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Planning Opportunities in the Government's Response to the Economic Downturn

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The government has responded aggressively to the economic downturn with relief strategies that affect individuals across the board. The media have publicized a few of these strategies, but there is hidden treasure in the American Recovery and Reinvestment Act of 2009 (ARRA) and other recent legislation.

Making-Work-Pay Credit

Over half the workers in the country will benefit from the making-work-pay credit included in the ARRA. The refundable credit, which is available in 2009 and 2010, is the lesser of $400 ($800 in the case of a joint return) or 6.2 percent of an individual's earned income. The credit is phased out at a rate of 4 percent of the individual's adjusted gross income (AGI) above $75,000 ($150,000 in the case of a joint return).

Individuals earning more than $6,452 ($400/.062) will receive a $400 credit if their AGI is below $75,000 ($150,000 if they are married filing a joint return). They will continue to receive a partial credit until their AGI exceeds $85,000 ($75,000 + ($400/.04)), ($170,000 if they are married filing a joint return). For example, a single individual with $82,000 of AGI will receive a credit of $120 ($400 – .04($82,000 – $75,000)).

Benefits to Retirees

Two changes are directed at retirees. First, qualified retirees, disabled individuals, and supplemental security income recipients, including many government retirees who are not eligible for Social Security benefits, will receive a $250 one-time payment in 2009.

Second, the Worker, Retiree, and Employer Recovery Act of 2008 suspended the required minimum distributions from retirement accounts in 2009. The waiver applies to individuals over 70½ with individual retirement accounts (IRAs) and defined contribution plans, including 401(k), 403(b), and 457(b) accounts. This provision also allows people who inherited such accounts who are taking distributions over five years to skip 2009, thus increasing the five-year payout rule by one year. Suspending the mandatory withdrawal allows individuals to avoid depleting retirement accounts that may have been severely hit by the market downturn and possibly recover some of their losses. However, the provision provides little benefit to retirees who rely on the distributions to pay living expenses.

For Businesses, New Breaks Are Added and Old Ones Are Extended

Continuing the relief available in 2008, taxpayers in 2009 may immediately expense up to $250,000 of new or used tangible personal property used in business and claim additional (bonus) first-year depreciation equal to 50 percent of the adjusted basis of new property with a recovery period of 20 years or less, including off-the-shelf computer software and qualified leasehold improvement property. The ARRA also increases the first-year depreciation limit for "luxury autos" by $8,000. The $25,000 cap on first-year SUV depreciation is not changed.

Under old law, net operating losses (NOLs) incurred during a taxable year could be carried back two years and/or carried over 20 years. Under the ARRA, the carry back period for a 2008 NOL has been increased to any whole number of years more than two and less than six. A 2008 NOL is one NOL for the tax year ending after December 31, 2007, or at the election of the taxpayer, a tax year beginning in 2008. Giving taxpayers the flexibility to choose which year to carry an NOL represents a new approach by the government and allows taxpayers to maximize the benefit from the loss. Taxpayers will carry losses back to years they paid taxes at high marginal rates rather than those years in which they paid at low marginal rates. The extended carry back period applies only to businesses with average gross receipts of $15 million or less in the three years prior to the NOL year.

The ARRA provides estimated tax relief to individuals with 2008 AGI less than $500,000 ($250,000 if married filing separately) who certify that at least 50 percent of their gross income came from a business that employed fewer than 500 persons during the year. Instead of making estimated tax payments in 2009 equal to 100 percent or 110 percent of their 2008 tax liability, these individuals can make estimated tax payments equal to the lesser of 90 percent of their 2008 or 2009 tax liability. This benefit can reduce cash outlays when the business may be short of cash as shown in the following example.

Example: Ann earns $300,000 of self-employment income in 2008 and owes $100,000 in federal income and self-employment tax for the year. She expects to pay tax of $120,000 in 2009. Under the old law, Ann's estimated tax payments for 2009 would be $108,000 (the lesser of (1) 90 percent of $120,000 or (2) 110 percent of $100,000). Under the ARRA, Ann's estimated tax payments for 2009 are $90,000 (the lesser of (1) 90 percent of $120,000 or (2) 90 percent of $100,000). She will still owe $120,000 of tax for 2009 but she can postpone paying $30,000 of the tax until April 2010, when the economy may have recovered.

First-Time Homebuyer Credit Enhanced

The ARRA increased the first-time homebuyer credit to $8,000 (from $7,500 in 2008), extended the date for purchases from July 1, 2009, to December 1, 2009, and eliminated the 15-year recapture (thus making it a true credit). A first-time homebuyer is any individual (and if married, the individual's spouse) who has not owned any principal residence during the three-year period ending on the date of the purchase of the new residence.

In Notice 2009-12, the IRS issued guidance concerning the allocation of the purchase price between taxpayers. The credit is phased out for taxpayers with AGI between $75,000 and $95,000 ($150,000 and $170,000 for joint filers) in the year of purchase. Unmarried individuals purchasing a home together must split the $8,000 credit. However, if one individual's income is too high to take advantage of the credit or one of the individuals has owned a home during the past three years, the credit may be allocated according to the taxpayers' contributions to the purchase price, ownership interests in the residence, or "any other reasonable method." In other words, the credit may be allocated to the individual who can use the credit without changing the equal ownership of the property.

Planning strategy: Most of our clients own a home or have incomes greater than the phase-out levels for this credit, but clients may wish to help their children buy a home and take advantage of this refundable credit. The parent could advance the $8,000 to a child to help with the down payment on the home before December 1, 2009. The child could repay the parent when the child files his or her tax return and receives the refundable credit in 2010.

Education-Related Changes

There are three education changes worthy of note. The first two apply to Section 529 education plans. First, in response to the volatile market conditions, the IRS has issued guidance allowing Section 529 plan sponsors to permit participants to change investment strategies twice in 2009. Previously, changes in investment strategy were permitted once during the year and when the Section 529 account's designated beneficiary was changed.

Second, for 2009 and 2010, computers are allowed as qualified education purchases. Distributions from a qualified tuition program are generally excludible from the beneficiary's gross income to the extent the total distribution does not exceed the qualified higher education expenses incurred for the year. Normally, qualified education expenses include tuition, fees, books, supplies, and equipment required for the beneficiary to enroll in or attend an eligible educational institution. The ARRA expands qualified education expenses to include the purchase of any computer technology or equipment and Internet access, if such purchases are to be used by the beneficiary or the beneficiary's family during any of the years the beneficiary is enrolled in college. Expenses for computer software designed for sports, games, or hobbies are not qualified expenses unless the software is predominantly educational in nature.

Third, the ARRA adds the American Opportunity tax credit for tax years beginning in 2009 and 2010. This effectively modifies the Hope credit, increasing the credit to $2,500 from $1,800, making the credit available for the first four years of post-secondary education rather than just the first two years, and raising the phase-out levels. These changes are summarized in Table 1.

Table 1:	Education-Related Changes of the ARRA	
	American Opportunity Tax Credit	Hope Education Credit
Applicable years	2009 and 2010	Pre-2009 and post-2010
Number of years of college	First four years	First two years
Amount	Up to $2,500 (100% of the first $2,000 plus 25% of the next $2,000)	$1,800 (100% of the first $1,200 plus 50% of the next $1,200)
Qualifying expenses	Tuition and related expenses, including books	Tuition and related expenses
Phase-out range	Taxpayers with AGI between $80,000 and $90,000 ($160,000 and $180,000 for joint filers)	Taxpayers with AGI between $50,000 and $60,000 ($100,000 and $120,000 for joint filers)
AMT	May be claimed against the AMT in 2009 and 2010	Under Congressional extensions, may be claimed against the AMT in 2009
Benefit over four years	$10,000 (4 years × $2,500), if the law is extended	$7,600 (2 years × $1,800 under the Hope credit, plus 2 years × $2,000 under the Lifetime Learning Credit)
Other	40% of the credit is refundable	Non-refundable

AMT Relief

For tax years beginning in 2009, the ARRA increases the AMT exemption amounts to:

- $46,700 (up from $46,200 in 2008) for unmarried individuals
- $70,950 (up from $69,950 in 2008) for married couples filing jointly and surviving spouses
- $35,475 (up from $34,975 in 2008) for married individuals filing separately

These amounts will be adjusted for inflation in future years.

Less publicized but also important are two other changes to the AMT. First, personal nonrefundable credits, such as the child and dependent care credit, education credits, and the elderly and disabled credit, may offset AMT and regular tax for 2009.

Second, tax-exempt interest on private activity bonds is not a tax preference item for 2009 and 2010. Private activity bonds are issued by governments to finance projects that are not governmental in nature, such as athletic stadiums, airports, and housing developments. The interest income of private activity bonds avoids regular tax but not AMT. Normally investors expect private activity bonds to pay a slightly higher interest rate than tax-exempt bonds that avoid both taxes. For the short-term, the rates for private activity bonds should decrease. Investors will earn lower rates but may enjoy a lower tax burden, and governments will benefit from lower financing costs.

Sales Tax Deduction for 2009 Vehicle Purchases

For purchases after February 16, 2009, and before January 1, 2010, the ARRA allows a deduction for sales and excise taxes on the first $49,500 of the purchase price for qualified motor vehicles. A qualified motor vehicle means a new motor home or a new vehicle that has a gross vehicle weight rating of not more than 8,500 pounds including a passenger automobile, light truck, or motorcycle.

The deduction is allowed to itemizers who deduct state and local income taxes and to non-itemizers claiming the standard deduction. The deduction also offsets the AMT. The amount of taxes treated as deductible phases out ratably for taxpayers with AGI between $125,000 and $135,000 ($250,000 and $260,000 for joint filers).

Example: Gary is single with $128,000 of AGI. He bought a $40,000 sedan in July 2009. The local sales tax is $3,000. If Gary does not itemize, he can deduct $2,100 ($3,000($135,000 – $128,000/$10,000)) as an additional standard deduction. If Gary itemizes, he can increase his tax deduction by the $2,100 of sales tax.

Looking Ahead

The Obama administration has given early notice of its plans for the estate tax and income tax rate increases. The leading estate tax proposal, House of Representatives Bill 436, maintains the estate tax with an applicable exclusion at the 2009 level of $3.5 million and a maximum 45 percent tax rate. The bill also repeals the carryover basis rule that was to take effect in 2010, and it attempts to limit the use of minority discounts and marketability discounts for nonbusiness assets, such as marketable securities and residences.

With his budget, President Obama proposes income tax increases for high-income taxpayers in 2011. The tax rates would return to Clinton-administration levels of a 39.6 percent top marginal income tax rate and a 20 percent capital gain rate. Most tax experts expected the increase sooner. This notice gives advisers time to help their clients plan. Clients should review their portfolios for securities they plan to sell shortly after 2010 to consider selling securities with significant gains and immediately reinvesting in the securities before 2011. The wash sale limitations apply to losses, not gains. This strategy allows clients to avoid paying the additional 5 percent capital gain rate on securities they plan to sell in the next few years. Additionally, if someone is in the 10 percent or 15 percent tax rate bracket including the capital gains, they may be eligible for the 0 percent federal tax rate on the capital gains.

Conclusion

As the government tries to lead us out of this economic downturn, short-term tax opportunities will become available. We can provide an important service to our clients by keeping them informed of these changes and helping them with advantageous strategies.