides that for tax years beginning in 2008 the amount of the deduction cannot exceed $250,000, and the deduction is phased out by the amount by which the cost of the depreciable property placed into service during tax year 2008 exceeds $800,000. The Recovery Act amends Section 179(b)(7) and extends the $250,000 and $800,000 amounts to tax years beginning in 2009. The Recovery Act extends these higher limitation amounts for an additional year, thus allowing a taxpayer to make the election and apply these limitation amounts for either or both taxable years 2008 and 2009.

One Year Extension of 50% First-Year Bonus Depreciation

Under Section 168(k), an additional (bonus) depreciation deduction is allowed in the placed-in service year equal to 50% of the adjusted basis of qualified property (generally, most types of new property other than buildings). The Recovery Act allows a first-year 50% bonus depreciation deduction to be taken for property placed in service after December 31, 2008 with respect to taxable years ending after that date. The property generally must be acquired before January 1, 2010.