

# Tax Law Changes For 2009--And Beyond

*How federal tax law changes could impact tax filings in upcoming tax years.*

March 2009

Many of the tax breaks in recent tax-relief bills were designed to be phased in over a number of years or are indexed to inflation. To help you determine how these tax laws affect your long-term plans, this article explains the changes scheduled to come into effect through 2017.

## Starting in 2009

**Tax Credit of Up to \$8,000 for First-time Home Buyers.** If you purchased a primary residence in 2009 before December 1, 2009 and are a "first-time" home buyer, you can qualify for a tax credit equal to 10% of up to \$80,000 of the purchase price. To be eligible, you must not have owned a residence in the U.S. in the previous three years. The credit phases out between \$150,000 and \$170,000 of adjusted gross income for joint filers and \$75,000 to \$95,000 for single filers. The credit is refundable to the extent it exceeds your regular tax liability -- which means that if it more than offsets your tax liability, you'll get a refund check -- but it does not offset the alternative minimum tax.

You can even elect to claim the credit for a 2009 home purchase on your 2008 tax return. (If you filed for 2008 before buying -- but before the November 30 deadline -- you can claim your credit by filing an amended return using Form 1040-X. Doing so will guarantee you a refund check.) Unlike the credit for 2008 purchases, the credit for 2009 purchases doesn't have to be paid back ratably over 15 years. But you will have to repay the credit if you sell the house within three years of the date you bought it.

## Payroll Tax Credit.

For 2009 and 2010, Congress gave workers a credit of 6.2% of their earned income, capped at \$400 for single filers and \$800 for joint filers. For single filers, it starts phasing out at \$75,000 of adjusted gross income and dries up at \$95,000. The phaseout zone for couples is \$150,000 to \$190,000. Employees will get the credit in advance via lower income tax withholding in each paycheck, not as a rebate check.

Self-employed workers can reduce their quarterly estimated payments to get an advance benefit from the credit. The exact amount of the payroll tax credit for the year will be calculated on the filers' tax returns.

Recipients of Social Security benefits, Railroad Retirement benefits, Supplemental Security Income or veterans disability pensions will get a one time \$250 check instead for 2009. Federal retirees who don't receive any Social Security will also get a \$250 check.

**Sales Tax Deduction for New Vehicles.** Buyers of new vehicles can deduct the sales tax paid on the purchase, even if they don't claim sales taxes as itemized deductions. They can add the tax

they pay to their standard deduction. This break applies to new cars, motor homes, light trucks and motorcycles purchased after February 16, 2009 and before January 1, 2010. Sales tax paid on the first \$49,500 of cost qualifies. The benefit begins phasing out for married couples with AGIs over \$250,000 and singles with adjusted gross incomes over \$125,000, and is completely gone for single filers with adjusted gross income of \$135,000 or more or joint filers with AGI of at least \$260,000.

Itemizers who elect to deduct state sales taxes in lieu of state income taxes get no benefit from this change because the auto sales tax is already included in the sales tax deduction. Itemizers who deduct state income taxes will get a separate deduction for auto sales taxes; non-itemizers will add the sales tax amount to their standard deduction amount.

**Indexed Tax Brackets.** Thanks to higher inflation in the past year, the 10%, 15%, 25%, 28%, 33% and 35% tax brackets all kick in at approximately 5% higher levels of income than in 2008.

**Larger Personal Exemptions.** For 2009, each personal exemption you can claim is worth \$3,650, up by \$150 from 2008.

**Higher Standard Deductions.** For 2009, the standard deduction for married couples filing a joint return rises to \$11,400, up by \$500 from 2008. For single filers, the amount increases to \$5,700 in 2009, up by \$250 over 2008. And heads of household can claim \$8,350 in 2009, a jump of \$350 from 2008. Non-itemizers who pay real estate taxes can claim even larger standard deductions. Joint filers can add in up to \$1,000 of property taxes paid. Singles can add in up to \$500 of real estate tax payments. Non-itemizers can also add any casualty losses that occurred in presidentially declared disaster areas.

**Reduction in Itemized Deductions and Personal Exemptions for High-Income Taxpayers.** Itemized deductions and personal exemptions are phased out as your income rises. In 2009, the reductions are a bit less painful. The cutback in itemized deductions occurs once your adjusted gross income exceeds \$166,800, regardless of your filing status. Your itemized deductions are reduced by 1% of the amount by which your AGI exceeds \$166,800, but you can never lose more than 80 percent of your itemized deductions. Also, your medical expenses, investment interest deduction, deductible gambling losses and any casualty and theft losses are not subject to the cut.

Personal exemptions are reduced by 2% for each \$2,500 of adjusted gross income over \$250,200 for married filing jointly, \$208,500 for heads of households and \$166,800 for singles, but the reduction cannot exceed \$1,217 per exemption.

**Increased Section 179 Expense Deduction.** The maximum amount of equipment placed in service in 2009 that businesses can expense stays at \$250,000. And the annual investment limit remains \$800,000. Thus, you won't begin to lose the benefit of expensing until you place more than \$800,000 of assets in service in 2009.

**Tax-free Parking for Employees.** Starting in 2009, firms can pay for \$230 a month of parking tax free for employees, up \$10 per month from 2008. The cap on tax-free transit passes is now \$230 a month as well, the same as for parking. The limit had been \$115 a month in 2008.

**Tax Credit for College Tuition.** For 2009 and 2010, the Hope credit is replaced by a new credit of up to \$2,500 per student a year for four years of college, not just the first two years. It now also covers the cost of books and begins to phase out at \$80,000 of adjusted gross income for single filers and \$160,000 for joint filers. If the credit is more than your income tax liability, 40% of it is refundable. Also, the full credit is allowed against the alternative minimum tax.

**Child Tax Credit.** If the credit exceeds the filer's tax liability, all or part of the credit will be refunded if the filer earns more than \$3,000 in 2009 and 2010, down from \$12,550.

**Earned Income Tax Credit.** For families with three or more children, the maximum earned income tax credit for 2009 and 2010 rises by \$628.50. And the phaseout of the credit for joint filers starts at higher income levels in 2009 and 2010, allowing more of them to claim the credit.

**Higher Income Limits for Deductible IRAs and for Roth IRAs.** If you are covered by a retirement plan at work, you can take a full IRA deduction in 2009 if your modified adjusted gross income is less than \$89,000 (married filing jointly) or \$55,000 (single or head of household).

A partial deduction is allowed until your adjusted gross income reaches \$109,000 if you are married filing jointly or \$75,000 if you are single or a head of household. Also, the opportunity to contribute to a Roth IRA is now phased out as your modified adjusted gross income rises between \$166,000 and \$176,000 if you are married filing jointly or \$105,000 to \$120,000 if you are single or a head of household.

**Increased Contribution Limit for 401(k) Plans.** The maximum employee contribution rises to \$16,500 from \$15,500 in 2009 for these and similar workplace retirement plans including 403(b)s and the federal Thrift Savings Plan. Workers age 50 and older in 2009 can put in an additional \$5,500 this year, also a \$500 increase from 2007. Thus, their maximum contribution is \$22,000.

**Estate Tax Exemption.** In 2009, the federal estate tax exemption rises to \$3,500,000 from its 2008 level of \$2,000,000.

**Higher Annual Gift Tax Exemption.** For 2009, you can give up any individual up to \$13,000 without owing any gift tax, a \$1,000 increase over 2008.

**Exemptions for the Alternative Minimum Tax.** For 2009, the exemption levels rise to \$70,950 for married filing jointly, \$46,700 for singles and heads of household, and \$35,475 for married couples filing separately. Congress is likely to act in 2009 to prevent this from happening.

Otherwise, more than 20 million filers will be added to the AMT rolls. Also, interest on private-activity bonds issued in 2009 and 2010 is exempt from the alternative minimum tax.

**Credit for Residential Energy-efficient Property.** The credit for 30% of the cost of installing solar water heating equipment, solar electric equipment, geothermal heat pumps or small wind turbines in your primary residence or a second home is no longer limited to \$2,000 after 2008. But the credit for fuel cell property still cannot exceed \$500 per half-kilowatt capacity.

**Credit for Energy-saving Home Improvements.** The old 10% tax credit of the cost of energy saving home improvements is increased to 30% for 2009 and 2010, up to a maximum of \$1,500 in the two-year period. It applies to skylights, windows, outside doors, biomass fuel stoves and high-efficiency furnaces, water heaters and central air conditioners. In addition, the dollar limits on the particular type of improvement, such as a \$200 cap on the credit for windows, are repealed.

**Converting a Second Home to a Primary Home.** If you convert a second home into a principal residence after 2008, you may not be able to exclude all of your gain. A portion of the gain on a subsequent sale of the home will be ineligible for the home-sale exclusion of up to \$500,000, even if the seller meets the two-year ownership and use tests.

The portion of the profit that's subject to tax is based on the ratio of the time after 2008 when the house was a second home or a rental unit to the total time you owned it. So if you have owned a vacation home for 18 years and make it your main residence in 2011 for two years before selling it, only 10% of the gain (two years of non-qualified second home use divided by 20 years of total ownership) is taxed. The rest qualifies for the home-sale exclusion of up to \$500,000.

**Refundable Child Tax Credit.** The \$8,500 income threshold needed to qualify to claim the child tax credit if it exceeds your regular income tax bill decreases to \$3,000 for 2009.

**Partial Exclusion for Unemployment Benefits.** For 2009, the first \$2,400 of unemployment benefits you received is tax free.

**College Savings Plans.** Beginning in 2009, 529 plans can be tapped tax free to pay for a computer or Internet access.

**Estimated Tax Relief for Owners of Small Businesses.** If an individual's adjusted gross income for 2008 was less than \$500,000 and more than half of his or her gross income was from a business with fewer than 500 workers, their estimated income taxes for 2009 estimates can be based on the lesser of 90% of their tax liability for 2008 or 2009. The usual estimated tax benchmarks of 100% or 110% of tax liability do not apply.

## **Starting in 2010**

**Estate Tax Repealed.** The federal estate tax is scheduled to be eliminated for estates of individuals dying in 2010. We expect Congress to act in 2009 to keep the tax alive.

**Roth IRA Conversions.** Starting in 2010, individuals with more than \$100,000 of modified adjusted gross income are free to switch a traditional IRA to a Roth IRA. For conversions in 2010, taxpayers can spread the tax due over two years. Half the tax will be due in 2011, and the remaining half will be payable in 2012.

Removing the limit on conversions effectively eliminates the income limit on contributions to Roth IRAs. A taxpayer with income too high to use a Roth will be able to contribute to a traditional IRA (which have not income limits for contributions) and immediately convert to a Roth.

**Domestic Production Activities Deduction.** In 2010, this deduction increases to 9% of qualifying business net income. This deduction applies to businesses engaged in construction, engineering or architectural services, film production, or the lease, rental or sale of equipment you manufactured. However, the rate remains 6% for oil and gas companies.

**State and Local Sales Tax Deduction.** The opportunity for itemizers to choose to deduct their state sales tax payments instead of deducting their state and local income taxes ends after 2009, unless Congress acts to extend it.

**Educators' Deduction.** This deduction for up to \$250 of classroom supplies purchased by educators lapses after 2009, unless Congress acts to extend it.

**Nontaxable Combat Pay Allowed for Earned Income Credit.** The election to include nontaxable combat pay in the calculation of earned income for the earned income credit is not available after 2009, unless Congress acts to extend it.

**Tuition and Fees Deduction.** The deduction for up to \$4,000 of college tuition and fees expires after 2009, unless Congress acts to extend it.

**Direct Donations of IRAs to Charity.** Beginning in 2010, the opportunity for IRA owners age 70½ to directly donate part of their IRA balance to charity will disappear, unless Congress acts to extend it.

**Additional Standard Deduction for Property Taxes.** Starting in 2010, non-itemizers will no longer be allowed to increase their standard deduction by up to \$1,000 of property taxes paid, unless Congress acts to extend this break.

**Limits on Deducting Farm Losses.** Beginning in 2010, the amount of farm losses you can use to offset nonfarm income is capped at the greater of \$300,000 or your net farm income over the past five years. But this limit will apply only if you get federal farm payments or CCC loans. You can take suspended losses in later years. The caps will also apply to partners and S firm owners.

**Credit for Energy-Saving Home Improvements.** The tax credit for 10% of the cost of energy saving home improvements ends for tax years after 2009, unless Congress acts to extend it.

**Exemptions for the Alternative Minimum Tax.** For 2010, the exemption levels drop to \$45,000 for married filing jointly, \$33,750 for singles and heads of household, and \$22,500 for married couples filing separately. Congress is likely to act in 2009 to prevent this from happening. Otherwise, more than 20 million filers will be added to the AMT rolls.

**Partial Exclusion for Unemployment Benefits.** For 2010, the first \$2,400 of unemployment benefits you received is no longer tax free.

**Sales Tax Deduction for New Vehicles.** Beginning in 2010, buyers of new vehicles no longer get a tax benefit for sales tax paid on new vehicles unless they itemize and elect to deduct sales taxes in lieu of state income taxes.

**Credit for Energy-saving Home Improvements.** The 30% tax credit of the cost of energy saving home improvements reverts to 10% after 2010, and is capped at \$500.

## Starting in 2011

**Higher Tax Rates.** Beginning in 2011, tax rates in effect prior to 2001 spring back into effect. The top income tax rate returns to 39.6%, and the special low 10% bracket is eliminated. Whether this will actually happen will be at the heart of a spirited battle in Congress.

**Estate Tax Revived.** For individuals dying after 2010, the federal estate tax returns with a \$1 million exemption and a 50% maximum rate. This assumes allows the estate tax to disappear in 2010, which is unlikely.

**Increase in Capital Gains and Dividend Tax Rates.** The tax rate reductions for long-term capital gains and dividends is scheduled to expire in 2010.

- In 2011, the maximum long-term capital gains tax rate goes back up to 20% from 15%. A lower 10% tax rate is used by individuals to the extent that they are in the 15% tax bracket. Their long-term capital gains had been tax free since 2008.
- In 2011, dividend income (other than capital gain distributions from mutual funds) is taxed as ordinary income at your highest marginal tax rate.

**Child Tax Credit.** The credit of \$1,000 per eligible child reverts to \$500 after 2010. This is one of many of the "Bush tax cuts" currently scheduled to expire after 2010.

**Payroll Tax Credit.** Starting in 2011, the partial credit for payroll taxes paid is no longer available.

**Decreased Section 179 Expense Deduction.** Taxpayers who purchase qualifying business property may elect to deduct the cost of the property (new or used) in the year that it is placed in service. This is referred to as a Section 179 deduction. In 2009 and 2010, the maximum amount of property that may be taken as a Section 179 deduction is \$125,000, as indexed for inflation. In 2011 and future years, the maximum deduction drops to \$25,000.

**College Savings Plans.** Beginning in 2011, 529 plans can no longer be tapped tax free to pay for a computer or Internet access.

**Tax Credit for College Tuition.** The Hope credit is now limited to the first two years of college and is capped at \$1,800 once more. None of the credit is refundable if it is more than your regular income tax liability.

**Child Tax Credit.** After 2010, none of the child tax credit will be refundable to taxpayers unless their earned income is more than \$12,550

**Earned Income Tax Credit.** Temporary increases in the earned income tax credit for filers with three or more children and the higher income levels for the phaseout of the credit are repealed.

### **Starting in 2013**

**Tax Relief for Taxpayers Who Lose Their Homes Due to Foreclosure Expires.** Beginning in 2013, debt forgiven in connection with the foreclosure of a principal residence will once again be considered taxable income (unless you are in bankruptcy or insolvent).

**Mortgage Insurance Premiums.** The special itemized deduction for mortgage insurance premiums paid on mortgages taken out after 2006 expires after 2012.

### **Starting in 2017**

**Credit for Residential Energy-efficient Property.** The credit for 30% of the cost of installing solar water heating equipment, photovoltaic or fuel cell equipment, geothermal heat pumps or wind turbines in your primary residence