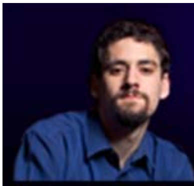
The Kitces Report
Advancing knowledge in financial planning... March 2009

Tax Planning Developments and Opportunities of the American Recovery and Reinvestment Act of 2009

On February 17th, 2009, the President signed the American Recovery and Reinvestment Act of 2009 (ARRA 2009). This so-called "stimulus bill" was designed to provide a broad range of economic stimulus, ranging from investments in infrastructure, and assistance to state governments, to numerous tax relief provisions.

In this month's newsletter, we explore the most significant of the individual tax planning provisions that have emerged from the ARRA legislation, ranging from the new Making Work Pay credit, the reformed American Opportunity [education] Tax Credit, to AMT relief and additional tax incentives for the purchase of both new homes and automobiles.

Tax Developments under ARRA

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Introduction

ARRA is estimated to provide a total of approximately $280 billion in tax relief - roughly 35% of the total cost of the bill - and its tax provisions are primarily front-loaded into the first two years (2009 and 2010). Consequently - as has been common for many of the tax incentive and relief legislation in recent years - the limited time period for which many of these provisions will operate requires clients to act promptly and efficiently to maximize their tax planning opportunities.

First-Time Homebuyer Tax Credit

Technical Provisions

The first-time homebuyer tax credit was originally created under the Housing Assistance Tax Act of 2008, and provided certain homebuyers the opportunity to receive a $7,500 tax "credit" of up to 10% of the amount paid for purchases made after April 8th, 2008, and before July 1st, 2009. Under the original law, though, the credit received would actually be recaptured ratably by the government over 15 years, starting in the second year after the purchase. Consequently, a taxpayer who purchased a home in 2008 and received the $7,500 tax credit, would be required to repay the government $500/year for 15 years starting in 2010 until the credit had been fully repaid - which in practice, made the first-time homebuyer tax credit operate more like an interest-free loan from the government than an actual credit.

Under the new provisions of ARRA, the existing first-time homebuyer tax credit is both expanded and extended from its original framework. The maximum amount of the credit (still calculated as 10% of the purchase price) is increased from $7,500 to $8,000, and the 15-year recapture/repayment rules are eliminated entirely, converting the amount from a quasi-credit/loan into a full value $8,000 tax credit. The maximum credit of $8,000 applies both for single individuals and

married couples (i.e., the amount for couples is not any higher than for single individuals); the credit is reduced to $4,000 for those who are married individuals filing separately. Notably, the credit is allowed for both regular tax and AMT purposes, so taxpayers will be eligible to claim the credit regardless of whether or not they are subject to the AMT. In addition, the tax credit is refundable; consequently, if the size of the tax credit exceeds the individual's tax liability for the year, the total tax liability will be reduced to $0 and the excess will be sent as a tax refund back to the individual.

Under the original rules, the first-time homebuyer credit would only apply to purchases completed by July 1st, 2009 (measured as of the date that the transaction closes and title is transferred to the new owner; if the property was new construction, the applicable date was when the taxpayer first moved in and actually occupied the residence). With the new rules, any purchase completed (still measured in the same manner) before December 1st, 2009, will be eligible for the credit. Notably, the higher credit amount, and the waiver of the credit repayment provisions, will technically apply to any purchase that occurs from January 1st, 2009 through November 30, 2009, which includes those who completed an eligible home purchase during the first 6 weeks of the year before the new law was passed. However, any purchase completed in 2008 will still be subject to the 2008 rules, both with respect to the maximum $7,500 credit amount and the requirement for repayment.

Although the credit is labeled as being for a "first-time" homebuyer, in reality the rules stipulate that anyone who has not had a present ownership interest in a principal residence for the three years preceding the purchase date will be eligible for the credit. (For a married couple to be eligible for the credit, *neither* of them may have had an ownership interest in the preceding three years, even if they choose to file separately.)

The credit is not available if the residence is purchased from someone who is related to the buyer. In this case, "related" would include purchases from a spouse, ancestor (e.g., parents, grandparents), or a lineal descendent. (Notably, siblings are not included as a "related party" in this case; nor are uncles, aunts, nieces, nephews, or cousins.) In addition, a purchase transaction between an individual and his/her controlled business, or a transaction between an individual and many types of trusts, would be disqualified. Furthermore, if the property was acquired via a gift or inheritance, the transaction is not treated as a purchase and is therefore not eligible for the credit.

The credit is also not available for nonresident aliens, nor to any individual who also claims the Washington D.C. first-time homebuyer tax credit; consequently, a Washington D.C. first-time homebuyer would likely choose to waive his/her claim on the D.C. homebuyer credit to utilize these more favorable provisions instead. (Notably, additional restrictions applied for those who tried to use the 2008 version of the first-time homebuyer credit).

In addition to the above restrictions, the credit is also subject to a phaseout based on AGI. For individuals, the credit phases out ratably from $75,000 to $95,000 of AGI; for a married couple, the phaseout range is from $150,000 to $170,000. (For purposes of this calculation, AGI also includes any foreign earned income exclusions, as well as any income excluded from American Samoa or Puerto Rico.)

If the property is purchased and subsequent sold (or ceases to be used as a principal residence) by the end of 2009, the taxpayer will not be eligible to claim the credit in the first place. If the property is held past the end of 2009, but within 36 months of the purchase date is either sold or the individual otherwise ceases to use the property as a principal residence (e.g., if the taxpayer moves into a new/second/other property and makes that the primary residence instead), the credit must be repaid. The repayment cannot exceed the amount of gain from the sale of the property (consequently, if there is no gain on the subsequent sale, there will be no repayment requirement). However, when calculating gain, the amount of the credit must be subtracted from the cost basis. Thus, for example, if an individual purchased a home for $100,000 and received an $8,000 credit, the cost basis for credit repayment purposes is $92,000; if the home is subsequent sold for $95,000 (a $5,000 loss from the original purchase price), there will still be a $3,000 credit recapture (the excess of $95,000 over the "modified" basis of $92,000). Notably, though, for capital gains tax purposes, the cost basis of the property will still be $100,000, the amount actually paid for the purchase. These repayment provisions will not apply if they were triggered due to an individual's death, nor if the primary residence was destroyed as long as a replacement property is acquired within 2 years. If the property is transferred pursuant to a divorce, the spouse who receives the property will be subject to the recapture rule if it is sold or ceases to be a primary residence in the future (although the divorce transfer itself will not trigger these rules).

Where a property is jointly purchased by two unmarried individuals (who would both otherwise be eligible to claim the first-time homebuyer credit), the IRS indicates that the credit is still only $8,000 total, but may be allocated between the buyers using "any reasonable method." This would apply in any joint purchase situation where the individuals are eligible, whether friends or siblings who co-purchase a property, or same-sex or unmarried domestic partners. The IRS's guidance indicates that reasonable methods include splitting the credit based on the contributions towards purchase (e.g, if you pay 55% of the purchase price, you claim 55% of the credit), or based on the ultimate ownership interest (e.g., if you end out owning 50% of the residence, you claim 50% of the credit). Notably, the IRS even indicates that if one taxpayer would be eligible for the credit and the other wouldn't (e.g., because the second individual's income exceeds the phaseout thresholds), that it would be a "reasonable" method for the first taxpayer to claim the entire credit and the second taxpayer to claim none because only the first taxpayer was eligible. However, both buyers must contribute in some way towards the purchase price (i.e., by cash paid or by taking a loan to contribute towards the purchase) to be eligible for the credit; consequently, having one individual make the entire purchase, and simply gift a 50% interest in the property to a second individual, does not mean that the second individual would be eligible to claim any of the credit. (See IRS Notice 2009-12 for further guidance on allocating the credit.)

Individuals who make a first-time homebuyer purchase in 2009 also have the option of choosing to claim the credit as though the purchase was made on December 31, 2008, in order to claim the credit on their 2008 tax return (and calculated based on their eligibility using 2008 income). Even if this election is made, the home will still be treated as having been purchased in 2009 for the purposes of all the other rules (e.g., 36-month recapture) described above. If the election is made after the 2008 tax return has already been filed, the individual may choose to file an amended return to seek a tax refund.

Planning Implications

Relative to the first-time homebuyer credit that was enacted in 2008, this new version of the credit represents a significant enhancement with far greater economic value. Although the maximum credit amount was increased from 10% of the purchase price up to a maximum of $7,500, to a new maximum of $8,000, the far-greater impact is the removal of the repayment provisions - converting the program from the equivalent of an interest-free loan into a bona fide credit subsidy towards a home purchase. As was discussed in the August issue of *The Kitces Report* when this credit was first introduced, the true economic value of the original provision was approximately $3,500 (the present value of the 15-year interest-free loan), whereas the new rules provide an outright $8,000 credit.

Because the credit is calculated as 10% of the purchase price, up to $8,000, any purchase greater than $80,000 will result in the maximum credit being available; this is likely to apply in the overwhelming majority of client situations in most areas of the country. Although an $8,000 credit may still not be a tremendous incentive to purchase in some of the more expensive areas of the country, in many parts the opportunity to receive an $8,000 credit may materially impact a client's decision to purchase.

However, due to the fact that the amount of the incentive is received as a tax credit, clients will still need to have sufficient funds available at closing in order to purchase a property (through some combination of financing and available cash), and should not rely on using the amount of the credit as funds available for closing the transaction. Nonetheless, ultimately receiving back $8,000 in the form of a Federal tax credit provides the client a "cushion" against losses in the property before his/her personal balance sheet is impaired, and/or helps to support funds used for a down-payment. In some cases, clients may even consider obtaining additional financing (e.g., borrowing money from family) for a purchase with the intent of using the $8,000 credit, when received, to quickly retire the extra debt. It is notable that some states have also created tax incentives to encourage

Out and About

- Michael will be presenting "Valuation and Safe Withdrawal Rates" at the FPA Retreat conference on April 28th

- Michael will also speaking at the Mokan Trust & Financial Services Regional Conference on May 7th on "Understanding the Credit Crisis"

- Michael will also be presenting "Rethinking Risk Tolerance" at FPA NorCal in San Francisco, CA, on May 26h

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home purchases; thus, in some situations, the total incentives for a client may be even higher and have a greater impact on an outright purchasing decision.

However, because there is an AGI phaseout limitation, the credit will not apply to all clients. For some clients, their income level will simply render them ineligible for the credit; for others, additional tax planning steps may be desirable to keep the client's AGI low, in order to qualify for the credit or avoid phasing it out completely. Clients who find themselves ineligible for the credit based on their 2009 income may also wish to make the election to claim the credit for 2008; if the home has already been purchased in the early months of the year, the client may simply make the election now as the 2008 tax return is filed. If the home is purchased later in the year, the client will need to file a timely tax return and later file an amendment; although there is likely some professional services cost for a client to receive assistance filing an amended tax return, if it provides the opportunity for the client to more fully claim an $8,000 tax credit it will likely be viewed as desirable in most situations. Alternatively, for some clients who are eligible in both 2008 and 2009, it may be desirable to make the election to claim the credit in 2008 simply to receive its value sooner, rather than waiting until the 2009 tax return is filed in the early months of 2010. On the other hand, clients should be cautious not to make the election to claim the credit in 2008 if their income would actually cause some or all of the credit to be phased out anyway.

Clients should still be cautious about utilizing the credit if related parties are involved. Congress had originally sought to reduce potential abuses of the new tax credit for intra-family transactions when the rules were first passed in 2008, and these restrictions still apply. Consequently, clients should not try to obtain the credit by purchasing a property from someone on the aforementioned list of “related parties,” or the purchase will not be eligible. In addition, the residence cannot be sold at a loss to a related party, in an attempt to avoid the 36-month recapture rules. Notably, though, “family members” for the purposes of these rules do not include siblings, cousins, aunts, uncles, nieces, and nephews, so some family-based transactions will not automatically run afoul of the rules simply by virtue of being "family."

In addition, the rules for the credit still retain the original flexible provisions that allow for the opportunity for the joint purchases of two unmarried individuals to still share in the tax credit. This may be relevant for same-sex couples, as well as opposite-sex unmarried couples, or even just siblings or friends who choose to share in the purchase of a primary residence; it may be also relevant in some family situations, such as a joint purchase between parent and child (as long as they aren’t purchasing *from* a related party). Although a single credit amount must be shared between the parties, it is still available to them, and the IRS has indicated a great deal of latitude in determining how to allocate the amount of the credit between the individuals to maximize its value. However, it is important to remember that both parties should be bona fide purchasers in the transaction; a joint purchase that it nothing more than a single individual making a 100% purchase and gifting part of the property to another joint owner will not allow the joint owner to claim the credit.

Clients must also be cautious not to accidentally run afoul of the rules that allow them to claim and keep the credit in the first place. As was discussed earlier, the label "first time" homebuyer credit is a bit of a misnomer, since clients may have in fact owner a home in the past - as long as it wasn't in the 3 years preceding the new purchase date - and in fact might even *currently* own real estate as long as it is a rental property, vacation property, and/or has otherwise *not* been a primary residence at any point in the past 3 years. In the case of clients who have had a prior primary residence, though, care should be taken to not accidentally fail to reach the required 3-year window before the new purchase; this is turn must be balanced against the requirement that the new purchase must be completed by November 30th, 2009, until/unless the credit is further extended. And as mentioned earlier, if the client currently has a property under construction, it will be important to actually *move in* by November 30th to be eligible for the credit.

Because of the 3-year holding requirement in which the credit can be recaptured, clients should not view this credit as an opportunity for a quick-turnaround real estate investment (at least, not if the client hopes to actually keep the amount of the credit). Notably, the current rules also apply the 3-year requirement as an all-or-none provision; if the client sells the property after only 2.7 years, 100% of the credit must be refunded even though the property was held for 90% of the time period.

Clients that are resolving the ownership of a primary residence due to a divorce should also be especially cautious. As discussed earlier, if the residence is transferred pursuant to a divorce, the 36-month recapture provisions for the credit are *not* triggered. However, the risk of credit recapture *goes with the residence* after the divorce! Consequently, in a situation where spouse A provided the original money to

purchase the residence, but spouse B receives the residence in the divorce, spouse B will be responsible for any credit recapture if the property doesn't remain as a primary residence until the end of the original 36-month period. Thus, if a property is transferred to a spouse who does not intend to stay in the property, it may be desirable as a part of the divorce agreement to adjust for the fact that the recipient spouse will face the full impact of the $8,000 credit repayment.

On the other hand, for clients who are getting married, it is important to remember that if *either* spouse has had a primary residence in the 3 years preceding the purchase date, the married couple will be ineligible for the credit. For some couples who plan to get married and purchase a house, this may affect the decision about whether to get married in 2009 or 2010, in the situation where one spouse would qualify for the credit and the other would not. If the couple marries in 2010, the eligible member of the couple can purchase the property in 2009 and claim the full amount of the credit; if the couple marries in 2009, the ineligible spouse may render the credit unavailable for both of them. Although many couples will not have their wedding date guided by some mundane tax planning concerns, nonetheless for some couples who also plan to buy a house, the difference between a 2009 and 2010 wedding date could be an $8,000 wedding present from Uncle Sam.

Overall, this expanded version of the first-time homebuyer credit will not likely be the driving factor in persuading a client to make a "first" home purchase, but it may nonetheless be a helpful amount of savings for some clients and a material impact in areas with lower real estate costs. In addition, the current version of the credit is far more economically valuable than the preceding one, and its extension allows clients an opportunity through November 30, 2009, to take advantage of the new rules. In any event, clients who are eligible to take advantage of the credit should certainly do so, and at the margin may find it desirable to take the additional steps necessary to ensure that the full amount of the credit can be received.

Sales Tax Deduction for Vehicle Purchases

Technical Provisions

Under the new rules for ARRA, taxpayers will be able to deduct the state and local sales and excise taxes paid on the first $49,500 of a new vehicle purchase. The new rules apply to any vehicle purchase that occurs on or after February 17th, 2009 (when the legislation was signed into law), and through the end of the year (December 31).

The deduction applies to the purchase of a "qualified motor vehicle," which includes:

- Passenger automobile, light truck, or motorcycle with a gross vehicle weight rating that doesn't exceed 8,500 pounds
- Motor home

For either type of qualified motor vehicle, the vehicle purchased must have "original use that begins with the taxpayer" - in other words, only a "new" vehicle where the buyer will be the first/original user is eligible for the deduction.

The deduction can be claimed as either an itemized deduction, or as an addition to the standard deduction (i.e., the taxpayer can receive the deduction even if the standard deduction is chosen). If the vehicle taxes are claimed as a deduction, they cannot be included in the cost basis of the vehicle purchase. The deduction applies for under both the regular and AMT tax rules, and will apply for AMT purposes regardless of whether it is claimed as an itemized deduction or an addition to the standard deduction.

The vehicle sales tax deduction will be phased out ratably from $125,000 to $135,000 of modified AGI (the phaseout range is $250,000 to $260,000 for married couples). Any income that was excluded from sources within American Samoa or Puerto Rico or because of the foreign earned income and housing cost exclusion rules for U.S. citizens living abroad, must be added back to AGI to calculate the phaseout amount.

Notably, many taxpayers could already claim at least a partial deduction for vehicle sales taxes under the more generalized itemized deduction for state and local sales taxes paid. (Under existing law in 2009, taxpayers have the choice to claim a deduction for state and local income taxes paid, or state and local sales taxes paid.) Consequently, to avoid "double counting" a deduction, if the taxpayer claims the new vehicle sales tax deduction, then the general state and local sales tax deduction may *not* be claimed (thus, the taxpayer would be required to utilize the state and local income tax deduction, in combination with the new vehicle sales tax deduction).

Additional guidance will likely be forthcoming from the IRS and the Treasury to clarify some ambiguities that do exist under the new law. Most notably, it is not yet

clear whether a taxpayer can qualify for multiple vehicle deductions in the same year, whether because an individual purchases multiple vehicles, or because a married couple each purchases a new qualifying vehicle in 2009.

Planning Implications

As with most tax deductions, the introduction of the vehicle sales and excise tax deduction is not likely, on its own, to drive someone out to make a new car purchase. For instance, assuming a sales tax rate of 6%, and a marginal tax bracket of 30%, in the end the new deduction will only reduce the actual cash cost of a vehicle by 6% x 30% = 1.8%, or about $180 of savings for each $10,000 of vehicle cost.

Nonetheless, maximizing any tax benefits available is virtually always desirable for clients, and for those who already were considering a car purchase, any additional savings will be welcomed. For most clients, this will require nothing more than simply being certain to maintain documentation of the sales and excise taxes paid on the car purchase, so that the deduction can be substantiated during tax season in early 2010. The overwhelming majority of typical vehicle purchases will satisfy the vehicle weight requirement, and the client simply needs to be certain that a "new" car is purchased (a purchase where the "original use" of the car begins with the client). And in point of fact, the new rules will already apply to any client car purchases that have occurred since February 17th.

Of course, from a broader economic perspective, it is still notable that many planners advocate purchasing used cars instead of new cars, because the depreciation of value for new cars is so severe in the first few years. Viewed in this manner, the introduction of a sales tax deduction for new vehicle purchases will be little incentive, because an actual cash cost savings of "only" about 1.8% (depending on tax assumptions) will mean that there is still *far* more cost savings by simply purchasing a used car in the first place. Thus, the new deduction should be treated as a tax savings for buying a new car, but not an outright material incentive to buy a new car *in lieu of* a used one.

It is also notable that the new rules do *not* specify that the vehicle must be purchased from any manufacturer in particular (i.e., the deduction is *not* restricted to only vehicles from Ford or GM, or that are built domestically). Any vehicle that meets the type, weight, and original use requirements will be eligible for the deduction.

For some clients, though, the greatest complication will come during tax season when it is time to determine whether to claim the vehicle sales tax deduction, or the more general state and local sales tax deduction. As indicated earlier, taxpayers may claim one or the other, but not both. For the majority of taxpayers, the state and local income tax deduction is already larger than the state and local sales tax deduction; consequently, the client will claim the state income tax deduction, and will then separately claim the new vehicle sales tax deduction.

However, for clients who live in states that have little or no state income tax deduction, where the state sales tax deduction will likely be the default (e.g., Florida, Texas, Alaska, Nevada, Washington, Wyoming, and a few others), the decision-making process becomes more complex. For some clients, the vehicle deduction will be more desirable, especially if there is at least a modest state or local income tax deduction, if the vehicle tax rate is high (because the broader state sales tax deduction caps the vehicle tax deduction to only the state's general tax rate, even if the vehicle rate is higher), if the individual's income is so low that the IRS tables for the state sales tax deduction would yield little benefit, if the client claims the standard deduction, or if the client is subject to the AMT. On the other hand, some clients may find that the more general state sales tax deduction is preferable, especially if a large portion of the vehicle purchase cost is above the $49,500 limit or the client's income exceeds the AGI phaseout thresholds (there is no purchase price limitation or AGI phaseout for claiming automobile sales taxes as part of the general sales tax deduction). Overall, the frequency of clients claiming the state and local sales tax deduction will likely decrease slightly, given that there is now a separate automobile sales tax deduction that can be claimed even for those who deduct state and local income taxes.

On a final note, the new rules for the vehicle sales tax deduction also make tax preparation slightly more complex for those who claim the standard deduction. This new deduction, as with the real property sales tax deduction established in 2008 (for further information, see the August 2008 issue of *The Kitces Report*), is a separate line item deduction available for those who are claiming the standard deduction. Thus, while just a few years ago the standard deduction was intended for those who didn't wish to itemize and track individual deductions, its "simplification" value is somewhat diminished as taxpayers must now track, claim, and

substantiate yet another deduction, even when *not* choosing to itemize deductions.

American Opportunity Tax Credit

Technical Provisions

As a part of the education incentives reform originally promised during President Obama's campaign trail speeches, ARRA has reformed and renamed the Hope Scholarship credit into the newly expanded "American Opportunity Tax Credit."

The new version of this education credit increases the amount of the credit to 100% of the first $2,000 of qualified tuition and related expenses paid in the current tax year, plus 25% of the next $2,000, resulting in a maximum credit of $2,500 (the former version of the Hope Scholarship credit {inflation-adjusted for 2009} provided 100% of the first $1,200 and 50% of the next $1,200, up to a maximum credit of only $1,800).

In addition, the expenses eligible for the credit as "qualified tuition and related costs" (e.g., tuition and associated fees) will now include course materials, expanding the range of expenses that may leave someone eligible to claim the credit. Expenses paid on behalf of the individual, individual's spouse, or the individual's tax dependents may be eligible to apply towards claiming the credit.

The availability of the new education credit itself is also significantly expanded under ARRA. Unlike the Hope Scholarship credit, which was applicable for only the first two years of post-secondary education, the American Opportunity tax credit will be available for the first four years of such education expenses. In addition, the $10,000 phaseout range is increase from a starting point of $50,000 of AGI under the Hope Scholarship credit to $80,000 for the American Opportunity tax credit (the starting point for the $20,000 phaseout range for married couples is increased from $100,000 to $160,000).

The new rules also explicitly stipulate that the American Opportunity tax credit will be allowed for AMT purposes as well (although the Hope Scholarship was already allowed for AMT purposes in 2009 as a result of separate AMT relief provisions). However, the education incentive coordination provisions still apply - consequently, if the American Opportunity tax credit is claimed for a student in a particular year, the taxpayer cannot also claim the Lifetime Learning credit or the above-the-line education deduction for that same student in the same year. In addition, expenses must be paid with after-tax dollars to be eligible for the credit; expenses that are paid via withdrawals/distributions from 529 plans or Coverdell Education Savings accounts are not eligible to count towards the American Opportunity tax credit.

Notably, if the new American Opportunity tax credit results in a negative tax liability for an individual (i.e., the amount of the credit is actually larger than the taxpayer's entire remaining tax liability before applying the credit), up to 40% of the credit will be refundable. As a result, the American Opportunity tax credit can actually result in a (larger) tax refund for some clients who otherwise have a low tax liability before claiming the credit. However, the refundability of the credit will not apply if it is for a child who would be subject to the so-called "kiddie tax" (i.e., a child under age 18, or a full-time student under age 24 who does not have earned income equal to at least one half of their support, if no other kiddie tax exceptions apply).

Unfortunately, though, the new American Opportunity tax credit rules will only apply for 2009 and 2010. After 2010, the new version of the credit will lapse, and the prior Hope Scholarship rules will return. Consequently, the American Opportunity tax credit will only apply for education expenses associated with academic periods that begin in 2009 or 2010, and the expenses must actually be paid in those tax years to be eligible. In addition, because the American Opportunity tax credit will only apply for two years, it was not created with any automatic inflation adjustments (i.e., the maximum credit amounts and phaseouts will be the same in 2010 as they are in 2009).

Planning Implications

As mentioned earlier, expanding and reforming the tax incentives and support for education under the tax code was a part of campaign trail promises made by President Obama, and the American Opportunity tax credit appears to be the first step down this road. At this point, the new rules do little to actually simplify the education incentive process - clients must still navigate amongst the Lifetime Learning credit, the above-the-line education deduction, 529 plans, Coverdell Education Savings account, and more, in addition to the newly expanded American Opportunity tax credit.

Nonetheless, the expansion of the credit and increase in the limits does lead to some simplification, because it will make it far less likely that taxpayers will wish to

claim the Lifetime Learning credit or the above-the-line education deduction. For instance, because the size of the new credit is larger than the Lifetime Learning credit, and is dollar-for-dollar for the first $2,000, and has a higher AGI phaseout level (the Lifetime Learning credit maintains its original phaseout thresholds), taxpayers will find the American Opportunity tax credit more desirable in virtually all situations where it can be claimed. Similarly, due to income phaseout levels, the above-the-line education deduction - a maximum deduction of $4,000 - will only be applied against income in the 10%, 15%, 25%, or possibly 28% tax bracket, yielding at most a tax savings of $4,000 x 28% = $1,120, which is far less than the benefits of the American Opportunity tax credit. Consequently, most clients will have no reason to consider claiming the Lifetime Learning credit or the above-the-line education deduction, unless the student has already completed four years of post-secondary education and would simply be ineligible for the American Opportunity tax credit (while still being potentially eligible for one of the other options).

At a maximum credit of $2,500 for the first $4,000 of education expenses, the new American Opportunity tax credit is likely to be a help, but not a material factor, for families that wish to send children to private colleges (where the average cost for tuition and fees alone is over $25,000). However, according to statistics from the College Board, approximately 56% of students are enrolled at four-year colleges and universities where the cost for tuition and fees is less than $9,000, and 38% of full-time students attend institutions with total tuition and fees of $3,000 to $6,000 per year. Only 9% of all students actually attend colleges with tuition and fees that exceed $33,000 per year. Thus, the American Opportunity tax credit may in fact be a very material cost savings for a large number of students, especially in the 3rd and 4th years of college (when previously the student would have been required to use the Lifetime Learning credit) and/or where the tuition and fees wouldn't have been high enough under the old rules to maximize the Lifetime Learning credit.

In addition, the American Opportunity tax credit will also result in a significant savings for families who have multiple children in college at the same time. Under the existing rules, the Lifetime Learning credit is limited to being claimed once per family tax return - consequently, for example, if a family had twins who were both in their 3rd year of college, the family would be restricted to claiming only one Lifetime Learning credit for the expenses of both students (who would also have been ineligible for the Hope Scholarship credit at that point). Under the new rules, the family could claim the American Opportunity tax credit for each student, receiving a larger tax credit than the Lifetime Learning credit, and receiving it for *both* students instead of just one; in point of fact, if this family had a 3rd child who was in graduate school, the family would now be able to claim to American Opportunity tax credits (for the two college juniors) *and* a Lifetime Learning credit (for the child in graduate school), instead of previously being restricted to one Lifetime Learning credit in the aggregate. That's a potential total of $7,000 of tax credits for this family with three children in college, instead of only $2,000.

The expanded American Opportunity tax credit is not likely to overshadow the benefits of using Coverdell Education Savings accounts or 529 plans, especially for families saving for private college education costs that are far greater than the tax credit. Nonetheless, families should plan to cover at least a portion of their annual child education costs from taxable accounts to be eligible to claim the generous credit - which returns in tax credits $2,500 (62.5%!) of the first $4,000 of expenses paid from a taxable account. Any costs that exceed the amounts necessary to claim the credit can then be funded from tax-favored education savings accounts.

In a preemptive effort to keep families from trying to shift money just to claim the tax credit on behalf of a child in order to receive the 40% refundable amount, the new rules do stipulate that a child who would be subject to the kiddie tax rules cannot claim a refund for the American Opportunity tax credit (even if there was no actual kiddie tax due). Nonetheless, for families where the child is able to avoid the scope of the kiddie tax - most commonly, because the child actually does have earned income equal to at least one-half of their own support needs - allowing the child to pay college expenses and claim the credit and the refund will be desirable. In such situations, it will likely be so favorable to have the child receive the credit and claim the refund amount that families may seek to gift assets to the child if the child does not have available assets to pay the education expenses. Nonetheless, the opportunity for this strategy will likely be severely limited for most families, whose college-attending children simply do not have sufficient earned income to avoid the kiddie tax rules (which render most such gifting strategies moot for college tax credit purposes). Still, such gifting strategies - even without the refundability of the credit - may be desirable if the parents are ineligible for any of the education credits due to high income (even with the new higher AGI phaseout limits for the American Opportunity tax

credit), while the child might be eligible to claim the credit on their own tax return.

It is notable as well that as a part of the new legislation, Congress has directed the Treasury to further study other aspects of the education tax credit system, including: how to coordinate higher education credits with Federal Pell grants; how to expedite the delivery of the higher education credit (for some families, the fact that you must pay the entire college expense up front and claim the credit on your tax return later is still a financial hardship); and the feasibility of requiring community service as a condition for making tuition and expenses eligible for higher education tax credits. The results of these studies from the Treasury will be due back to Congress by February 17th, 2010 (one year from the date the legislation was passed). Whether or to what extent the higher education system of tax credits is reformed further in light of this research remains to be seen.

Making Work Pay Credit & Payment to Seniors

Technical Provisions

In pursuit of completing another campaign trail promise, the new ARRA legislation also includes President Obama's proposed "Making Work Pay" credit, in addition to a stimulus check payment to seniors who generally wouldn't be eligible for the credit.

The new Making Work Pay credit provides an income tax credit equal to the lesser of 6.2% of the taxpayer's earned income, or $400 (increased to $800 for a joint return). Thus, the Making Work Pay credit effectively provides a savings of 6.2% on the first $6,452 of earned income (or $12,903 of earned income for joint returns). “Earned income” is income earned from employment, including wages, salaries, tips, etc., to the extent that they are included in gross income; earned income also includes net self-employment earnings that are taken into account in computing taxable income, as well as any military combat pay that may have otherwise been excluded from income. The Making Work Pay credit is a refundable credit, and consequently the taxpayer may receive a tax refund if the credit causes their total tax liability to be negative. The Making Work Pay credit will be applicable for the 2009 and 2010 tax years.

Any individual with earned income is eligible for the Making Work Pay credit, except for a nonresident alien, an individual who is eligible to be claimed as a dependent on someone else's tax return, or an estate or trust that cannot have earned income. In addition, though, to claim the credit the individual must report a Social Security number on their tax return (or at least one Social Security number for a joint tax return); consequently, the Making Work Pay credit is effectively only available to those who are working legally in the U.S. and have received their Social Security number.

As is common for the other tax credits created/expanded under ARRA, the Making Work Pay credit will also phase out at higher income levels. For the Making Work Pay credit, the phaseout begins at $75,000 of AGI ($150,000 for joint returns), and the amount of the credit is reduced by 2% of the taxpayer's excess income above the threshold. Thus, the maximum credit would be completely phased out for an individual at $95,000 of income (a $20,000 excess at a 2% phaseout rate would reduce the entire $400 maximum credit to $0), and $190,000 for joint filers. As with the other credits discussed earlier, the phaseout is based on AGI, increased by any income excluded from American Samoa or Puerto Rico sources or excluded due to the foreign earned income exclusion for U.S. citizens living abroad.

Unlike stimulus payments in prior years, the Making Work Pay credit is not intended to be distributed as a check to all eligible Americans now that it has been signed into law. Instead, it will be administered as an adjustment to the IRS Withholding Tables for wage withholding, allowing eligible taxpayers to receive a slightly increased regular paycheck throughout the year. New withholding tables were released by the IRS on February 21st, and are required to be adopted by employer payroll systems by April 1st. Self-employed individuals who do not have wage withholding from their self-employment income may wish to alter their estimated tax payments instead. To the extent that the withholding is not implemented correctly for a taxpayer, the Making Work Pay credit will still ultimately be reconciled when the tax return is filed at the end of the year.

In addition to the Making Work Pay credit, ARRA also created a $250 "stimulus check" style payment that will generally go to seniors. Specifically, individuals will be eligible for the payment if they are eligible for Social Security benefits (including SSI recipients as long as they are not in a Medicaid institution), railroad retirement benefits, veterans compensation or pension benefits, or if they are state or Federal government

retirees who receive retirement benefits but never participated in Social Security (e.g., Federal employees under CSRS and many municipal employees). If both spouses filing a joint return are eligible for a payment, each will receive a separate $250 stimulus payment. To be eligible for the stimulus check, the individual must have been receiving one of the above retirement income payments for any of the three months before February 2009 when the new law was enacted (i.e., the individual must have received payments in November or December of 2008, or January of 2009). If an individual becomes eligible due to participating in more than one of the retirement programs listed above at the same time, the individual is still limited to only one $250 stimulus payment. In addition, if an individual is eligible for both the stimulus check payment and the Making Work Pay credit (e.g., a retiree receiving retirement benefits who still engages in part-time work for earned income), then any amount received as a stimulus check will reduce the amount of the Making Work Pay credit.

Beyond the requirement to be receiving certain retirement benefits as indicated above, to be eligible individuals must also have a current address of record in the U.S. or a specified U.S. possession (i.e., those living abroad are not eligible), and must not have had retirement benefits suspended due to being in prison, a fugitive or otherwise no longer living in the U.S., a probation or parole violation, or having committed benefits fraud. The estate of a deceased individual may still receive a credit, but only if the individual was certified to receive a stimulus payment before death.

Stimulus checks for those eligible are required to be distributed no later than June 17th, 2009. Currently, most stimulus checks will be distributed using the retirement benefit programs' existing electronic payment systems - for example, Social Security recipients will likely receive their $250 stimulus check as an extra amount along with their regular monthly Social Security benefit payment. However, any extra payment attributable to the stimulus check is not required to be reported in income for tax purposes.

Planning Implications

Although the nature of the Making Work Pay may seem similar to other "few hundred dollar" payments that have been utilized as fiscal stimulus over the past 8 years, the intention of the Making Work Pay credit is different. The credit was actually a pillar of President Obama's tax policy initiatives on the election campaign trail (before we acknowledged the current environment as a full blown recession and credit crisis).

The primary purpose of the credit, in essence, is to offset the first $400 of FICA Social Security taxes (which are 6.2% of earned income), to help make employment income more financially rewarding for those at the lower end of the income scale. For those who earn less than approximately $15,000 - $20,000, FICA taxes actually represent a greater financial burden than income taxes (after deductions are taken into account), and consequently this tax incentive yields the greatest value to those with more modest employment income. By making the credit refundable as well, the net result is that for many who earn less than $10,000 of earned income (and total income) and who face no Federal income tax, the Making Work Pay credit will nearly eliminate the FICA tax burden as well and in the process will yield a higher paycheck and/or a small tax refund. Thus, the credit is intended to be a direct incentive for those who are not working to begin to work, by minimizing any taxation on initial amounts of employment income. Notably, though, this incentive will not be effective for children in a family, because the credit is not available to those who are able to be claimed as a dependent on someone else's tax return.

Nonetheless, with the income phaseout not setting in until $75,000 of AGI (or $150,000 for joint returns), a fairly broad base of clients may be eligible for the Making Work Pay credit. As discussed earlier, most clients will receive the value of the credit through an adjustment to their wage withholding. However, many clients may ultimately find that they need to adjust for the credit at tax season. If the employer estimates that the client's income is too high for the credit but ultimately AGI turns out to be lower, the client will not receive the value of the Making Work Pay credit through withholding and will need to wait until the tax return is filed to harvest the credit. On the other hand, many clients may ultimately find that the adjustment for the Making Work Pay credit will leave them under-withheld and facing a remaining tax liability when the tax return is filed. This will especially be an issue for married clients where one spouse earns significantly more than the other (and consequently the lower income spouse's employer will not

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realize that the couple will ultimately be ineligible due to the higher income spouse's earnings), or for clients who have significant taxable income from outside sources (e.g., investment income, rental income, or even self-employment income from a side business, that causes the client to exceed the AGI phaseout even though employment income alone would have left them eligible). On the other hand, for clients who are primarily self-employed, a tax projection may be very helpful to determine whether estimated tax payments for the remainder of the year should be adjusted to account for the Making Work Pay credit (if the client will be eligible).

Unlike the Making Work Pay credit, the stimulus payment to seniors will be distributed in the style of a "stimulus check" in the coming months. For clients who are eligible, the stimulus payment should be received automatically via the same channel/process that the client receives the associated retirement income benefit that made the client eligible. Thus, for planners, the primary step should simply be to monitor that clients eligible for the payment do in fact receive it. Given that Congress has required that the stimulus payments be made by June 17th, planners have a concrete target date that they can use to check in with clients regarding the stimulus payments, and inquire as to whether any follow-up steps need to be taken (e.g., for clients who do not receive checks). Additional guidance will likely be forthcoming about how those who don't receive stimulus checks but believe they should have can appeal for a payment to be made.

In the end, the size of the Making Work Pay credit and stimulus check for seniors isn't likely to significantly change behavior for most financial planning clients; nonetheless, for those who wish to maximize what clients may get, planners can assist by ensuring that eligible payments are received, and that (especially for those receiving the Making Work Pay credit) there are no surprises during tax season (e.g., for clients who had reduced withholding for the credit but ultimately were not eligible to receive it).

AMT Tax Relief

Technical Provisions

After the temporary AMT relief provisions of 2008 expired on December 31st, the AMT exemption reverted back to its pre-2001 levels of $33,750 for individuals and $45,000 for joint filers. Under the new provisions of ARRA, these amounts are increased again, for 2009 only, to $46,700 for individuals and $70,950 for joint returns (an increase of $500 and $1,000, respectively, over the 2008 temporary exemption amounts).

The new ARRA rules do nothing to change the phase-out rules for the AMT exemption; however, given that the AMT exemption has been increased, it will take a greater amount of total income to fully phase out the new AMT exemptions. Thus, with the higher exemption, the entire amount is not fully phased out until AMTI (taxable income for AMT purposes) exceeds $299,300 for individuals or $433,800 for joint filers.

In addition to the reinstatement of the temporary AMT exemption increase, ARRA also extended the use of so-called nonrefundable personal credits (tax credits that can reduce your tax liability to $0, but cannot be used to create a tax refund) against the AMT. Without this extension, technically taxpayers who were subject to the AMT would be unable to claim any nonrefundable personal credits, including the child and dependent care credit, the adoption credit, the child tax credit, the Hope Scholarship and Lifetime Learning credits (before the modifications to the Hope Scholarship Credit described earlier), the retirement saver's credit, and others. Thanks to the one-year extension from ARRA, though, all of these credits continue to be allowed for both regular *and* AMT purposes in 2009. Under current law, though, many of these credits will no longer be allowed for AMT purposes after 2009, unless further modified by Congress.

In another notable provision of ARRA, private activity municipal bonds - which are tax-exempt for regular tax purposes, but must be included in income for AMT purposes - will also enjoy a temporary AMT carve-out for 2009 and 2010. Specifically, under the new rules, any private activity bonds *that are issued in 2009 or 2010* will not be treated as an adjustment for AMT purposes. Consequently, taxpayers subject to the AMT may still enjoy tax-exempt interest on any such bonds, as long as they were issued in 2009 or 2010. This provision does not apply to interest earned in 2009 or 2010 on private activity bonds that were issued prior to 2009.

Planning Implications

The AMT relief provisions under ARRA - increasing the AMT exemption, and extending the use of nonrefundable personal credits against the AMT -

postpone once again what would otherwise be a very significant increase in the number of taxpayers subject to the AMT. The Congressional Budget Office estimates that the number of taxpayers affect by the AMT in 2009 may have otherwise increased from approximately 4-5 million under current law, to as much as nearly 25 million if the patched AMT exemption were to lapse back to pre-2001 levels.

In most cases, clients who are already subject to the AMT can do little but simply adjusting their thinking and tax strategies to acknowledge the fact that they are subject to the AMT - e.g., by properly accounting for the after-tax interest cost of home equity indebtedness, or by avoiding "tax-exempt" private activity bonds that would still be subject to taxation for an AMT taxpayer. In addition, for clients who are currently subject to the AMT, it is advisable to plan the timing of income and deductions - to the extent possible - to maximize the amount of the AMT exemption that can be used each year and minimize the impact of the exemption phaseout.

However, clients who are not currently subject to the AMT face a different set of AMT planning circumstances. First of all, they should be cautious about the timing of any AMT adjustments that may cause them to cross the threshold into AMT, such as large state and local income tax deductions, or significant miscellaneous itemized deductions. On the other hand, given an annually increasing cost for AMT "patch" fixes (this year's was estimated to be approximately $70 billion), and a rapidly increasing budget deficit, there is also a rising risk that Congress may not be able to implement as meaningful of an AMT patch in future years. Any reduction in the magnitude of the AMT patch that is implemented will, at the margin, result in a large number of additional taxpayers facing the AMT, especially including the moderate to high income individuals who are clients of many financial planners. Thus, in an environment where there is an elevated risk of increased AMT exposure for 2010 and beyond, it is advisable for planners to be especially focused on maximizing any deductions that *can* be taken in 2009 without triggering the AMT. In the past, the timing of a deduction may have simply been the different between claiming it in the current year or next year; however, with the shifting focus of the AMT, there is a risk that any deductions not maximized this year may be lost entirely in 2010 if a comparable AMT patch cannot be implemented.

Beyond planning around the AMT exemption and the patch, the exclusion of private activity bonds issued in 2009 and 2010 from the purview of the AMT also creates a unique investment opportunity for some clients. In many cases, private activity bonds offer relatively favorable tax-exempt yields, and the opportunity for clients to own them despite facing the AMT invites them to view such bonds as a new investment opportunity (and of course, incentivizing more taxpayers to invest in such bonds was Congress' intent in the first place). However, clients considering private activity bonds in today's environment should still be cautious to do proper due diligence on any potential bond purchases, as a recessionary environment in general is not favorable to the credit quality and safety of many private activity bonds. In addition, planners will still have to be cautious for AMT clients when examining any municipal bond mutual funds, as such funds may potentially hold pre-2009 private activity bonds that will still be subject to taxation for an AMT taxpayer.

Overall, the AMT tax relief of ARRA does not provide any substantive fix to the perennial problem of a lapsing AMT patch and a potential increase in the number of taxpayers subject to the AMT. Nonetheless, ARRA does at least clarify the status of AMT relief for 2009, a welcome relief from prior years when such AMT patch legislation was not resolved until the final months, or even final weeks, of the year.

Other Miscellaneous Provisions

As a major tax bill, ARRA includes numerous other tax provisions that may impact select client situations. The following is a brief summary of other notable provisions of ARRA:

- *Computer costs eligible for 529 plan distributions*. For 2009 and 2010, any costs for computers and internet access on behalf of a student will count as expenses eligible for tax-free distributions from a 529 plan.
- *Bonus depreciation for businesses*. The provisions of ARRA extend the 2008 rules for 50% bonus depreciation on the purchase of new business property through 2009 and 2010. This allows businesses acquiring new property to deduction a larger portion of the total cost in the first year, and is intended to incentivize businesses to purchase new property and grow.
- *Section 179 expensing for businesses*. Under ARRA, the Section 179 small business expense deduction will remain at the 2008 level of $250,000, with a phaseout threshold at $800,000 of acquired property. This rule applies for 2009 only.

- *Energy incentives*. Numerous aspects of the Residential Energy Property credit are expanded under ARRA.
- *Lower income support*. The provisions of ARRA increase the amount of the child tax credit that is refundable, and also create a temporary increase in certain aspects of the Earned Income Tax Credit.
- *COBRA subsidy*. Under ARRA, individuals who are involuntarily separated from employment may be eligible for a subsidy of 65% of the cost of their COBRA coverage for up to 9 months of COBRA insurance payments. The subsidy begins to phase out if the employee's AGI exceeds $125,000 (or $250,000 for joint filers). For former employees eligible for the subsidy, the individual pays only 35% of the cost of COBRA coverage (up to the maximum time period), and the remainder of the cost is initially covered by the employer, and is credited back to the employer when monthly payroll and withholding payments are made to the Federal government.

Summary

While ARRA does not significantly reform the tax code, it has created numerous provisions that may be helpful for client planning situations. The focus of ARRA was intended towards economic stimulus, and consequently, many of its planning provisions are intended to encourage clients to make certain purchases or transactions.

Although the tax incentives alone are not likely to induce most clients to make a primary residence or vehicle purchase that wasn't otherwise planned, at the margin the value of the tax credit is large enough that it may help manage the cost, or partially mitigate the risk, or such purchases.

However, not all provisions of ARRA were purely intended to induce client spending. The expansion of the Hope Scholarship credit into the American Opportunity tax credit likely represents the first of many planned steps by the Obama administration to expand and simplify the education tax incentives under the tax code, and the Making Work Pay credit was proposed long before the government had acknowledged a need for economic stimulus (both were tax policy initiatives that Obama introduced in 2008 while still on the campaign trail). In addition, the AMT relief under ARRA likely represents not so much a spending incentive, as simply an attempt to patch a different AMT situation until it can be further addressed with future legislation and reform.

In any event, though, planners should also stay alert for future tax developments throughout the remainder of 2009. Several tax policy issues, notably including estate tax reform, have not yet been addressed by Congress and are likely to be explored further in the coming months. Stay tuned.

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