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On February 17th, the American Recovery and Reinvestment Act of 2009 (the Stimulus Act) was signed into law by President Obama. As you know, the new legislation includes some federal income tax changes. However, you may not realize how many. This letter briefly summarizes what we think are the most important changes. That said, we encourage you to contact us for details because there are some new provisions that we simply don't have space to even mention here. We will start with changes that affect individuals and personal returns.

### Tax Changes for Individuals

**Refundable Making Work Pay Credit.** The Stimulus Act establishes the new *Making Work Pay* credit for 2009 and 2010. The credit amount equals the lesser of 6.2% of earned income or \$400 (\$800 for a married joint-filing couple). Since the credit is refundable, it can offset your entire federal income tax liability, including any Alternative Minimum Tax (AMT). Any leftover credit can be collected in cash or applied to your estimated tax payment obligation for the following year.

The credit is phased out (reduced or eliminated) by of 2% of your Modified Adjusted Gross Income (MAGI) in excess of the applicable threshold—\$75,000 for an individual taxpayer or \$150,000 for a married joint-filing couple. The \$400 individual credit is fully phased out when MAGI reaches \$95,000 and the \$800 married joint-filing credit is fully phased out when joint MAGI reaches \$190,000.

To get credit dollars into the economy quickly, the IRS has already released new federal employment tax withholding tables. The new tables will allow employees to collect credits in advance in the form of lower payroll tax withholdings for the rest of 2009. Self-employed individuals can collect credits in advance by reducing their quarterly estimated tax payments.

**One-time \$250 Economic Recovery Payment for Eligible Federal Program Recipients.** The new law provides a one-time \$250 *Economic Recovery Payment* to the following government program recipients.

- Adults eligible for Social Security benefits.
- Individuals of any age who are eligible for Supplemental Social Security Income (SSI) benefits (other than those who receive them while in a Medicaid institution).
- Adults eligible for Railroad Retirement benefits.
- Adults eligible for veteran's compensation or pension benefits.

To receive the \$250 payment, you must have been eligible for at least one of these programs for at least one month during the three-month period that includes

November and December of 2008 and January of 2009. Congress has ordered these government agencies to get these payments underway as soon as possible, but they must begin no later than the middle of June.

**One-time \$250 Refundable Credit for Eligible Government Retirees.** The Stimulus Act also provides a one-time \$250 credit to certain government retirees who won't qualify for the Economic Recovery Payment benefit. The money is delivered in the form of a refundable tax credit for 2009 of \$250 for each eligible individual or \$500 for a married joint-filing couple when both spouses are eligible individuals. To be eligible, you must pass all of the following three tests.

1. During the 2009 tax year, you receive any pension or annuity benefits for service as any employee of the U.S. or any state (or instrumentality thereof) that is based on wages that were not subject to FICA tax withholding at the time they were paid.
2. You are ineligible for the aforementioned Economic Recovery Payment benefit.
3. You report a Social Security Number (SSN) on your 2009 Form 1040. (If married, either you or your spouse must report an SSN on the return.)

Since the credit is refundable, it can offset your entire federal income tax liability, including any AMT. Any leftover credit can be collected in cash or applied to your 2010 estimated tax payment obligation.

**Temporary Sales Tax Deduction for Buyers of New Vehicles and Motor Homes.** The new law adds a new deduction for state and local sales and excise taxes paid on new (not used) (1) passenger autos and light trucks with gross vehicle weight ratings of 8,500 pounds or less, (2) motorcycles, and (3) motor homes purchased between 2/17/09 and 12/31/09. However, the deduction is limited to taxes allocable to the first \$49,500 of the purchase price. The amount will be claimed as an additional itemized deduction if you itemize. If you don't itemize, it will be added to your standard deduction.

The new standard deduction add-on or additional itemized deduction (whichever applies to you) is subject to phase-out provisions. The phase-out range is between MAGI of \$125,000 and \$135,000 for unmarried individuals and between MAGI of \$250,000 and \$260,000 for married individuals who file separately.

**Liberalized Higher Education Credit.** For 2009 and 2010, the Stimulus Act includes taxpayer-friendly modifications to the Hope Scholarship higher education tax credit. (The Hope credit is also temporarily renamed the American Opportunity credit, but we will stick to calling it the modified Hope credit for the sake of continuity.) Under the revamped rules, the modified Hope credit equals 100% of the first \$2,000 of qualified post-secondary education expenses paid during the year plus 25% of the next \$2,000. So the maximum annual credit is now \$2,500. Under prior law, the maximum Hope credit for 2009 was only \$1,800, and it probably would have been about the same for 2010.

The modified Hope credit covers the cost of tuition, fees, and course materials (but not room and board) for the first four years of post-secondary education in a degree or certificate program. It is unavailable for a year if the student has already logged in four years worth of academic hours as of the beginning of that year. Under prior law, the Hope credit was only allowed for the first two years of post-secondary study, and the cost of course materials did not count as a qualified expense.

The modified Hope credit is subject to phase-out rules, but they are considerably more lenient than the prior-law Hope credit rules. The modified Hope credit phase-out range is between MAGI of \$80,000 and \$90,000 for unmarried individuals and between MAGI of \$160,000 and \$180,000 for married joint-filers.

The modified Hope credit can offset your entire federal income tax liability, including any AMT. In addition, up to 40% of the modified Hope credit can be a refundable credit, which means you can get some cash back after reducing your federal income tax bill to zero.

**Temporary Homebuyer Credit Extended and Liberalized.** Legislation passed last year established a temporary refundable tax credit for first-time homebuyers. The Stimulus Act extends the credit for five more months, to cover qualified home purchases between 1/1/09 and 11/30/09. In addition, the maximum credit amounts are slightly increased for 2009 purchases. More importantly, the requirement to repay the credit over 15 years is deleted for 2009 purchases (but not for 2008 purchases).

For a qualified home purchase between 1/1/09 and 11/30/09, the maximum credit equals the *lesser* of: (1) 10% of the purchase price or (2) \$8,000 (\$4,000 if you use married filing separate status). Since the credit is refundable, it can offset your entire federal income tax liability, including any AMT. Any leftover credit can be collected in cash or applied to your estimated tax payment obligation for the following year.

Eligibility is restricted to individuals who have not owned a principal residence in the U.S. during the three-year period that ends on the home purchase date. If you are married, both you and your spouse must pass the three-year test.

If you make a qualified 2009 home purchase (between 1/1/09 and 11/30/09), you can choose to treat the purchase as having occurred in 2008. That allows you to claim the credit (which can be as high as \$8,000) on your 2008 return and receive the benefit that much sooner.

**Computer and Internet Costs—Qualified Expenses for 529 Plan Distributions.** The Stimulus Act counts computer costs (including peripheral equipment and software) and charges for Internet access and related services as qualified higher education expenses for purposes of receiving tax-free distributions from 529 plan accounts. This change applies to eligible expenses paid in 2009 and 2010. To be eligible, however, the expenses must be for computer and/or Internet use by the 529 account beneficiary (the student) during any of the years of enrollment in an eligible educational institution. No harm is done if the student's family also uses the computer and/or Internet access. The cost of software designed for sports, games, and hobbies won't qualify unless it's primarily educational in nature.

**One-year AMT "Patch".** The Stimulus Act includes another one-year "patch" to prevent millions of individuals from being hit with the dreaded Alternative Minimum Tax (AMT) for the 2009 tax year. The new law increases the AMT exemption amounts for 2009 to \$70,950 if you're a married joint-filer or a surviving spouse (up from \$69,950 for 2008), \$46,700 if you're unmarried (up from \$46,200), and \$35,475 if you use married filing separate status (up from \$34,975). Unfortunately, these exemptions are phased-out (reduced or eliminated) for higher-income taxpayers, and the new law doesn't make any changes in the phase-out rule. The Stimulus Act also includes changes that permit you to use all nonrefundable personal tax credits to reduce your 2009 AMT liability as well as your regular tax liability.

**AMT Exemption for Interest on Certain Private Activity Bonds.** Interest on public purpose municipal bonds (those issued by state and local governmental entities for public projects) is tax-exempt under both the regular tax and the AMT rules. However, interest on most qualified private activity municipal bonds (state and local government bonds issued for private sector projects like sports venues) has been taxable under the AMT rules (although tax-free under the regular tax rules). The Stimulus Act changes the landscape by making interest on all qualified private activity bonds issued in 2009 and 2010 exempt from the AMT. Therefore, interest on such bonds is exempt from both the regular tax and the AMT.

**Tax-free Treatment for First \$2,400 of 2009 Unemployment Benefits.** In general, unemployment compensation benefits count as income for federal income tax purposes. However, the Stimulus Act grants a one-year exemption for the first \$2,400 of unemployment compensation received in 2009. Unemployment benefits above the \$2,400 limit will still count as taxable income.

**Liberalized Employer-provided Transportation Fringe Benefit Rule.** Starting with March of this year and through December of 2010, the Stimulus Act increases the amount you can receive as a tax-free fringe benefit for employer-provided transit passes and van pooling. The maximum tax-free amount is increased to \$230. The \$230 limit applies to the value of transit passes and van pooling separately or together. Before this change, the 2009 limit for these benefits (separately or together) was only \$120.

**Hybrid Vehicle Credits Can Offset AMT Liabilities.** The new law includes another change that allows you to use your credit from buying a qualifying new hybrid or lean-burn diesel vehicle to offset your AMT liability as well as your regular tax liability. This favorable change is effective for 2009 and beyond.

**Residential Energy Credits Liberalized.** The Stimulus Act liberalizes the nonrefundable personal credit for up to 30% of expenditures to install: solar water heating equipment, wind energy equipment, geothermal heat pumps, solar electricity generation equipment, or fuel cell equipment in your home. The new law also extends (through 2010) and liberalizes the separate nonrefundable personal credit for expenditures to install energy-efficient insulation, windows, doors, roofs, and heating and cooling equipment in your residence. Most importantly, the previous lifetime limit of \$500 was replaced with an aggregate \$1,500 cap for 2009 and 2010.

### **Business and Other Tax Changes**

**Generous Section 179 Deduction Rules Extended.** The Stimulus Act extends the \$250,000 Section 179 first-year depreciation deduction allowance by one year, through tax years beginning in 2009. Without this change, the maximum Section 179 deduction would have been only \$133,000. The new law also extends the \$800,000 phase-out threshold for reduced Section 179 deductions. Without this change, the threshold would have been only \$530,000.

**First-year Bonus Depreciation Extended.** The Stimulus Act extends the 50% first-year bonus depreciation break to cover qualifying new (not used) assets that are placed in service by no later than 12/31/09. However, the deadline is extended through 12/31/10 for certain longer-lived assets, transportation equipment, and aircraft.

For a new passenger auto or light truck that's used for business and is subject to the luxury auto depreciation limitations, the extended bonus depreciation break increases the maximum first-year depreciation deduction by \$8,000 for vehicles

placed in service by 12/31/09. The estimated maximum first-year depreciation deduction for 2009 is now \$10,960 for new cars and \$11,060 for new light trucks.

**Corporate Election to Claim Credits Instead of First-year Bonus Depreciation Extended.** Prior law allowed corporations that are otherwise eligible to claim 50% first-year bonus depreciation to elect to forego bonus depreciation and instead “free up” otherwise unusable R&D and minimum tax credit carryovers. Credits freed up by this election are refundable. However, the election was only available with respect to bonus depreciation on qualified assets that were: (1) purchased after 3/31/08 and (2) placed in service by 12/31/08 or by 12/31/09 for certain longer-lived assets, transportation equipment, and aircraft. The Stimulus Act extends the two placed-in-service deadlines by one year to 12/31/09 and 12/31/10, respectively.

**Note:** Making the election doesn’t result in any lost depreciation deductions. It just postpones depreciation deductions for affected assets.

**Longer Carryback Period for 2008 Losses (Small and Medium-sized Businesses Only).** The new law allows eligible businesses to elect to carry back 2008 Net Operating Losses (NOLs) for three, four, or five years to obtain refunds of taxes paid for those years. This is a favorable (but temporary) exception to the general two-year NOL carryback rule. The election is only available for losses generated by businesses with average annual receipts of \$15 million or less.

For calendar-year taxpayers, the election is available for NOLs generated in calendar-year 2008. For fiscal-year taxpayers, the election is available for NOLs generated in tax years that either begin in 2008 or end in 2008. (A fiscal-year taxpayer can make the election for one year or the other—but not both.)

**No Corporate ACE Adjustment for Interest on Tax-exempt Bonds Issued in 2008 and 2009.** C corporations affected by the corporate AMT rules generally must include tax-exempt interest as income in calculating the Adjusted Current Earnings (ACE) adjustment for AMT purposes. The Stimulus Act deletes the ACE adjustment for tax-exempt interest on bonds issued in 2009 and 2010.

**Government Contractor Withholding Rule Delayed until 2012.** The Stimulus Act delays by one year a controversial provision that will eventually require 3% federal income tax withholding from certain payments to government contractors. The withholding rule is now scheduled to apply to payments made in 2012 and beyond. Before this change, it was to apply to payments made in 2011 and beyond.

**Debt Discharge Income from Reacquiring Debt in 2009 and 2010 Can Be Deferred.** The new law allows a business that reacquires its own debt at a discount to elect to defer the resulting taxable debt discharge income and then spread it out over five years. This election is available with respect to debt discharge income that results from debt reacquisition transactions that occur in 2009 and 2010. The intent is to allow struggling businesses to restructure their debts in a tax-favored fashion.

Pursuant to the election, debt discharge income from a debt reacquisition that occurs in 2009 is deferred until the fifth tax year after the tax year in which the reacquisition occurs (2014 for a calendar-year taxpayer). The income is then spread evenly over five tax years beginning with that fifth year (2014–2018 for a calendar-year taxpayer). Debt discharge income from a reacquisition in 2010 is deferred until the fourth tax year after the tax year in which the reacquisition occurs (2014 for a calendar-year taxpayer), and the income is then spread evenly over five tax years beginning with that fourth year (2014–2018 for a calendar-year taxpayer).

**Break for S Corporation Built-in Gains in 2009 and 2010.** When a regular C corporation converts to tax-favored S corporation status, the corporate-level built-in gains tax generally applies when built-in gain assets (including receivables and inventories) are turned into cash or sold within the *recognition period*. The *recognition period* is the 10-year period that begins on the conversion date.

The Stimulus Act establishes an exception for built-in gains recognized in S corporation tax years beginning in 2009 and 2010 if the seventh year of the recognition period has gone by before the beginning of the tax year beginning in 2009 or 2010. Gains that fall under this exception won't be hit with the built-in gains tax.

**Liberalized Small Business Stock Sale Rules for New Issues.** Sellers of qualified small business corporation (QSBC) shares can potentially exclude up to 50% of the resulting gains from federal income taxation (subject to several limitations). To encourage new investments in QSBC stock, the Stimulus Act increases the gain exclusion percentage from 50% to 75% for qualifying sales of QSBC shares that are issued between 2/18/09 and 12/31/10.

**Work Opportunity Credit Rules Liberalized.** The Work Opportunity Tax Credit (WOTC) is intended to give employers a tax incentive to hire members of certain targeted groups. The new law adds unemployed veterans and disconnected youths as new targeted groups. This change applies to unemployed veterans and disconnected youths who begin work for electing employers in 2009 and 2010.

**COBRA Premium Subsidy.** Group health plans maintained by employers that have at least 20 employees are required to offer certain employees and their dependents the opportunity to continue to participate in the group health plan for up to 18 months. This is referred to as COBRA continuation coverage. The Stimulus Act provides for a 65% government-provided subsidy for COBRA continuation payments for up to nine months to Assistance Eligible Individuals (AEIs) for periods of coverage beginning on or after 2/17/09. Although this subsidy is provided by the government, AEIs will pay 35% of their COBRA premiums with the remaining 65% being paid by the former employer, who is effectively reimbursed for these payments by a reduction in payroll taxes.

An *AEI* is an employee (and COBRA eligible family members) whose employment has been involuntarily terminated between 9/1/08 and 12/31/09 and who elects COBRA coverage. AEIs who were involuntarily terminated after 8/31/08 and before 2/17/09 and did not enroll for COBRA benefits at the time of their termination, have a special extended 60-day period in which to elect COBRA benefits. They can make the COBRA election during the period beginning on 2/17/09 and ending 60 days after the date on which their former employer provides them the notice regarding the extended election period.

We ask you to contact us if you want additional information or if you have questions. We will be pleased to help.

- Stapp Financial Planning, PLLC