

November 5, 2009

House and Senate Pass NOL Carryback Legislation

Revenue Provisions of the Worker, Homeownership, and Business Assistance Act of 2009 Include Five-Year Carryback of Net Operating Losses, an Extension and Modification of the First-Time Homebuyer Credit, and a Delay in Application of Worldwide Allocation of Interest

SUMMARY

The House of Representatives today passed the Worker, Homeownership, and Business Assistance Act of 2009 (the "Act") one day after the Senate passed identical legislation. The Act now only needs President Obama's signature to be enacted as law. One of the most significant items of the Act is the provision of an election to taxpayers to extend the carryback period to a period of up to five years for a net operating loss ("NOL") arising in a taxable year beginning or ending in either 2008 or 2009. However, a taxpayer will be ineligible to make the election if it or any affiliate had at any time issued, or issues after the enactment of the Act, equity or warrants to the Federal government pursuant to TARP. For eligible financial institution taxpayers, this could create a material increase in regulatory capital ratios.

If enacted, the Act would also provide for:

- a delay in the effective date of the worldwide interest allocation rules until December 31, 2017; and
- an extension and modification of the first-time homebuyer credit to principal residences purchased before May 1, 2010.

Other provisions in the Act include a modification of the penalty for failure to file partnership or S corporation tax returns, an expansion of electronic filing by return preparers, and an increase in estimated corporate tax due in the third quarter of 2014 for corporations with assets of at least \$1 billion.

DISCUSSION

A. ELECTION TO CARRY BACK NET OPERATING LOSSES TO A PERIOD OF UP TO FIVE YEARS

Generally, taxpayers are entitled to carry back a net operating loss (“NOL”) to the two years prior to the year of the loss. Many taxpayers, however, incurred substantial losses in 2008 that exceeded the total net income reported in 2006 and 2007. Accordingly, while these taxpayers could carry forward excess NOLs to future taxable years, they could not currently benefit from the full amount of such NOLs. Recently, the two-year carryback limitation was amended to allow small businesses¹ to carry back NOLs incurred in 2008 for a period of up to five years.² If enacted, the Act would extend this benefit to all taxpayers (other than those taxpayers participating in the TARP program) for NOLs that arose in either 2008 or 2009.

In particular, if the Act is enacted, any eligible taxpayer may elect to carry back NOLs arising from one (and only one) taxable year that begins or ends in 2008 or 2009 for a period of up to five years.³ If the taxpayer elects to carry back NOLs for the full five years available, the NOLs can only offset 50 percent of the taxable income that arose in the fifth preceding taxable year. Any remaining NOLs can be used to offset up to 100 percent of the taxable income that arose in the other four prior taxable years.

Under the Act, any taxpayer that ever issued any equity interest (or any warrant to receive any equity interest) to the Federal government pursuant to the Emergency Economic Stabilization Act (“EESA”) of 2008 (in other words, roughly speaking, most recipients of TARP funds), is ineligible to make the election to extend the NOL carryback period. Such taxpayer will be ineligible even if it repaid the TARP funds and redeemed the Treasury’s equity or warrants prior to making the election or prior to the enactment of the Senate provision. Furthermore, any taxpayer who in the future issues an equity interest (or right to acquire any equity interest) to the Federal government under the EESA will be ineligible to make the election, unless the taxpayer is a financial institution issuing the interest pursuant to a program established for the stated purpose of increasing the availability of credit to small businesses. Additionally, any taxpayer that in 2008 or 2009 was or is a member of the same affiliated group as an entity that issued or issues equity or warrants to the Federal government under the EESA is also ineligible to make the election.

The Act also provides for a similar extension for life insurance companies, which under current law are generally allowed a three-year operations loss carryback in lieu of the NOL carryback.

¹ For these purposes, small businesses are defined as businesses for which the average annual gross receipts of the previous three taxable years was \$15 million or less.

² See S&C Publication “American Recovery and Reinvestment Act”, dated February 24, 2009.

³ Small businesses who made, or make, an election under the previous law for its 2008 NOL may also make an election for a 2009 NOL.

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Finally, if enacted, the Act would suspend the limitation applicable to corporate taxpayers subject to the alternative minimum tax that allows the use of NOLs to offset only 90% of alternative minimum taxable income. This suspension would apply to those NOLs that are elected to be carried back to an extended carryback period.

B. SEVEN-YEAR DELAY IN EFFECTIVE DATE OF WORLDWIDE INTEREST ALLOCATION RULES

Taxpayers are required to allocate interest and other expenses between U.S. and non-U.S. sources for foreign tax credit limitation purposes and for certain other purposes. Generally, for purposes of allocating interest expense, all domestic corporations that are members of the same affiliated group are treated as one corporation, and the interest expense is allocated on the basis of assets. Foreign corporations are not treated as members of the affiliated group, and thus their assets and interest expenses are not included in the allocation of interest expense by related domestic corporations.

The American Jobs Creation Act of 2004 provided that a domestic corporation could elect to allocate interest as if all members of its worldwide affiliated group were a single corporation. The worldwide affiliated group would consist of all corporations in an affiliated group and also all controlled foreign corporations that would be members of the affiliated group if the rule excluding foreign corporations did not apply. This election would, for many taxpayers, reduce the amount of interest expense allocated to non-U.S. source income for foreign tax credit limitation purposes, and thus for such taxpayers would increase the amount of available foreign tax credits. The "worldwide interest allocation rules" were originally to be effective for taxable years beginning after December 31, 2008, but the Housing and Economic Recovery Act of 2008 delayed the effectiveness of these rules by two years to taxable years beginning after December 31, 2010. The Act would further delay the effectiveness of these rules to taxable years beginning after December 31, 2017.

C. EXTENSION AND MODIFICATION OF FIRST-TIME HOMEBUYER CREDIT

Under current law, individuals who are first-time homebuyers are allowed a credit equal to the lesser of \$8,000 or 10% of the purchase price of a principal residence. This credit is only allowed for purchases on or after April 9, 2008 and before December 1, 2009. The credit phases out for individual taxpayers with modified adjusted gross income between \$75,000 and \$95,000 (\$150,000 and \$170,000 for joint filers) for the year of purchase. If enacted, the Act will extend this credit to apply to principal residences purchased before May 1, 2010. The credit would also be available to individual taxpayers who enter into a written binding contract before May 1, 2010 to close on the purchase of a principal residence before July 1, 2010. The Act would also raise the income limitations such that the credit would phase out for individual taxpayers with modified adjusted gross income between \$125,000 and \$145,000 (\$225,000 and \$245,000 for joint filers) for the year of purchase.

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D. OTHER PROVISIONS

Other revenue provisions in the Act include:

- a modification of the penalty for failure to file partnership or S corporation tax returns, to \$195 per partner or shareholder per month that the failure continues;
- an extension of the mandate for Treasury regulations requiring electronic filing of tax returns to require electronic filing for individual tax returns filed by tax return preparers who reasonably expect to file more than ten individual tax returns; and
- an increase by 33 percentage points in the amount of estimated corporate tax otherwise due in the third quarter of calendar year 2014 for corporations with assets of at least \$1 billion.

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