ARRA: Businesses feel the changes in ten big ways

May 22, 2009 - Long Island

In a special update to our readers on February 18th, we provided an overview of the recently signed American Recovery & Reinvestment Act (ARRA). In the previous issue of The Grassi Advisor we discussed, in detail, personal tax highlights of the plan and in today's special edition, we take a look at the business tax advantages of ARRA. The law, enacted on February 17, 2009, contains tax incentives designed to get the stagnant U.S. economy moving again. As always, if you have questions about how the American Recovery and Reinvestment Act of 2009 will affect you, please contact your Grassi tax advisor.
Here are 10 significant changes that might have an impact on your business:

Change #1: Some Businesses Can Carry Back 2008 Losses Up to Five Years
Under the new law, eligible businesses can elect to carry back 2008 net operating losses (NOLs) for either three, four, or five years to claim refunds of federal income taxes paid for earlier years. This is a beneficial exception to the general NOL carryback rule, which allows businesses to carry back most losses only two years.
It can be a great way for eligible businesses that are hurting in today's economy to improve cash flow with a refund of taxes they paid years ago when profits were up.
For a calendar-year taxpayer, the extended carryback election can be made for an NOL generated in calendar year 2008.

For a fiscal-year taxpayer, the extended carryback election can be made for an NOL generated in the tax year that begins in 2008 or for an NOL generated in the tax year that ends in 2008 (The election can be made for one year or the other, but not both).

Eligibility: The election privilege is only allowed for businesses (including sole proprietorships) with average annual gross receipts of $15 million or less for the three-year period that precedes the loss year for which the election is made.
The election generally must be made by the due date of the return for the relevant loss year. However, the law provides that the election deadline cannot be any earlier than April 17, 2009. The claim for a tax refund from carrying back an NOL with the election must generally be filed by no later than 12 months after the end of the NOL year. Once again, the deadline cannot be any earlier than April 17, 2009.Your tax adviser can provide all the details.

Change #2: Extension of $250,000 Section 179 Depreciation Allowance
The new law extends the $250,000 Section 179 first-year depreciation write-off by one year, to cover tax years beginning in 2009. Without this change, the maximum deduction for 2009 would

have been only $133,000.
The new law also extends the $800,000 phase-out threshold by one year, to cover tax years beginning in 2009. If a taxpayer adds qualifying property in excess of the $800,000 threshold, the $250,000 Section 179 allowance begins to be phased out (reduced or eliminated). Without this change, the threshold for 2009 would have been only $530,000.

For tax years beginning in 2010, the deduction amount and the threshold will fall back to much lower amounts unless Congress takes further action.

Change #3: Extension of 50 Percent First-Year Bonus Depreciation
The Recovery Act extends the beneficial 50 percent first-year bonus depreciation provision to cover qualifying new assets that are placed in service by December 31, 2009 (A later deadline applies to limited assets described below).
To be eligible for 50% first-year bonus depreciation, an asset must pass the following tests:
* It must be new qualified property. This term includes most purchased software and certain leasehold improvements. Used assets are not eligible.
* It must be placed in service by December 31, 2009 or by December 31, 2010 for certain long-lived assets, transportation equipment, and aircraft. Under the extended deadline privilege through 2010, only the part of an asset's basis that is attributable to costs incurred before January 1, 2011 is eligible for 50% first-year bonus depreciation.
Change #4: Bigger First-Year Write-offs for Autos and Light Trucks
For a new passenger auto or light truck that falls under the luxury auto depreciation limitation rules, the 50% first-year bonus depreciation benefit translates into an $8,000 increase in the maximum write-off obtained in the first year.
* For new cars placed in service in 2009, the estimated maximum first-year depreciation deduction is $10,960 ($8,000 plus $2,960). This assumes 100 percent business use of the vehicle.
* For new light trucks placed in service in 2009 and used 100 percent for business, the estimated maximum first-year depreciation deduction is $11,060 ($8,000 plus $3,060).
Change #5: Favorable AMT Depreciation Side Effect
Fortunately, 50% first-year bonus depreciation applies equally for both regular tax and Alternative Minimum Tax (AMT) purposes. Just as good, there are no AMT adjustments necessary for depreciation deductions claimed for the remaining 50 percent of depreciable basis left after subtracting the bonus depreciation write-off. In other words, when 50 percent first-year bonus depreciation is claimed for an asset, the rules are the exactly the same for both regular tax and AMT purposes.
Change #6: Corporate Option to Claim Certain Credits Instead of Bonus Depreciation
Under prior rules that applied to tax years ending after March 31, 2008, corporations could elect to forego claiming 50% first-year bonus depreciation deductions and instead "free up" limited amounts of otherwise unusable Research (R&D) Credit and AMT credit carryovers. The freed-up credits are refundable, which means the electing corporation can use them to offset both regular tax and AMT liabilities. Any freed-up credits remaining, after the electing corporation's federal income tax bill is reduced to zero, can be collected in cash.
However, the election was only available for first-year bonus depreciation on qualified assets that were:

* Purchased after March 31, 2008 (assuming no binding purchase contract was in effect as of that date);
* Placed in service by December 31, 2008 (or December 31, 2009 for certain assets).
* There is a limitation on the amount of freed-up credits that equals the lesser of:
* The amount of foregone bonus depreciation multiplied by 20 percent;
* $30,000,000;
* 6% of the unused R&D and minimum tax credits from tax years beginning before 2006.

The new law extends the aforementioned placed-in-service deadlines to December 31, 2009 and December 31, 2010, respectively, and it also provides electing corporations with three options:

Option 1 - If a corporation makes the election to claim credits instead of bonus depreciation for the first tax year ending after March 31, 2008, the calculations to determine the amount of freed-up credits can be made without counting any extension property (which qualifies for the election solely because of the extended deadlines).

Option 2 - If the corporation makes the election for the first tax year ending after March 31, 2008, it can also choose to make separate credit limitation calculations for extension property and non-extension property. Exactly how this option will work will be addressed in future IRS guidance.

Option 3 - If the corporation does not make the election for the first tax year ending after March 31, 2008, it can instead be made for the first tax year ending after December 31, 2008. Under this option, the credit limitation calculations are made taking into account only extension property.

Important: Making the election doesn't result in any lost depreciation deductions for the corporation. However, it postpones depreciation write-offs that would otherwise be allowed sooner for affected assets.

Change #7: Income Triggered by Reacquiring Taxpayer's Own Debt at a Discount Can Be Deferred

Under the new law, a business that reacquires its own debt at a discount can:
* Defer the resulting taxable debt discharge income (DDI)
* Spread the DDI over five years after the deferral period is over.

The election is allowed for DDI that is triggered by debt reacquisition transactions in calendar years 2009 and 2010. The intent of this beneficial provision is to allow financially stressed businesses to restructure their debts in a tax-favored manner. Here are some considerations:
* If the election is made for DDI from a debt reacquisition transaction in calendar year 2009, the income is deferred until the fifth tax year after the year when the reacquisition takes place (which means 2014 for a calendar-year taxpayer). Then, the DDI is spread out evenly over five years beginning with the fifth year, which means 2014 to 2018 for a calendar-year taxpayer.
* If the election is made for DDI from a debt reacquisition transaction in calendar year 2010, the income is deferred until the fourth tax year after the year when the reacquisition takes place (again, this means 2014 for a calendar-year taxpayer). Then, the DDI is divided evenly over five years beginning with the fourth year (again, this means 2014 to 2018 for a calendar-year taxpayer).

Key Point: The election is made on a debt-by-debt basis. However, when the election is made for DDI from a particular transaction, the taxpayer is generally ineligible for other beneficial provisions under Internal Revenue Code Section 108 that could potentially make the DDI tax-free.

Change #8: Tax Break for Some S Corporation Built-In Gains

When a C corporation switches to S corporation status, the built-in gains tax (BIG tax) can be a big issue. The BIG tax is a corporate-level tax on income and gains that are recognized when the S corporation sells assets or converts them into cash (including receivables and inventories) within the

recognition period. However, the BIG tax only hits assets that have built-in gains (excess of fair market value over basis) as of the C-to-S corporation conversion date. The recognition period is the 10-year period that begins on that date.

The new law grants a temporary BIG tax exemption for built-in gains recognized in an S corporation's tax years beginning in 2009 and 2010, but only if the seventh year of the recognition period has elapsed before then. Here are a couple examples to help explain this complex provision:

Example 1: ABC Corporation, which has always used the calendar year for tax purposes, converted from C to S status on January 1, 2002. At the beginning of ABC Corp.'s 2009 tax year (January 1), seven years of the recognition period have elapsed (2002 to 2008). Therefore, ABC Corp is exempt from the BIG tax for built-in gains recognized in both the 2009 and 2010 tax years.

Example 2: XYZ Corp has also always used the calendar year for tax purposes. It converted from C to S status on January 1, 2003. At the beginning of XYZ Corp.'s 2010 tax year (January 1), seven years of the recognition period have elapsed (2003 to 2009). Therefore, XYZ Corp is exempt from the BIG tax for built-in gains recognized in its 2010 tax year. However, it is not exempt for the 2009 tax year, because seven years of the recognition period had not elapsed as of January 1 of that year.

Change #9: Subsidized COBRA Coverage for Terminated Workers

The legislation includes a new provision that allows eligible individuals to pay only 35 percent of the health plan premiums that would otherwise be required for up to nine months of coverage under COBRA (the Consolidated Omnibus Budget Reconciliation Act).

This provision is effective for periods of COBRA coverage beginning on February 17, 2009, and it is available to individuals who are eligible for coverage at any time between September 1, 2008 and December 31, 2009 due to "involuntary termination" of employment during that period (It does not apply to employees who voluntarily leave).

The new law also stipulates that the federal government will subsidize 65% of COBRA premiums to compensate for the discount received by the former employee. The government subsidy will generally come in the form of a federal payroll tax credit for the employer on its quarterly employment tax return.

Bottom line: The terminated worker pays 35 percent of the COBRA premiums for up to nine months. The employer provides the subsidy after it receives the 35 percent premium payment from the individual and then breaks even by taking the federal payroll tax credit on its quarterly return.

Implications for beneficiaries: For federal income tax purposes, the 65 percent subsidy is not counted as gross income for beneficiaries.

An individual who takes advantage of the 65 percent subsidy becomes ineligible for the subsidy if he or she obtains health coverage from a new employer. The individual must notify the COBRA provider when this happens or face a penalty.

Finally, the 65 percent subsidy is "recaptured" from higher-income individuals if they fall into the following modified adjusted gross income (MAGI) ranges.

* $125,000 to $145,000 for single taxpayers and married individuals filing jointly.
* $250,000 to $290,000 for joint-filing married couples.

The recapture will come in the form of an addition to an affected individual's federal income tax liability, which cannot be offset by any nonrefundable credits.

Change #10: Liberalized Gain Exclusion for New Issues of Small Business Stock

Under Section 1202 of the tax code, non-C corporation sellers of qualified small business

corporation stock can potentially exclude up 50 percent of their gains from federal income taxation (subject to several limitations).

However, an amount of gain equal to the excluded amount (typically 50 percent of the total gain) is taxed at a maximum federal rate of 28 percent, which usually works out to an effective maximum rate of 14 percent (versus the normal 15 percent maximum rate on long-term gains). In addition, 7 percent of the excluded gain counts as income under the AMT rules.

To encourage more investment in qualified small business corporations, the Recovery Act increases the gain exclusion percentage from 50 to 75 percent. This beneficial change only applies to qualifying sales of eligible shares that are issued between February 18, 2009 and December 31, 2010.

These are only some of the business tax breaks in the new law. In a future article, we will cover the energy incentives included in the legislation. To find out about the tax breaks for individuals, click here to read our previous article.

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