

April 20, 2009

Stimulated Federal Income Tax Benefits For Business

By Mark R. Sieke

Most clouds have at least a thread of silver lining. As a result of our troubled economic times, the American Recovery and Reinvestment Act of 2009 (commonly referred to as the Stimulus Act) was enacted, carrying an estimated \$787 billion price tag.

Fortunately, the Stimulus Act contains roughly \$300 billion of tax benefits, a wide range of tax reductions, and deferrals for individuals and entities. The following is a brief overview of some of the key tax provisions of the Stimulus Act applicable to business.

S Corporation Built-In Gain Period Is Shortened

An S corporation ordinarily is not subject to federal income tax on its income tax. There is a major exception for gains which were "built-in" at the time a C corporation makes an S election: if triggered within ten years after the effective date of the S election, these gains are subject to corporate-level tax at the highest rate. The Stimulus Act shortens this ten-year period to seven years for sales of assets during 2009 and 2010.

Carryback Period for Certain Small Business NOLs Can Be Extended

A business generally can carry a net operating loss back two years (and forward 20 years). The Stimulus Act allows small businesses to elect to carry back up to five years net operating losses (NOLs) arising in tax years beginning or ending in 2008. For this purpose, a "small business" is a trade or business (whether conducted through a corporation, partnership, or sole proprietorship) with average annual gross receipts of \$15 million or less for the three-year period before the loss year.

Gain Exclusion for Sale of Qualified Small Business Stock Is Increased

Individuals generally can exclude from income 50% of their gain on the sale of qualified small business stock (QSBS) which they have owned for at least five years. In order to qualify as QSBS, stock must meet many conditions; primarily, it must be stock in a corporation with no more than \$50 million of gross assets and which meets certain active business requirements. For QSBS stock purchased directly from the issuing corporation after February 17, 2009, and before January 1, 2011, the Stimulus Act increases the exclusion to 75% of the gain when the stock is later sold.

Income From Certain Debt Restructuring Can Be Deferred

When a solvent business renegotiates its debt, cancellation of debt (COD) income can result in a significant income tax cost to the debtor. There are exceptions to this rule, although many apply only if the debtor is insolvent or in a Chapter 11 bankruptcy or require the debtor to reduce its NOLs or other tax attributes.

In a provision with potentially far-reaching impact, the Stimulus Act permits debtors to both defer and extend the period during which they must recognize COD income from certain debt restructurings. This relief is generally available for the reacquisition of most debt instruments by a debtor C

corporation or any other person in connection with its trade or business. Fortunately, a debt "reacquisition" is defined very broadly to generally include a debtor's cash-for-debt, debt-for-debt, and equity-for-debt exchange, as well as debt modification and forgiveness, contribution of debt to capital, and related-party debt acquisition.

Qualifying debtors with COD income from applicable debt reacquisitions in 2009 and 2010 can elect to defer taxation until 2014, then spread the income recognition ratably over five years (i.e., 20% per year from 2014 through 2018). In the case of an S corporation, partnership (including a limited liability company treated as a partnership for income tax purposes), or other pass-through entity, the election is made at the entity level. Deferral is generally terminated -- triggering the income -- if the debtor liquidates, sells substantially all of its assets, ceases business, or dies.

Taxpayers must make a choice. They cannot exclude COD income from taxation under the traditional rules and make a Stimulus Act deferral election with respect to the same debt instrument. However, deferral elections are made on a debt instrument-by-debt instrument basis. The taxpayer can selectively pick and choose.

Section 179 Deduction Limits Increased

Small businesses can write off (rather than depreciate over time) up to a certain dollar amount of assets in the year placed in service. This dollar limit is reduced if the business places greater than a certain amount of assets in service in a year. For 2009, the limit on the amount that could be expensed was scheduled to be \$133,000, and the cap on overall investment was to be \$530,000. For 2009 only, the Stimulus Act increases the immediate write-off limit to \$250,000 and the cap on investment to \$800,000.

We are in an era of seemingly constant changes to the federal tax laws. In the past year or so alone, tax provisions have played a part in no fewer than seven major legislative enactments. The future promises more significant changes, not the least of which are those described in the Obama Administration's proposed 2010 budget or yet to come from the White House task force purposed to recommend ways to reduce tax evasion and - yes - simplify the tax code. Other changes may be prompted by external influences, such as the EU's recent decision to impose antidumping duties on imports of U.S. biodiesel, in response to our domestic tax laws subsidizing production.

For at least a moment, we seem to have a break from the traditional pay-as-you-go model in which a dollar in revenue has been required to counterbalance each dollar in tax reduction. In our current time of stimulus, recovery, "bailout" and similar legislation, we can expect further provisions intended to reduce the bite on certain taxpayers. Then will follow the legislation eventually needed to raise tax revenues to pay for it all. We assist our clients in planning, given their specific circumstances and goals, for whatever changes may come.

If you have received this alert from a colleague and would like to subscribe, kindly forward your email address to mqm@msk.com.

Lessing E. Gold
Practice Chair
(310) 312-3228
leg@msk.com

Mark R. Sieke
Of Counsel
(310) 312-3169
mrs@msk.com

Mitchell Silberberg & Knupp LLP