Tax Briefing:

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BIG CHANGES COMING WITH 2009 TAX RETURNS

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- ✔ *New Making Work Pay Credit*
- ✔ *Enhanced Child Tax Credit*
- ✔ *American Opportunity Tax Credit for Education*
- ✔ *Expand Homebuyer Tax Credit*
- ✔ *Extended Bonus Depreciation and Code Sec. 179 Expensing*
- ✔ *Five-Year Carryback of NOLs*
- ✔ *Extensions/Increases of Many Energy Tax Incentives*

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Key Credits & Deductions to Watch For

In February 2009, massive changes were made to the tax law with the passage of the 2009 American Recovery and Reinvestment Act (ARRA). Although headlines focused on benefits to large financial institutions, many of the credits and deductions instituted apply directly to average taxpayers and small businesses.

INCENTIVES FOR INDIVIDUALS

Making Work Pay Credit

The Making Work Pay Credit, a refundable income credit for 2009 and 2010, is the lesser of (1) 6.2% of the individual's earned income, or (2) $400 ($800 for married filing jointly, or MFJ). This credit is available, in full, to workers with a modified Adjusted Gross Income up to $75,000 ($150,000 for MFJ). Above that amount, the credit is phased out at a 2% rate.

You may already be benefitting from the Making Work Pay Credit, which is handled differently from prior stimulus programs in that it isn't automatically distributed via a one-time check, but as reduced wage withholdings. For most W-2 employees, employers are already having withholdings adjusted automatically. Alternately, taxpayers can take the credit as a lump sum when filing their annual tax return.

First-Time Homebuyer Credit

The First-Time Homebuyer Credit, a 2008 credit that has been widely publicized by real estate firms, was extended and changed for 2009. For home purchases made after December 31, 2008, the credit has been raised to $8,000 (from $7,500) and extended to November 30, 2009. Any required repayments to the IRS are eliminated after 36 months in the home.

As with the previous homebuyer credit, the taxpayer (1) has to have purchased the primary residence during the current calendar year, and (2) cannot have owned a residence in the U.S. during the previous three years. A taxpayer who bought a home on or after April 9, 2008, and before January 1, 2009, does not qualify for the 2009 homebuyer credit; the purchase will continue to be governed by the original 2008 credit.

Phase-outs apply for both 2008 and 2009 and begin for individuals with AGI greater than $75,000 ($150,000 for MFJ) for the year of purchase.

Temporary Tax Deduction on Car Purchases

This benefit is actually an above-the-line deduction for the state sales taxes, local sales taxes, and excise taxes paid by a purchaser of a new vehicle. To qualify, a taxpayer must have purchased the vehicle for first use between February 17 and December 31, 2009. The vehicle must be either (1) a passenger vehicle, light truck, or motorcycle with a gross weight of no more than 8,500 pounds, or (2) a motor home. Deductible taxes can't exceed the portion attributable to the first $49,500 of the price paid for any single vehicle. Phase-outs start for individuals with AGI greater than $125,000 ($250,000 for MFJ).

American Opportunity Tax Credit

The American Opportunity Credit is a reworking of the Hope Credit and has been enhanced in the following ways under ARRA:

- Amount increased to a maximum of $2,500 (from $1,800) per eligible student per year
- Modified rate of 100% of the first $2,000; 25% of the next $2,000, with a maximum $2,500 per year allowed on $4,000 in qualifying payments
- 40% of the credit is refundable for 2009 and 2010
- Applies for all four years of college
- Qualifying expenses include course materials

The credit can be claimed by either a non- dependent taxpayer student or a parent of a qualifying student. Along with the changes listed above, the phase-out level for claiming the credit has increased to $80,000 AGI ($160,000 for MFJ).

Qualified Tuition Programs ('529 Plans")

Changes in qualifying expenses have been made to tax-free college savings plans for 2009 and 2010. A beneficiary of a qualified tuition program can now use distributions to pay for computers and computer technology (including Internet). Distributions are tax-free.

Earned Income Credit (EIC)

For 2009 and 2010, EIC percentage is increased to 45% of the first $12,750 of earned income for taxpayers who have three or more qualifying children. (Prior to the new law, the credit was 40% of this amount for taxpayer with two or more qualifying children.) In addition, the EIC phase-out range has been adjusted upward by $1,880 to eliminate any marriage penalty for joint filers.

Child Tax Credit

In another child-related credit, the refundable part of the Child Tax Credit is increased for 2009 and 2010. The income threshold is now set at $3,000 (down from $8,500). The full credit amount is still $1,000.

Unemployment Compensation

Generally, a taxpayer's gross income must include all unemployment compensation benefits received. In 2009 only, up to $2,400 of unemployment compensation is excluded from gross income for federal income tax purposes.

Transit Benefits

Transit passes, van pooling, qualified parking, and other qualified transportation fringe benefits are not typically included in employee income up to a certain dollar amount. In March 2009, this dollar amount was increased to $230 per month (up from $120) for transit passes and van pooling. This increased exclusion will continue through 2010 with adjustments made for inflation.

AMT Patch

Under ARRA, the Alternative Minimum Tax (AMT) patch for 2009 features the following exemption amounts:

- For joint filers and surviving spouses: $70,950 (up from $69,950)
- For singles and heads of households: $47,200 (up from $46,200)
- For married filing separate filers: $35,475 (up from $34,475)

Other Incentives for Individuals

Property Tax Deduction: Allows homeowners up to $500 deduction ($1,000 for MFJ) of property taxes, with no itemizing required. Teacher Expense Deduction: Allows educators a $250 deduction for out-of-pocket educational expenses, with no itemizing required. Charitable Giving from IRA's: Allows transfer of up to $100,000 from tax-deferred retirement account to a qualified charity. Generally available to 70+ taxpayers who can make such transfers without penalty. Donation counts as a minimum distribution, but cannot be deducted.

INCENTIVES FOR BUSINESSES

Bonus Depreciation

The 50% first-year bonus depreciation, a result of the 2008 Economic Stimulus Act, has been extended through December 31, 2009, and made retroactive to January 1, 2009. The additional year of bonus depreciation for certain properties is also extended through 2010. In general, property must be acquired before January 1, 2010 (or January 1, 2011 for certain property).
In addition, higher caps, effective January 1, 2009, have been placed on vehicle depreciation, with the regular dollar cap raised by $8,000 for vehicles placed in service in 2009. Limits are $10,960 for autos and $11,160 for light trucks and vans.

Section 179 Expensing

The 2008 Economic Stimulus Act increased the Section 179 expensing amount to $250,000, with an $800,000 threshold for reducing the deduction. Under the new law, these amounts will remain the same. (Without the extension, the expensing amount would have been limited to $125,000, with a $500,000 maximum deduction threshold.)

Longer NOL Carryback Periods

A qualified small business with average gross receipts of $15 million or less can now deduct a 2008 loss through a net operating loss (NOL) carryback period of up to five years. For NOLs incurred in 2009, the normal carryback period of two years applies.

Estimated Tax Burden Reduction

Individuals whose incomes are primarily from a small business are generally required to make quarterly estimated tax payments based on 100% of their tax returns. For 2009, these individuals can compute their estimate amounts based on 90% of the tax liability for the previous year. AGI must be less than $500,000, and the taxpayer must certify that more than 50% of gross income on the prior year return was from a small business.

Work Opportunity Credit

The Work Opportunity Tax Credit can be elected by employers who hire individuals from one or more of certain targeted groups. This credit now covers two more groups: unemployed veterans, and disconnected youth. The new categories apply to taxpayers who are hired and begin working for the employer in 2009 and 2010.

Qualified Small Business Stock (QSBS)

An investor may now exclude 75% of the gain from the sale of certain QSBS that was (1) acquired after the date of enactment and before January 1, 2011, and (2) held for more than five years. To qualify, a small business must be an active trade or business with $50 million or less in assets.

Temporary COBRA Subsidy Continuation

Workers who are involuntarily terminated between September 1,2008, and January 1, 2010, can elect to pay 35% of COBRA coverage and have it treated as paying the full amount. The former employer must pay the other 65% but can be reimbursed by crediting those amounts against income tax withholding and payroll taxes that it would otherwise have to pay.
If an individual receiving COBRA assistance has a modified AGI of more than $125,000 ($250,000 if MFJ), he or she should be aware that all or part of that assistance may need to be recaptured on the 1040.

Built-in Gain Period for S Corps

The holding period for assets subject to built-in gains tax is seven years (down from 10) for C corps converting to S corps in TY 2009 or 2010.

ENERGY INCENTIVES

Residential Energy Property Credit

This credit is allowed for eligible property placed in service in 2009 or 2010, with the following modifications to the pre-2008 credit:

- Increase of residential energy property tax credit to 30% (from 10%)
- Increase of maximum cap to $1,500 aggregate amount for 2009 and 2010 installations
- Elimination of the $500 lifetime cap

Residential Energy-Efficient Property Credit

Modifications include removal of individual dollar caps under credit regulations for solar hot water property, geothermal heat pumps, and wind energy property. In addition, a $500 credit cap is placed on all qualified fuel cell property expenditures

Renewable Electricity Production Credit

This credit apples for electricity produced from wind and other renewable sources. ARRA extends the placed-in-service dates for qualified facilities under Code Sec. 45 through 2012 for wind facilities, and through 2013 for most other facilities.

Investment Credit Election

Instead of producers taking the Code Sec. 45 production credit, taxpayers can treat certain alternative energy facilities as energy property eligible for a 30% investment credit under Code Sec. 48, which can be coordinated with renewable energy grants.

Energy Investment Credit

ARRA removes the credit cap for small wind energy property under Code Sec. 48 energy investment property. A taxpayer may be able to take a 30% credit for certain small wind energy property expenses made during the tax year.

Plug-in Electric Vehicles

An existing credit for plug-in vehicles has been modified, with separate treatment for low-speed vehicles. The credit’s base amount is $2,500; the full amount will be reduced once the manufacturer records its 200,000th sale of these vehicles, which are not yet on the market.

ESTATE TAX UPDATE

As of December 23rd, Senate Democrats have failed to reach a deal with Senate Republicans to temporarily extend the estate tax into 2010, when it is scheduled to be repealed for one year.

But that doesn't necessarily mean there won't be any estate tax next year. If the Senate adjourns without getting an extension before Jan. 1, Senate Finance Chairman Max Baucus, D-Mont., and House Ways and Means Chairman Charles Rangel, D-NY, will try to get it reinstated for 2010 after the New Year, according to Congress Daily.

"We'll clearly work to do this retroactively," Baucus said. Baucus and others were pushing to temporarily extend the estate tax in 2010, when lawmakers are expected to debate what permanent changes they wish to make to the tax.

The temporary extension would have kept the 2009 estate tax levels in place: the first $3.5 million of an estate would be exempt from the estate tax and the highest rate on the taxable portion of an estate would be 45%.

Those levels don't capture a large number of estates. Of the roughly 2.5 million Americans expected to die in 2009, only 5,500 - or 0.25% - will have estates large enough to be taxable, the Tax Policy Center estimates.

Imposing a tax retroactively can create administrative and planning headaches for accountants, lawyers and heirs of estates. And it is almost a guarantee that the IRS will get an earful from heirs of large estates arguing that they don't owe the estate tax, if a decedent died during the months when the repeal was in place.

Given that there are not 60 votes yet in the Senate to support a temporary extension of the estate tax, it's not clear whether there will be a sufficient number of votes next year either. If the attempt to make the tax retroactive fails and the repeal stands, that still doesn't mean there won't be any tax consequences for those who inherit assets.

That's because along with the repeal of the estate tax, the so-called "step-up" in basis for heirs of any estate, no matter how large or small, would be limited to the first $1.3 million in assets.

The step-up simply means that when heirs sell an inherited asset, they only owe capital gains tax on the asset's appreciation from the day the asset was inherited to the date of sale rather than from the day the asset was originally purchased by the decedent.

Say a parent buys stock at $20 a share, dies and leaves it to his son when the stock is trading at $60 a share. If the son later sells the stock at $80, he only owes capital gains tax on the $20 gain ($80-$60), rather than the full $60 gain that his parent would have owed.

Under estate tax repeal, any asset over the $1.3 million threshold would not be granted a step-up in basis. So any heirs of estates that fall between $1.3 million and $3.5 million next year will pay more in capital gains tax than if there were an estate tax in place.