

Top Dozen Tax Changes in the 2009 Economic Stimulus Plan

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The American Recovery and Reinvestment Act of 2009 (the “Act”), signed into law on February 17, 2009, contains several favorable tax breaks for individuals and businesses. The tax cuts have been estimated to cost the federal government approximately \$282 billion, and it has been suggested that 97% of individuals will be able to take advantage of some of the new tax provisions. This update briefly describes the “top dozen” changes to the Internal Revenue Code in the Act that benefit either individuals or businesses. We encourage you to consult our tax department if you would like to discuss these changes or any other items that may be in the legislation.

Tax Relief for Individuals and Families

Aside from slight AMT and estimated tax relief, the Act’s key individual provisions will not benefit households with incomes above \$250,000. For high net worth individuals, we explained in a previous Update dated February 11, 2009 that the low interest rate environment makes this an attractive time for estate planning techniques that are interest rate sensitive.

1. **“Making Work Pay” Tax Credit.** The Act provides that many working individuals and working families are allowed a refundable credit in 2009 and 2010. Individuals with modified adjusted gross incomes (“MAGI”) of less than \$95,000 and married couples with MAGI of less than \$190,000 are eligible for the credit. The “making work pay” credit is \$400 for most eligible working individuals and \$800 for most eligible married couples. Instead of claiming the credit at the time of filing their 2009 income tax return by April 15, 2010, eligible individuals and married couples will be able to benefit from this credit nearly immediately. In what the White House deems “the quickest and broadest tax cut ever,” President Obama, on February 21, 2009, ordered the U.S. Treasury to adjust its withholding schedules for employers beginning April 1, 2009. It is anticipated that the average working family will see its monthly paychecks increase by \$65 or more as of that date.

2. **“American Opportunity” Tax Credit.** Individuals or married couples that pay for qualified tuition and related expenses (including books) in 2009 and/or 2010 will be allowed a partially refundable tax credit of up to \$2,500 per year per eligible student, which includes the taxpayer, his or her spouse, and any dependents. The credit is equal to 100% of the first \$2,000 of eligible tuition and expenses and 25% of the next \$2,000. The student must be in the first four years of his or her post-secondary education in a degree or certificate

program to be eligible for the credit. Individuals with MAGI of \$80,000 or less and married couples with MAGI of \$160,000 are eligible for the full credit of \$2,500, while individuals with MAGI of \$80,001 to \$90,000 and married couples with MAGI of \$160,001 to \$180,000 are eligible for a reduced credit.

3. **First-Time Homebuyer Tax Credit.** Individuals or married couples that purchase their first home in the period from January through November 2009 are eligible for this refundable credit, which has been significantly modified from the corresponding 2008 credit. The tax credit is equal to 10% of the purchase price of the home, up to \$8,000 (i.e., the credit for a purchase of a home for over \$80,000 is limited to \$8,000). Taxpayers who purchase their first home during this period may take the credit on their 2009 or 2008 tax returns, meaning that those purchasing a home can choose to receive a nearly immediate benefit. Individuals with MAGI of \$75,000 or less and married couples with MAGI of \$150,000 or less are eligible for the full credit of \$8,000, while individuals with MAGI of \$75,001 to \$95,000 and married couples with MAGI of \$151,000 to \$170,000 are eligible for a reduced credit. The tax credit is fully refundable. However, if the taxpayer sells the home or ceases to use it as his or her principal residence within 3 years of the purchase, the tax credit will have to be repaid, in the form of an additional income tax in the amount of the credit taken in the year in which the home is sold (or the taxpayer ceases to use it as his or her principal residence).

4. **Sales Tax Deduction for Vehicle Purchase.** The Act provides for a deduction for state and/or local sales tax on purchases of passenger cars, light trucks, motorcycles, and motor homes. The deduction is limited to sales tax attributable to the first \$49,500 of the purchase price. This deduction is available both to taxpayers that itemize their deductions and those that take the “standard deduction.” The income thresholds for this deduction are higher than the other new tax provisions. Individuals and married couples with MAGIs of \$125,000 and \$250,000, respectively, are eligible to take the entire deduction, while individuals with MAGI of \$125,001 to \$135,000 and married couples with MAGI of \$250,001 to \$260,000 are eligible to take a reduced deduction.

5. **Reduced 2009 Estimated Tax Payments for Individuals with Small Businesses.** Under prior law, individuals were required to make estimated tax payments

equal to the lesser of 90% of the individual's current year's tax liability or 100% of the individual's prior year's tax liability (or 110% of the individual's prior year's tax liability for individuals with MAGI of more than \$150,000 in that prior year). The Act provides that in 2009 only, the estimated tax payments for certain individuals must equal the lesser of 90% of the individual's current year's tax liability or 90% of the individual's prior year's tax liability. This provision only applies to individuals with MAGI of less than \$500,000 for whom more than half of that individual's income is derived from a small business, which is generally defined as a business with fewer than 500 employees.

6. 2009 AMT Relief. Instead of waiting until the end of the year to "patch" the alternative minimum tax for 2009, in the Act, Congress increased the 2009 AMT exemption amount to \$46,700 for individuals and \$70,950 for married couples. However, Congress did not permanently "fix" the AMT, as, absent some other action, another "patch" will be needed for 2010.

Tax Incentives for Businesses

7. Extension of Bonus Depreciation. The "bonus depreciation" provisions of 2008 have been extended for qualifying property purchased by the taxpayer and placed into service during 2009. Most machinery, equipment, tangible personal property, computer software, and leasehold improvements are qualifying property. Business taxpayers may choose to write off 50% of the cost of such property in 2009 in addition to any regular depreciation deductions they are entitled to take on the balance, regardless of when the property is placed into service during the year. For corporations (or certain S corporations that are subject to tax on their built-in gains) with AMT and R&D credits, there is a new opportunity to utilize these credits in lieu of claiming bonus depreciation. These credits may be refundable even if the entity does not have a tax liability.

8. Extension of Enhanced Small Business Expensing. Under the Act, taxpayers can elect to deduct some of the cost of certain tangible personal property and computer software that is purchased and placed into service in 2009. The immediate deductions allowed are in lieu of capitalization and later depreciation deductions. If the cost of the qualifying property does not exceed \$800,000, \$250,000 may be deducted in the fiscal year. A reduced deduction is available for qualifying property placed into service in 2009 that costs between \$800,001 and \$1,050,000. The excess of the cost over the allowed immediate deduction is capitalized and later depreciated.

9. 5-Year Carryback of Net Operating Losses for Small Businesses. Under prior law, small businesses (including corporations, S corporations, partnerships, or sole proprietorships) with average annual gross receipts of \$15 million or less were able to "carry back" net operating losses (generally the excess of business losses over business income in any year) into their two prior tax years and were able to "carry forward" these losses in the succeeding twenty years. Under the Act, these small businesses may carry back net operating losses which were realized in their fiscal years that ended in 2008 to up to five prior years,

but may elect to carry back the losses to only two, three, or four prior years. This is an opportunity to obtain needed cash flow.

10. Small Business Capital Gains. The Act provides a 75% exclusion of the gain on sales of "qualified small business stock" in certain situations. In order to qualify for the exclusion, the stock must be purchased by individuals between February 17, 2009 and December 31, 2010 and must be held for at least five years after the date of acquisition. The exclusion is generally limited to the greater of 10 times the taxpayer's basis in the stock or \$10 million. The taxable portion of the gain is taxed at the lesser of ordinary income rates or 28%. Qualified small business stock is stock in a corporation (but not an "S corporation") which has assets of less than \$50 million and uses at least 80% of its assets in the active conduct of a trade or business. There are also certain types of businesses, such as those providing health, financial, insurance, or engineering services that do not qualify for the preferred treatment.

11. Delayed Recognition of Certain Cancellation of Debt Income. If an issuer of debt repurchases its own debt instrument for less than the adjusted issue price, the issuer will generally have income from the discharge of indebtedness in the amount by which the adjusted issue price exceeds the repurchase price. Under prior law, the issuer was required to report all of the income in the year in which it repurchases the debt. Under the Act, issuers repurchasing their debt instruments for less than the adjusted issue price can elect to simultaneously defer and spread out the recognition of the income from the discharge of indebtedness. The Act provides that for repurchases of debt in either 2009 or 2010, the issuer can elect (on its 2009 or 2010 return, as applicable) to defer any recognition of the income until 2014, and can pro-rate the income over the five year period from 2014-2018. The insolvency and bankruptcy exceptions to recognition of cancellation of debt income continue to apply, so that these new rules apply to the income that does fall within these exceptions. It allows businesses to restructure debt without an immediate tax consequence.

12. Reduction of S Corporation Built-in Gains Holding Period. Generally, corporations can convert from corporate status to S corporation status under the tax code tax free. However, under prior law, if any of the assets had "built-in gains" (i.e., the fair market value of the asset exceeded its adjusted acquisition cost) at the time of the conversion, and such assets were sold within ten years of the conversion, the built-in gains are taxed at the highest corporate rate in the year the asset is sold. The Act reduces the recognition period to seven years for sales occurring in 2009 and 2010. Thus, corporations that elected S corporation status in 2002 (or prior years) can dispose of such assets in 2009 without the normal tax on the built-in gains. Similarly, corporations that elected S corporation status in 2003 (or prior years) will be able to dispose of such assets in 2010 without the normal tax on built-in gains.

It must be kept in mind that state income tax consequences do not always follow the federal rules, particularly as to relief provisions in new legislation.

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