

# Minnesota Symposium 2009: Planning for Success

## Newest Tax Update Issues and Planning

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# Newest Tax Update Issues and Planning

## I. Proposed individual tax law changes

### A. 2001 tax cuts – ordinary income

#### 1. Retaining rates for lower-income taxpayers

- Make permanent select provisions, including child-credit expansions; 10-, 15-, 25-, and 28-percent rates; changes to tax implications of marriage.
- Extend the child-credit expansions.
- End the changes to marriage bonuses and penalties.
- Retain the 10-, 15-, 25-, and 28-percent income-tax rates.

**Note:**

The Taxpayer Certainty and Relief Act of 2009 would immediately and permanently change the statutory brackets. Under the pre-2001 tax law, the brackets were 15-percent, 28-percent, 31-percent, 36-percent, and 39.6-percent. The 28-percent slides down to 25-percent (as it is under the current tax structure imposed for 10 years back in 2001), the 31-percent to 28-percent, the 36-percent to 33-percent, and the 39.6-percent to 35-percent (all as they are under the current tax structure imposed for 10 years back in 2001). The sunset provision for tax rates enacted in 2001 would then not apply.<sup>1</sup> One effect of the repeal of the sunset would be the permanence of the 10-percent rate. This only sets the stage for the Obama proposals for increases in later years.

#### 2. Increase ordinary income tax rates for certain taxpayers

The 2001 tax act retroactively imposed a 35-percent highest tax rate in lieu of a scheduled tax rate reduction in 2001 from a 39.6-percent to a 38.6-percent tax rate. The Obama proposal would reinstate the 39.6-percent and 36-percent tax rates in effect pre-2001 taking aim at “wealthy taxpayers.”

**Note:**

The 28-percent bracket would end at \$250,000 for married taxpayers filing jointly and \$200,000 for single taxpayers. Currently, the bracket ends at \$200,300 (\$208,850 in 2009) for married filing jointly and \$164,550 (\$171,550 in 2009) for singles. It is unclear what happens to head-of-household taxpayers. This would mean that the bracket from these thresholds to \$250,000 could be appended to the 28-percent bracket if the former 31-percent tax bracket is repealed by TCRA.

This causes the bottom of the 36-percent to be adjusted upward to \$250,000 for married filing jointly (\$200,000 for unmarried) taxpayers. One consequence is that some taxpayers now in the lower portion of the 33-percent bracket will move into a lower 28-percent (or 31-percent if TCRA 2009 is not enacted) bracket under the Obama plan.

**Planning point:**

The Obama administration has indicated that it will **not enact rate increases until 2011**, given the economic circumstances. It appears that it counts on the economy being out of recession by that year.

<sup>1</sup> TCRA §201.

### **Planning points:**

In **most cases**, if tax rates will increase, deductions should be deferred and income accelerated; conversely, if tax rates remain the same, deductions should generally be recognized and income deferred. Tax rates are not going to decline for upper-income taxpayers.

One factor that must be brought to bear is the **time value of money**. While it is true that a future deduction may be more valuable in the following year in absolute dollar amounts by reason of the increase in rates, in present-value terms a current deduction may be more valuable than its deferral. For example, if tax rates increase from 35 percent to 37 percent, the deduction of \$1,000 today is worth \$350; the deduction of \$1,000 a year later is worth \$370 at that time. At the present time it is worth  $\$370/(1 + i)$ , where  $i$  is the taxpayer's after-tax time value of money. If it is 15 percent, the time-adjusted value of the later deduction is \$343, \$7 less than the current deduction. At current interest rates and proposed levels of tax increase, this will not likely tip the scales in most instances. Likewise, if tax rates were to increase from 35 percent to 39.6 percent, the future cost of the deferred income is \$396, which discounts down to a present tax cost of \$350 when the discount rate is about **12.9** percent; for taxpayers with discount rates below this amount the deferral is more costly, while for those above that time value of money, the additional return for one year makes up for the increased dollar amount.

The **kiddie tax** should also be considered; a shifting of income can reduce an economic unit's overall tax. The use of deductible compensation may accomplish the goal of shifting income from a high-bracket taxpayer to a lower-bracket one to mitigate the increased higher-tax brackets. It can also achieve the goal of changing the status of the individual from kiddie to non-kiddie with the added benefit of the presumably lower tax-rate brackets available to the non-kiddie on unearned income (dividends, capital gains, and interest). The kiddie tax applies not only to children under age 18 (regardless of any other circumstance), but also to children who are 18 years old or who are full-time students over age 18 but under age 24, but only if such children's earned income does not exceed one-half of the amount of their support. A child within the new suspect-age ranges can avoid the kiddie tax if he or she has enough earned income. The accounting problem raised is that the measuring rod is the total amount of support the child has. Now, an **earned income strategy** cannot be suddenly implemented at year-end when the handwriting is on the wall for that year without enough time to justify the amounts paid for services actually performed; the services must have been performed throughout the year in general. However, if tax rates are about to increase, one must consider the benefits of deferring the deductible payment for such services in order to reduce the amount of taxpayer income taxed at the higher tax rate in the following year. By accelerating income (by not immediately reducing it in the current year by payment), the taxpayer can reduce the present value of the tax liability and, in many instances, the tax liability of the child.

### **3. Marginal rates**

In general, the taxpayer will pay less tax on income when the marginal rate on such income is lower than when it is higher. Conversely, more taxes are saved if a deduction is taken when the marginal rate is higher than when it is lower.

The focus is on the **marginal rate**, which is not the same as the statutory rates discussed above. Understanding the tax-bracket structure is important, and for certain levels of income the tax bracket will be the same as the marginal rate, but in many cases it will not. Why not? The marginal rate attempts to measure the additional (or less) tax that is paid as a result of the inclusion of additional income or deduction. Thus, **exclusions, deductions, and credits** can affect the income tax, but even more so **phaseouts** operate to cause a tax differential that is not the same as the Code's bracket rates multiplied by the amount of the item.

In general, the phaseout ranges of AGI or MAGI differ for different items, but in some cases multiple phaseouts may apply to certain bands of AGI or MAGI, which can result in significant disparities between the marginal tax rate and the nominal bracket rate.

**Example 1:** Married taxpayers have \$130,000 of MAGI before taking into account a \$4,000 tuition deduction. They take the standard deduction (\$11,400) and three personal exemptions (\$10,950). Taxable income is \$103,650 (\$130,000 - \$4,000 - \$11,400 - \$10,950). The qualified tuition deduction phases out dramatically when MAGI exceeds \$130,000. If the taxpayers increase income by \$1, MAGI exceeds \$130,000 threshold, and the tuition deduction is reduced to \$2,000.<sup>2</sup> Net effect is to increase taxable income by \$2,001 (the \$2,000 lost deduction and the \$1 of income). Since taxpayers are in a 25-percent tax bracket at these levels of taxable income, the tax increases by \$500.25, a marginal tax rate of 50,025 percent.

Assume instead that the taxpayers recognize \$24,850 more income (not enough to cross the \$160,000 threshold at which the qualified tuition deduction is eliminated). This causes the same loss of a \$2,000 deduction but results in an increase of \$26,850 in taxable income to \$130,500. This increases tax by \$6,712, a marginal tax rate of 27 percent (\$6,712/\$24,850) on the additional income, so marginal tax rate can be a function of how much income (or deduction) is involved.

**Example 2:** Married taxpayers have AGI of \$250,200,<sup>3</sup> four personal exemptions and itemized deductions (taxes and charitable contributions) of \$45,000. At this level of AGI, personal exemptions are not phased out, but will be with the next \$1 of AGI. The itemized deductions, on the other hand, are reduced by one percent of the AGI that exceeds the threshold level (\$166,800 in 2009) (which must be reduced by \$834 (1 percent x [\$250,200 AGI - \$166,800 threshold])). Taxable income is \$191,434 (\$250,200 - \$14,600 exemptions - \$44,166 (\$45,000 - \$834) itemized deductions). Taxpayer in 2009 is in the current 28-percent tax bracket.

If the taxpayers recognize \$2,500 more income, this will cause the AGI and the excess AGI over the threshold to increase by a like amount. As a result, an additional one percent of the additional excess (\$2,500 x 1% = \$25) is phased out of the itemized deductions. The personal exemptions are reduced by two-thirds of one percent of the \$14,600 personal exemptions (\$97). Taxable income increases by \$2,622 (the \$2,500 income plus the \$97 loss of personal-exemption deduction plus the \$25 loss of itemized deductions), creating a tax of \$734 (.28 x \$2,622), and a marginal rate of 29.36 percent (\$734 additional tax/\$2,500 income).

What the Obama proposals do in the first instance is to create a new set of marginal tax rates for different ranges of income, caused in part by the change in the statutory bracket rate and in part on the updated or adjusted phaseout ranges.

As noted, without taking into account the effects of phaseouts and the like on the effective marginal tax rates, many taxpayers may find themselves in a 39.6-percent rate; some of these will incur additional Social Security taxes of up to two percent on wages (four percent of self-employment income, but with a partially offsetting deduction). Self-employed persons may deduct one-half of their self-employment tax above the line in computing AGI, and for these purposes it is assumed that the additional tax will be treated as such tax for purposes of this deduction.

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<sup>2</sup> It is reduced to zero once MAGI exceeds \$160,000.

<sup>3</sup> The level in 2009 above which the personal exemptions are phased out.

Not taking into account the AMT or the effect of potential phaseouts, many taxpayers may experience a marginal tax-rate increase of **13.14 percent** ( $[(39.6 - 35)/35]$ ) in the tax rate on ordinary income (for those in the 33-percent rate going to the 36-percent rate, there is a marginal tax rate increase of **9.09 percent** ( $[(36 - 33)/33]$ )).

#### **4. Income strategies**

Increase tax-favored income.

- a. Converting taxable interest to tax-exempt interest will serve to reduce AGI, which will accomplish the following:
  - Reduce the effect of certain phaseouts based on AGI;
  - Limit the excess over the \$250,000 threshold to minimize or eliminate any additional Social Security tax (assuming the Obama initiative is made law); and
  - Limit the exposure to a higher tax bracket through rate increases.<sup>4</sup>

#### **Note:**

Of course, 2009 may not be the right year because the taxpayer's income is significantly lower than usual as a result of the bad economy. In this case, the tax may not be as important.

#### **Planning point:**

One has to take the costs of conversion into account. The sale of a corporate bond could produce gain or loss, while withdrawal of funds from a money market account to tax-exempt bonds or funds (or a tax-exempt money-market account) would not.

#### **Caution:**

Taxpayers who might be subject to the alternative minimum tax should not invest in tax-exempt private activity bonds because the interest on such instruments is included in determining alternative minimum taxable income.

On the other hand, taxpayers who are not subject to the AMT may benefit from the purchase of such bonds because the AMT compels such bonds to trade at slightly higher yield than other tax-exempt funds. The consequence is that the taxpayer may net more after-tax cash on those investments.

- b. Converting taxable interest to tax-deferred interest or income may reduce the level of current income.
  - The interest on U.S. Series EE bonds or inflation-indexed U.S. Series I savings bonds is generally deferred until redemption or maturity of the bond or the election by the taxpayer to include all accrued interest.
  - The appreciation on stocks is generally not subject to current taxation. In light of the factors influencing the decline in stocks, purchase of undervalued stocks today gives the taxpayer further flexibility to time when to recognize gains. Many such "growth" stocks have enhanced appreciation potentiality by reason of their policy of not paying dividends, reducing further the amount subject to current taxation.
  - A Coverdell education savings account may be established for qualified higher education expenses of a designated beneficiary. Earnings on contributions are

<sup>4</sup> However, it will be included in the side computation of determining the amount of Social Security benefits included in gross income.

distributed tax-free to the beneficiary, provided they are used to pay the beneficiary's **qualified education expenses**. The contribution may not exceed \$2,000, is not deductible, and may fund both elementary and secondary education expenses (kindergarten through grade 12) whether in a public, private, or religious school. The earnings on those contributions is tax-deferred, while helped by the account. Qualified expenses include tuition, fees, books, supplies, equipment, and room and board. This contribution is phased out for joint filers having MAGI between \$190,000 and \$220,000, but generally other persons who are not in the phaseout can make contributions, including the minor to whom a cash gift has been made.

***Planning point:***

Qualifying expenses include the purchase of computer equipment, software (other than programs designed for sports, games, or hobbies) and Internet access for use by students and their family.

- Nondeductible contributions may be made to state-sponsored and private institution tuition-guarantee §529 plans. Unlike the Coverdell, contributions are not AGI-limited. In theory there is no contribution limit, but the contribution will be treated as a gift (of a present interest); this limits the amount to a \$13,000 annual exclusion (\$26,000 with spousal gift-splitting) without incurring a taxable gift, but donors can elect to treat a lump-sum gift as if made ratably over a five-year period, increasing the amount that can be so given in one year to \$65,000 (\$130,000 with gift-splitting). Distributions from state-run qualified tuition programs that are used to pay **qualified higher education expenses** are permanently tax-free, while those from a Coverdell lose this tax favor after 2010.

***Planning point:***

A §529 account may be moved from one generation to the next without estate or GST tax. This enables the perpetuation of an income-tax-free savings account for multiple generations.

***Note:***

The Coverdell and §529 plans, while not deductible, nevertheless generate tax-deferred income, which, when distributed, may be converted into tax-free income to the extent the beneficiary incurs qualified education expenses.

## **5. Deduction strategies**

A deduction taken at a higher marginal tax rate is generally more valuable than one taken at a lower bracket (although time-value-of-money principles may make the opposite true in particular circumstances). This means that, in general, deductions should be accelerated.

***Note:***

However, with a bad economy in 2009, deferral of these deductions may be appropriate where the taxpayer is at a lower marginal tax rate than in later years.

Clients should be encouraged to increase the deductions in certain discretionary areas.

- a. Taxpayers should increase contributions to §401(k) plans, SIMPLE pension plans, and other arrangements that are deductible by the taxpayer.

- b. Taxpayers should increase contributions to a health savings account (HSA), if the taxpayer is an eligible individual. Individuals who are covered by a qualifying high-deductible health plan (and are generally not covered by any other health plan that is not a qualifying high-deductible health plan) may make deductible contributions to an HSA, subject to certain limits. For calendar year 2009, assuming a full year of coverage, the maximum contribution for self-only coverage is \$3,000. For family coverage, the maximum coverage is \$5,950. Distributions from an HSA to pay qualified medical expenses are not taxable. Distributions used for non-medical purposes are taxable, and if made before age 65, are subject to a 10-percent penalty tax. An individual's HSA contribution level may be based on expected out-of-pocket medical expenses, but an individual may make deductible contributions up to the maximum allowable, regardless of expected expenses. These contributions in excess of medical needs can be withdrawn from the HSA and used for any purpose without penalty (but subject to tax) once the individual reaches age 65.

**Note:**

This serves not only to remove the income from the amount invested from adjusted gross income while it is held in the account but also manages the medical deduction more efficiently by avoiding the AGI haircut of medical expenses. One ultimately funds future medical expenses with before-tax dollars, but gets to exclude the proceeds to the extent applied to medical uses.

- c. Long out of favor by reason of the complexity and overhead costs, defined benefit plans in specific circumstances may prove valuable in creating a deduction larger than that available for defined contribution plans. In 2009, the maximum contribution to a defined contribution plan is \$49,000, and will index for inflation in years thereafter. In contrast, the amount of the contribution to a defined benefit plan (and consequently the employer deduction) is based on actuarial data that often produces a far higher amount.

**Note:**

Another reason to consider the higher set-aside for a defined benefit plan is the proposed change in Social Security discussed above. In a service S corporation, if both the Rangel and Obama employment tax proposals are enacted, the shareholder will be subject to primary and additional tax on all of the pass-through income of the S corporation even if not distributed to the shareholder. Contributions to a qualified plan are not subject to Social Security either when made to the plan or when distributed to the participant. Thus, reduction of the tax base in this case serves two purposes. Even if the participant will be in the same tax bracket at retirement as at contribution, a permanent savings of Social Security tax may be achieved.

**Example:** To appreciate the quantum of difference, consider a 55-year sole practitioner in an S corporation who makes in excess of \$245,000. A defined benefit plan can be designed to determine a maximum benefit at retirement (assumed age 65) of \$195,000 a year. Simplifying some of the actuarial complications and assuming that the taxpayer will (i) survive to retirement and (ii) live to life expectancy (assumed 21 years), and assuming a five-percent discount rate, the money needed in 10 years is \$2,500,125. This means, in turn, that to fund this amount over 10 years, level contributions must be made in the amount of approximately \$198,771, a lot more than a \$49,000 contribution – almost \$150,000 more, avoiding as much as \$6,000 in additional Social Security tax annually while sheltering \$150,000 from current income tax, which in turn could represent another \$60,000 savings.

- d. Deductions must be carefully managed. For example, a loss from an S corporation or partnership is currently deductible only to the extent the investor has basis in the entity. Therefore, taxpayers must be prepared to make **contributions** in order to reap deductions.

**Note:**

However, a current deduction may not be warranted if 2009 is a bad year for the investor, since a deduction in like amount will be more valuable in 2010 if the investor's marginal rate will be higher then. A **distribution** from the entity that reduces the investor's basis to zero or near zero will effectively "trap" the loss deduction so that it can only be taken in a subsequent tax year when the investor has sufficient basis. The deduction will be deferred, and will offset the income that is taxed at a higher marginal tax rate in that later year than the current (2009) year.

- e. Losses arising from passive activities may only be used to offset passive activity income. However, if a taxpayer disposes of his entire interest in such an activity in a fully taxable transaction, then any loss from the activity for the tax year of disposition (including suspended losses), over any net income or gain for the tax year from all other passive activities (including suspended losses), is treated as a loss that isn't from a passive activity. Because such losses become available for use in offsetting nonpassive income only as the payments are received and in proportion to the amount of gain recognized with respect to these payments, an election out of an installment method may accelerate income or gain, but it will also accelerate the deduction freed up by the disposition.
- f. Use of an IRA by taxpayers who are at least 70 1/2 years old for charitable contributions can allow a taxpayer to make a contribution of up to \$100,000. While the taxpayer cannot deduct such amounts, the contribution to a charity from the IRA is not included in gross income, thereby reducing the AGI and thus preventing or limiting in some instances the phaseout of other tax deductions or credits.

### **6. Audacious proposal on deductions**

The above discussion assumed that the marginal rate for \$1 of deduction is the same as the marginal rate for \$1 of income from that same level of assumed income. One proposal the Obama administration has made is to limit the benefit of **itemized deductions** to 28 percent of the total deductions allowed.

**Caution:**

The most controversial proposal is simultaneous with the income rate increases to limit the benefit of itemized deductions to 28 percent of the total deductions allowed (it is unclear whether the cut-back of the cut-back [of itemized deductions] is repealed here as it apparently will be for personal exemptions). This of course means that a 39.6-percent taxpayer on income is only a 28-percent taxpayer on below-the-line deductions.

In other words, the tax cost of a charitable contribution increases by 29 percent from what we have expected in the past. If an individual has AGI of, say \$600,000 and makes a contribution of \$150,000, we would expect the tax to be close to the tax on \$450,000 of income. But the math requires a tax on the \$600,000 and then a reduction in tax of 28 percent of the deduction. Thus, the taxpayer pays tax on \$450,000 AND pays a tax on the 11.6 percent difference on the income side and the deduction side on that \$150,000, yielding an additional tax of \$17,400. Thus, the after-tax cost of the contribution is not \$90,600 (\$150,000 - .396 x \$150,000), but \$118,000.

Similar objections can be raised with respect to mortgage interest and state and local taxes. Such deductions have been major constituents in the itemized-deduction return of many high-income taxpayers. Slashing their benefit will produce even higher marginal tax rates than the nominal increases.

It is no wonder why New York politicians, primarily Democratic, have lead the opposition to this proposal, representing as they do people in a high state-and-local-tax state, communities in which many of its charities have been depleted or reduced to nothing by the Madoff scandal, and areas with high property values that are financed by large mortgages. The U.S. Senate however unanimously approved an amendment to a pending budget plan that rejects the proposal to limit the size of itemized deductions that can be taken by those earning more than \$250,000.<sup>5</sup> Political outlook: very little chance of enactment.

Nevertheless, what might be the result of such a measure? Since charitable contributions and principal residence mortgage interest are deductible for AMT purposes, they do not impact the AMT, but the income taxes are not deductible and are a major source of AMT liability. The reduction of the benefit for the regular tax would have the effect of increasing the regular tax, thereby reducing the effect of the non-deductibility on the AMT. In certain circumstances, individual taxpayers who are in the AMT would experience no change because the regular tax liability would merely be increasing, but still under the AMT; only when the regular tax crosses over the AMT does the tax benefit begin to bite. By contrast, taxpayers not currently in the AMT would generally be moving further away from it, so the increased regular tax increases the taxpayer's liability dollar-for-dollar.

## **7. Phaseout proposals**

The Obama administration seeks also to restore the phaseouts of personal exemptions and itemized deductions, but to set the income threshold at \$250,000 for married couples filing jointly. The thresholds for the phaseout of personal exemptions would be lower for singles and heads-of-household, but those for the phaseout of itemized deductions would not vary with filing status.

## **B. Capital gains and qualified dividends**

### **1. Capital gains – current law**

Under current law, long-term capital gains have been taxed at low rates, and in 2010 up to the income floor of the 25-percent rate bracket of such income may be taxed at a zero-percent rate. Such rates revert to the 20-percent rate on long-term capital gains in 2011.

<sup>5</sup> Senate Rejects Obama Plan to Cut Tax Breaks on Charitable Gifts, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aAKI4RpzgwpY&refer=worldwide>, April 2, 2009.

**The Obama plan:** Retain the lower tax rates on capital gains and qualified dividends for taxpayers in the 10-, 15-, 25-, and 28-percent income tax rates.

**Note:**

TCRA of 2009 would institute effective for taxable years beginning after December 31, 2010, a multi-layer tax on adjusted net capital gain first on so much of: (i) the adjusted net capital gain as does not exceed the excess of the taxable income taxed below 25 percent over (ii) the taxable income reduced by adjusted net capital gain at a zero percent rate; second on the lesser of so much of the adjusted net capital gain (as reduced by the amount so taxed at the zero percent rate) or of the excess of amount of taxable income taxed below the 36-percent rate over the greater of (i) or (ii) at a 15-percent rate; and finally so much of the adjusted net capital gain or, if less, taxable income in excess of the sum of the amounts taxed in the first two layers. Essentially, this merely takes current 2009 law and imposes a 20-percent bracket for higher-income taxpayers with large capital gains.<sup>6</sup> A corresponding structure would be imposed on the alternative minimum tax in respect of net capital gain.<sup>7</sup>

**Summary for Taxpayer with Taxable Income in the 15-Percent Bracket**

Characteristic	Maximum capital-gains tax rate
Collectible	15%
Unrecaptured §1250 gain	15%
Section 1202 gain*	3.75%
<b>Long-term (&gt;12 months; &lt; or =60 months) recognition after December 31, 2010</b>	<b>0%</b>

**Summary for Taxpayer with Taxable Income in the 10-Percent Bracket**

Characteristic	Maximum capital-gains tax rate
Collectible	10%
Unrecaptured §1250 gain	10%
Section 1202 gain	2.5%
<b>Long-term (&gt;12 months) recognition after December 31, 2010</b>	<b>0%</b>

**Summary for Taxpayer with Taxable Income in the 10- or 15-Percent Bracket**

Characteristic	Maximum qualifying dividend tax rate
<b>Qualifying dividend after December 31, 2010</b>	<b>0%</b>

**Summary for Taxpayer with Taxable Income in the 25-Percent Bracket**

Characteristic	Maximum capital-gains tax rate
Collectible	25%
Unrecaptured §1250 gain	25%
Section 1202 gain*	6.25%
<b>Long-term (&gt;12 months) recognition after December 31, 2010</b>	<b>15%</b>

<sup>6</sup> TCRA §202(a).  
<sup>7</sup> TCRA §202(b).

**Summary for Taxpayer with Taxable Income in the 28-Percent Bracket**

<b>Characteristic</b>	<b>Maximum capital-gains tax rate</b>
Collectible	28%
Unrecaptured §1250 gain	25%
Section 1202 gain*	7%
<b>Long-term (&gt;12 months) recognition after December 31, 2010</b>	<b>15%</b>

**Summary for Taxpayer with Taxable Income in the 25- or 28-Percent Bracket**

<b>Characteristic</b>	<b>Maximum qualifying dividend tax rate</b>
<b>Qualifying dividend after December 31, 2010</b>	<b>15%</b>

**2. Increase capital gains tax on certain taxpayers**

**The Obama plan:** Increase the tax rates on capital gains and qualified dividends for taxpayers in an income tax bracket above the 28-percent income tax bracket.

Apart from ordinary market forces, a tax hike on capital gains will have a depressing effect on stocks. They can also trigger a depressing effect on real estate.

- Suddenly taking the gains and running may make some sense. If done before the market anticipates the tax hit and the taxpayer reinvests after market corrections, a taxpayer may emerge relatively unscathed.
- Suddenly, tax-exempt bonds will look more attractive. They will be made more so by a repeal of the AMT and an increase in the highest income tax rates. However, if interest rates fall, as many economists are now predicting, a tax hike on capital gains coupled by a low interest rate will mean lower yields on such bonds.

**Planning point:**

**Installment sales:** These are currently somewhat dubious because current rules require the seller to recognize the higher-taxed, unrecaptured §1250 gain first. For many sellers of real estate, this means that there is little chance to recognize any substantial portion of gain at current 15-percent tax rates, even if the effective date is 2011. The bottom line: If the changes in capital gains rates (which would take place in any event in 2011, when capital gains rates would revert to the 8/10/18/20-percent regime under the EGTRRA sunset) seem likely, it is probably better to accelerate the gain in a non-installment sale to gain the benefit of the lower capital-gains tax rates than to obtain deferred taxation at a higher tax cost in the future. Structure an “elect-out” installment sale so that the down payment covers the full tax bite.

**Planning point:**

**Capital gains:** There is a no wash-sale rule applicable to gains. Consequently, investors may sell the appreciated portion of their portfolios and purchase the same securities back immediately. Here this enables the taxpayer to lock in the current lower tax rates on the more substantial gains. It probably is not worth the transaction costs for small gains, but for stocks and bonds with a substantial gain that are not likely to be held by the investor until death (when a basis adjustment will highly likely be available), there may be real savings to be enjoyed, but without having to cut off the investment.

However, by paying the tax up front, one loses the appreciation on the tax paid; at some point, a longer holding period will cause the appreciation that is not reduced by a protective sale, even with a higher capital gains tax rate, to exceed the net proceeds of a second sale of the stock.

**Planning point:**

**Capital losses:** Many taxpayers have built-in capital losses in investments that must be carefully timed. Individuals cannot carry capital losses back, so recognition of gains is not available as an offset to future losses. Here the wash-sale rules will apply, so one must cut off investment in the loser for at least 31 days to recognize the loss. But investors must also take into account that a current capital loss only offsets 15-percent income, while a future capital loss may offset a higher capital gain. Thus, an investor with a portfolio having winners and losers may decide to defer the recognition of gains to higher capital-gains-rate years if they have offsetting capital losses that: (i) will be taken before such gains; and (ii) will not be disallowed by a purchase within the 61-day window.

The good news is that current capital losses that should be taken for investment purposes may offset \$3,000 of ordinary income in a year the investor has no gains and offset any higher-taxed capital gains recognized in a later year. The key is to recognize losses first because they have a future. Don't recognize them after gains; they have no past.

If and when capital-gains tax rates increase on high-income taxpayers, the potentially lower tax rates applicable to other family members will make transfers of such securities even more important as the tax gap increases. Currently, taxpayers who can fit all of their income (including their net capital gains) into the 10-percent and 15-percent tax brackets can recognize such gains at a 0-percent rate – no tax at all! The 0-percent tax rate is not scheduled to expire until January 1, 2011.

The Congress has, in 2003 when it last seriously adjusted the maximum long-term capital gains tax rates, used a cut-off method of determining what gain from sales would qualify for the lower tax rate when a tax rate change would take place. It would seem most likely then that a mid-year enactment would permit gains recognized in that year but before the cut-off to be taxed at the lower rate, while gains recognized on or after would be subject to the higher rate. Thus, taxpayers who might be subject to the tax increase may – may – be able to retain the investment and still take advantage of the lower rate. This will work where the legislation uses the date of enactment as its cut-off, but the reality is that more often the cut-off will be the date the bill is introduced into Congress. Without any advance warning, it will already be too late to take advantage of the lower rate when the taxpayer learns of the proposed change (but, even here, the Congress has later changed the cut-off to a later date in the legislative process, so one never really knows).

On the other hand, taxpayers in the 0-, 10-, and 15-percent tax brackets may be in no rush to recognize gains in 2009 or 2010. The Obama proposal claims not to affect such taxpayers with respect to any increase in the maximum capital-gains tax rate. Such taxpayers may, at least in either of those years, recognize some or all of their long-term capital gains at a 0-percent tax rate.

**Caution:**

Some of the taxpayers who appear to be in the 10- or 15-percent brackets are, by law, not in these brackets by reason of the kiddie tax. New in 2008 is the definition of those persons whose unearned income is taxed at their parents' tax bracket; this has been broadened to include not only the under-18 child but also the 18-year olds and 19- through 23-year olds who are full-time students. Such individuals determine their tax bracket on capital gains by reference to their parents' applicable rates.

While 2008 was a bad year, and a terrible year for the stock market, that doesn't mean that all investments are in a tax-loss position. If the taxpayer has already taken capital losses, consideration should be given to selling gain securities to offset those losses. As noted elsewhere, state law may deny

any deduction for capital losses not offset in the current year by capital gains, and while federal law allows a carryover, it only permits \$3,000 of such excess losses to offset ordinary income each year.

Capital losses offset any capital gains, but long-term capital losses are used to offset long-term capital gains before they are used to offset short-term capital gains. Similarly, short-term capital losses must be used to offset short-term capital gains before they are used to offset long-term capital gains. Because short-term gains are taxed at ordinary income tax rates, a capital loss can offset it at a higher marginal rate than when it offsets a long-term gain taxed at a lower, preferential tax rate. If a short-term gain has already been recognized, it is better to avoid selling property that would generate a short-term loss than one that will produce a long-term loss. To do this requires making sure that the long-term capital losses are not taken in the same year as the long-term capital gains are taken. Of course, deferral of the recognition of gain (or loss) until the following year should not be entertained where the risk is high that the value of the property will decline before it can be sold. Similarly, a taxpayer won't want to risk increasing the loss on property that he expects will continue to decline in value by deferring the sale of that property until the following year. If a taxpayer has recognized capital gains and has net capital losses that would otherwise be recognized in 2009, an acceleration of capital losses to 2008 can offset current year gains, and this will be particularly attractive when those losses substantially exceed \$3,000 if no gains are anticipated in 2009.

Taking such losses on stock or securities implicates the wash-sale rule. If the stock is otherwise desirable because of its strong possibility of a quick or robust turnaround in market value, in order to recognize the loss limits the taxpayer can:

- Buy more stock, but outside the 61-day window; or
- Buy stock in a different, but similar company if the attractiveness lies in the sector more generally.

### **3. Dividends**

Under current law, qualifying dividends have been taxed at extraordinarily low rates, and in 2008 up to the income floor of the 25-percent rate bracket of such income may be taxed at a 0-percent rate. Such rates revert to the 39.6-percent tax rate on dividends in 2011. More recent statements suggest that, in an uncertain economy, dividends may tag along with capital gains without reversion to pure ordinary income. **Under the current Obama plan, dividends would have a maximum 20-percent rate for taxpayers with taxable incomes in excess of \$250,000.**

#### ***Planning point:***

Certain tax strategies that arose in a low-dividend climate will be eliminated. One particular strategy was to disgorge earnings and profits of a corporation to its shareholders at the low rates to avoid the much higher tax rates in the future. This could be particularly helpful to a corporation straying dangerously close to the personal-holding-company or accumulated-earnings tax lines, as a dividends-paid deduction can reduce the penalty tax base. In many instances, the double tax on corporate earnings was less than the individual tax on singly taxed compensation; this was particularly true for taxpayers who could take advantage of the zero-tax rate in 2008 through 2010.

**Dividends:** Now seems like a good time, as with capital gains, to disgorge dividends, because it is unlikely the rates that currently apply will be available. The cost in the future (in terms of individual tax rates and Social Security tax) of extracting corporate earnings as compensation is likely to become more expensive, although a comparison to dividends depends on the ultimate rates chosen for ordinary income, the taxable wage base, the rate on dividends, and corporate tax rates.

## C. AMT

### 1. Proposal

Currently, the AMT exemption levels are set to return to pre-2002 levels in 2010. The Congress continued the process of applying one-year band-aids to the increasingly politically sensitive topic of AMT relief by extending the enhanced AMT exemption for one more year over the baseline amount, and in fact increasing the amount in ARRA. For married filing jointly or surviving spouse, the \$45,000 base amount was increased in the current one-year patch to \$70,950; the \$33,750 base amount for single taxpayers who are not a surviving spouse increased likewise to \$46,700 in 2009; and for married filing separately, the \$22,500 base amount was increased to \$35,475 in 2009. Without any fix in 2010, many taxpayers will face much higher AMT bills in April 2011 if the exemption otherwise reverts to its base amounts in 2010.

The Obama administration has rejected the Rangel plan to repeal the AMT. Obama has indicated he favors **proposing a permanent indexing of the AMT.**<sup>8</sup> The application of nonrefundable credits against the AMT would also be made permanent.<sup>9</sup> This, combined with Rangel's apparent political weakness arising from his own tax problems, probably spells the death knell for the premature death of the AMT.

#### *Planning point:*

Now the AMT, which is likewise in a state of uncertainty, must be brought into the calculation, as described below. Suffice it to say that projections must be done to determine whether acceleration or deferral is warranted, as a taxpayer in the AMT may find strategies opposed to those for the regular income tax effective in some circumstances.

### 2. General strategies for AMT taxpayers

Tax advisors are used to devising strategies that defer income and accelerate deductions, but that may have to be reversed in the case of clients with these problems.

- Because the effective tax rate on AMTI is often less than the taxpayer's regular tax rate, additional income (up to a point) is taxed at a lower rate than it will be in a later year if the regular tax then applies. Sometimes it is better to take IRA or retirement-plan distributions (above any required by the minimum-distribution rules) when the client is in the AMT. The actual increase in tax liability is often smaller than the tax that would be paid in a later year (determined on a time-value basis).
- Conversely, the benefit of a deduction that is recognized for regular tax purposes but not for AMT purposes, such as state and local taxes, may be nonexistent for certain clients, and, in fact, is the cause of the AMT liability itself. The reduction of the regular tax by reason of such deductions increases the spread between the "tentative tax" and the regular tax, thereby causing additional AMT liability. The tentative tax is not affected by the amount of the deduction. Sometimes, it makes sense to defer paying state and local taxes to the next year, when they may provide some tax benefit.
- A final counter-intuitive AMT strategy may be to take itemized deductions if less than the standard deduction, depending on the "mix" of deductions. For example, while state and local taxes are deductible for regular tax purposes, they are not deductible for AMT purposes. In contrast, charitable contributions and the home mortgage interest are deductible for both. A taxpayer having favored deductions may be better claiming them,

<sup>8</sup> The Taxpayer Certainty and Relief Act of 2009 ("TCRA"), §101 proposes to establish the 2009 levels as the base and §102 to index these levels in later years based on a cost-of-living adjustment based on calendar year 2008.

<sup>9</sup> TCRA §103.

although less than the standard deduction, because the standard deduction itself is wholly nondeductible for AMT purposes.

### **3. AMT marginal tax rates**

The AMT must be considered. High-income taxpayers in the AMT have already phased out the exemption so they will not generally be subject to a higher AMT tax rate than the regular income-tax rate. However, lower-income taxpayers in the AMT that are phasing out the exemption must be careful because the effective AMT rate can exceed the regular income-tax rate, so acceleration may increase the tax and income should probably not be accelerated. The reason for this is the phaseout of the AMT exemption. For married taxpayers filing jointly, the AMT exemption is phased out 25 cents for every additional dollar of alternative-minimum-taxable income for certain ranges of AMTI. The result is that each additional dollar recognized for regular income-tax purposes triggers the inclusion of \$1.25 of additional AMTI. This means that the effective marginal AMT rate is actually 25 percent higher than the nominal rate. Such taxpayers can have a 32.5-percent marginal tax rate when the AMT nominal tax bracket is 26 percent, and 35 percent when the nominal tax bracket is 28 percent. Such taxpayers may be “in” the AMT because their computed tentative tax on AMTI is greater than the regular tax.

Some taxpayers in the 33-percent regular tax-rate bracket are phasing out the AMT exemption and are thus in the 35-percent effective AMT tax bracket; they may be in the 28- or 36-percent (projected) bracket in a later year and the time-value-of-money analysis will generally point to deferral of income. In some cases, a taxpayer in the AMT may have emerged from the phaseout and can absorb additional income at the 28-percent AMT rate, making it attractive not only with respect to the current year but also with respect to the higher marginal tax rates in the following year. Conversely, certain deductions have less of a tax benefit because they are not allowed for AMT purposes. If the taxpayer will be in the AMT in the later year but not in the earlier year, the deferral of a deduction to the later year may actually have less benefit at the higher statutory regular rate in the later year than the lower regular tax rate in the earlier year.

#### **Note:**

Is there really relief? With a regular tax-rate increase, many of those who are currently in the AMT may bear a higher tax burden under the regular tax (depending on the tax rates established) than they would have had under the AMT, even if the AMT is not repealed.

### **4. Effect of marginal rates on planning**

As noted, the AMT strategies may run counter to those for the regular tax. This is certainly the case where regular taxes are about to increase but the AMT rate will remain the same. In this case, if the taxpayer is in the AMT, the recognition of some deductions – those that are not deductible for AMT purposes – will have the effect of reducing regular income but not AMT income; such expenses result in no tax benefit. In contrast, other deductions that are deductible in the AMT system reduce both regular income and AMT liability, but the AMT is reduced at a presumably lower rate (effective 26 percent, 28 percent, 32.5 percent, or 35 percent) than the individual's income tax rate (33 percent or 35 percent); each dollar of expense closes the gap between the tentative tax and the regular income tax, and at certain levels the regular tax will exceed the tentative tax, but up to that level the deduction is providing a benefit only at the AMT tax rate. If there is no change in the AMT rate, the value of the deduction is essentially the same for each year, and if one factors in time-value-of-money then a taxpayer will choose to take the deduction today. If the taxpayer will not be in the AMT in the following year, however, then all or a portion of the deduction will create a tax benefit at the higher regular-income tax rate. In addition, if

regular tax rates increase in the following year, the value of those deductions under the regular tax system will increase, but the reduction will likewise decrease the AMT income and tentative tax liability, albeit at a lower rate; at some level of expense, the AMT could kick back in.

This can also work the other way if the taxpayer would, by accelerating income, place himself in a higher AMT marginal rate in a later year than the current year's marginal tax rate. However, the increase of the regular tax rate while the AMT nominal rates remain the same makes the AMT less implicated in many instances than it has been when the regular and marginal AMT tax rates were closer together.

Taxpayers who are in the AMT from year to year may benefit from spreading out preference items, since this may enable a taxpayer to retain more of the AMT exemption than when those items are concentrated in a single year. Taxpayers could limit their AMT to the \$150,000 threshold at which the exemption phaseout begins annually, which will produce a better result than when the taxpayer exceeds this limit and winds up in a marginal 32.5-percent or 35-percent tax bracket. Of course, the regular tax effects must be taken into account in determining how close one could get to these levels without increasing regular tax liability in excess of the AMT. One of the choices for a self-employed taxpayer is whether to pay quarterly state income taxes on January 15 of the following year when the payment is due, or in December of the current year. Alternatively, an employee can accelerate state income taxes by increasing withholding with the employer. Such items are AMT preferences, but the taxpayer has some flexibility in determining the applicable tax year. In some cases, the taxpayer can shift the treatment of an item, (research expenses, certain drilling costs) by electing whether to take a less advantageous position (write-off period) that is not treated as a preference.

## **D. Social Security Proposal**

### **1. Obama proposal**

Social Security consists of an OASDI component of 12.4 percent of the taxpayer's self-employment income or wages up to a maximum taxable wage base (\$106,800 in 2009) and a 2.9-percent Medicare tax on all self-employment income or wages. The tax burden on wages is shared equally between the employer and employee, but paid fully by a self-employed person.

The Obama proposal would provide an additional percentage of approximately four percent (two percent on the employer and the employee) for employment income in excess of the taxable wage base to the extent the taxpayer has income in excess of \$250,000. This proposal has garnered probably more questions than any other, largely because of the shifting character of the proposal and the uncertainty of the provisions even when pinned down. Above the threshold, earned income and wages would be subject to the OASDI tax. Originally the provision would not apply to wages between the taxable wage base and the \$250,000 threshold. (Of course, as under current law, all such income would be subject to the health insurance (Medicare) 2.9-percent portion of the Social Security tax). The reason for this interpretation being open was confusion as to what the threshold level was measured as. It is unclear whether this refers to just earned income and wages or all income; equally mushy is whether a taxpayer will have to aggregate whatever the defining base for the threshold is for members of the family unit, or at minimum, a spouse.

The most current interpretation, using a four-percent add-on, supposes the threshold refers to AGI, but the additional Social Security tax still only applies to wages or self-employment income.

**Example:** Case I: In 2009, taxpayer has \$150,000 of self-employment income and AGI of \$195,000. Because taxpayer does not have income in excess of the \$250,000 threshold, only the taxpayer's taxable wage base is subject to the OASDI tax.

Case II: Suppose instead taxpayer has AGI of \$255,000. Although in 2009 taxpayer has \$43,200 (\$150,000 - \$106,800) of excess self-employment income, only \$5,000, the AGI in excess of the \$250,000 threshold (\$255,000 - \$250,000), is subject to the four-percent tax.

Case III: If instead, taxpayer had \$300,000 of AGI, taxpayer would now have \$50,000 of AGI in excess of the \$250,000 threshold, but would be subject to the four-percent tax only on the \$43,200 excess self-employment income.

**Caution:**

Suppose taxpayer was an employee receiving wages in the same amounts. The taxpayer would be responsible for a two-percent tax on the amount subject to the tax, and the employer for a two-percent tax on the amount subject to the tax. The practical problem is that the employer should be collecting the employee's share through withholding and remitting that together with its share, but how does the employer know that the employee is subject to the tax and in what amount? All the employer knows is that the wages were \$150,000, but this does not necessarily trigger a tax (Case I), a small tax (Case II), or a significant tax (Case III).

**2. How social security applies to partnerships**

In general, a partner is subject to the self-employment tax on the partner's net earnings from self-employment, which includes the distributive share (whether distributed or not), of the gross income derived from a trade or business, less deductions allocable to such trade or business.<sup>10</sup> In general, this refers to bottom-line §702(a)(8) trade or business income; it does not include dividends and other portfolio income. It also includes the payments received by the individual from a partnership, of which the individual is a member, for services rendered to the partnership or for the use of capital by the partnership, to the extent the payments are determined without regard to the income of the partnership.<sup>11</sup> For this purpose, whether a person is a partner and whether the entity is a partnership is determined under the classification regulations.<sup>12</sup>

**Note:**

However, the key is the existence of a trade or business. Such payments, received from a partnership not engaged in a trade or business do not constitute gross income derived by an individual from a trade or business. An investment activity has been determined in numerous cases not to be a trade or business.

In order for an individual to have net earnings from self-employment, he must carry on a trade or business, either as an individual or as a member of a partnership. In general, the term "trade or business," for the purpose of the tax on self-employment income, has the same meaning as when used in §162. Whether or not an individual is also engaged in carrying on a trade or business depends upon all of the facts and circumstances in the particular case.<sup>13</sup>

The proposed regulations retain the concept that an individual's net earnings from self-employment do not include the individual's distributive share of income or loss as a limited partner. However, guaranteed payments made to the individual for services actually rendered to or on behalf of the partnership engaged in a trade or business are included in the individual's net earnings from self-employment.<sup>14</sup> Is a limited partner engaged in a trade or business? Without such involvement, the partner's distributive share is not

<sup>10</sup> Treas. Regs. §1.1402(a)-1(b).

<sup>11</sup> Treas. Regs. §1.1402(a)-1(b).

<sup>12</sup> Prop. Regs. §1.1402(a)-2(f).

<sup>13</sup> Treas. Regs. §1.1402(c)-1.

<sup>14</sup> Prop. Regs. §1.1402(a)-2(g).

included in net earnings from self-employment. The regulations provide that an individual's net earnings from self-employment do not include the individual's distributive share of income or loss as a **limited partner**, described below.<sup>15</sup> The short answer is that a limited partner is not engaged in a trade or business. However, **guaranteed payments** made to the individual for services actually rendered to or on behalf of the **partnership engaged in a trade or business** are included in the individual's net earnings from self-employment.

- a. The issue of who is a limited partner is not clear. The Service has issued regulations, discussed below, that, while never formally withdrawn, were suspended for a period of time due to Congressional displeasure. The definitional aspect of the term 'limited partner' became more complicated with the advent and quick universal adoption of the limited liability company where the categorization of the member was an issue. In a general partnership, none of the partners were regarded as limited partners, and in a limited partnership none of the general partners were regarded as limited partners; this distinction was largely driven by the distinction of management authority given to a general partner but denied a limited partner. In an LLC, by contrast, a member may or may not participate in the management of the business without becoming the equivalent of a general partner under state law.
- b. Under the most recent guidance, the **general rule** is that an individual is treated as a limited partner unless the individual:<sup>16</sup>
  - Has **personal liability** for the debts of or claims against the partnership by reason of being a partner;
  - Has **authority** (under the law of the jurisdiction in which the partnership is formed) **to contract** on behalf of the partnership; or
  - **Participates** in the partnership's trade or business **for more than 500 hours** during the partnership's taxable year.
- c. An individual holding more than one class of interest in the partnership, who is not treated as a limited partner under the general rule, is treated as a limited partner with respect to a specific class of partnership interest held by such individual if, immediately after the individual acquires that class of interest:
  - Limited partners within the meaning of the general rule own a substantial, continuing interest in that specific class of partnership interest;<sup>17</sup> and
  - The individual's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that specific class of partnership interest held by the limited partners described in the preceding bullet.<sup>18</sup>

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<sup>15</sup> Prop. Regs. §1.1402(a)-2(g).

<sup>16</sup> Prop. Regs. §1.1402(a)-2(h)(2).

<sup>17</sup> Prop. Regs. §1.1402(a)-2(h)(3)(i).

<sup>18</sup> Prop. Regs. §1.1402(a)-2(h)(3)(ii).

**Note:**

A **class of interest** is an interest that grants the holder specific rights and obligations. If a holder's rights and obligations from an interest are different from another holder's rights and obligations, each holder's interest belongs to a separate class of interest. An individual may hold more than one class of interest in the same partnership provided that each class grants the individual different rights or obligations. The existence of a guaranteed payment made to an individual for services rendered to or on behalf of a partnership, however, is not a factor in determining the rights and obligations of a class of interest.<sup>19</sup>

A **substantial interest in a class of interest** is determined based on all of the relevant facts and circumstances. In all cases, however, ownership of 20 percent or more of a specific class of interest is considered substantial.<sup>20</sup>

- d. An individual who is not treated as a limited partner under the general rule solely because that individual participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year is treated as a limited partner with respect to the individual's partnership interest if, immediately after the individual acquires that interest:
- Limited partners within the meaning of the general rule own a substantial, continuing interest in that specific class of partnership interest;<sup>21</sup> and
  - The individual's rights and obligations with respect to the specific class of interest are identical to the rights and obligations of the specific class of partnership interest held by the limited partners described in the preceding bullet.<sup>22</sup>
- e. An individual who is a **service partner** in a **service partnership** may not be a limited partner under paragraphs b., c., and d., above.<sup>23</sup>
- A **service partner** is a partner who provides services to or on behalf of the service partnership's trade or business. A partner is not considered to be a service partner if that partner only provides a de minimis amount of services to or on behalf of the partnership.<sup>24</sup>
  - A **service partnership** is a partnership substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.<sup>25</sup>

**Example:** (i) A, B, and C form LLC, a limited liability company, under the laws of State to engage in a business that is not a service partnership. LLC, classified as a partnership for federal tax purposes, allocates all items of income, deduction, and credit of LLC to A, B, and C in proportion to their ownership of LLC. A and C each contribute \$1x for one LLC unit. B contributes \$2x for two LLC units. Each LLC unit entitles its holder to receive 25 percent of LLC's tax items, including profits. A does not perform services for LLC; however, each year B receives a guaranteed payment of \$6x for 600 hours of services rendered to LLC and C receives a guaranteed payment of \$10x for 1000 hours of services rendered to LLC. C also is elected LLC's manager. Under State's law, C has the authority to contract on behalf of LLC.

(ii) A is treated as a limited partner in LLC because A is not liable personally for debts of or claims against LLC, A does not have authority to contract for LLC under State's law, and A does not participate in LLC's trade or business for more

<sup>19</sup> Prop. Regs. §1.1402(a)-2(h)(6)(i).  
<sup>20</sup> Prop. Regs. §1.1402(a)-2(h)(6)(iv).  
<sup>21</sup> Prop. Regs. §1.1402(a)-2(h)(4)(i).  
<sup>22</sup> Prop. Regs. §1.1402(a)-2(h)(4)(ii).  
<sup>23</sup> Prop. Regs. §1.1402(a)-2(h)(5).  
<sup>24</sup> Prop. Regs. §1.1402(a)-2(h)(6)(ii).  
<sup>25</sup> Prop. Regs. §1.1402(a)-2(h)(6)(iii).

than 500 hours during the taxable year. Therefore, A's distributive share attributable to A's LLC unit is excluded from A's net earnings from self-employment.

(iii) B's guaranteed payment of \$6x is included in B's net earnings from self-employment. B is not treated as a limited partner because, although B is not liable for debts of or claims against LLC and B does not have authority to contract for LLC under State's law, B does participate in LLC's trade or business for more than 500 hours during the taxable year. Further, B is not treated as a limited partner because B does not hold more than one class of interest in LLC. However, B is treated as a limited partner because B is not treated as a limited partner solely because B participated in LLC's business for more than 500 hours and because A is a limited partner who owns a substantial interest with rights and obligations that are identical to B's rights and obligations. In this example, B's distributive share is deemed to be a return on B's investment in LLC and not remuneration for B's service to LLC. Thus, B's distributive share attributable to B's two LLC units is not net earnings from self-employment.

(iv) C's guaranteed payment of \$10x is included in C's net earnings from self-employment. In addition, C's distributive share attributable to C's LLC unit also is net earnings from self-employment because C is not a limited partner. C is not treated as a limited partner because C has the authority under State's law to enter into a binding contract on behalf of LLC and because C participates in LLC's trade or business for more than 500 hours during the taxable year. Further, C is not treated as a limited partner because C does not hold more than one class of interest in LLC. Finally, C is not treated as a limited partner because C has the power to bind LLC. Thus, C's guaranteed payment and distributive share both are included in C's net earnings from self-employment.

Perhaps less heralded than its S corporation counterpart (discussed below) is a companion Rangel proposal that would eliminate the cover currently given to a limited partner under the Social Security provisions. At present, the distributive share of any item of income or loss is excluded from a limited partner unless it is for a guaranteed payment for services actually rendered to or on behalf of the partnership to the extent those payments are established to be in the nature of remuneration for those services. The Rangel proposal would not apply this provision to any partnership which is engaged in a trade or business consisting **primarily of the performance of services** with respect to a limited partner who performs substantial services with respect to such trade or business.

Current law provides exclusion to any trade or business as to the limited partner to the extent that the amount is not a guaranteed payment. A guaranteed payment is one whose amount is determined without regard to the income of the partnership; thus, in general, just providing a distributive share to a limited partner, which is determined by the income of the partnership, does not run afoul of the guaranteed payment exception and avoids self-employment tax, even if the limited partner provides services to the partnership.

**Note:**

This proposal would cause the limited partner to be subject to self-employment tax but only if the partnership is one whose trade or business consists primarily in the performance of services. And then, the tax would only arise if the limited partner provided not merely services but substantial services with respect to that partnership.

First, is the trade or business primarily in the performance of service, as opposed to the rendition of capital? Is this primarily determined by income attribution, hours, or some other basis, and if so, will this require cost accounting? Such questions are probably not a concern in the case of clearly service operations such as an accounting or medical firm or in the case of such clearly non-service enterprises such as manufacturing.

Second, when are the services substantial? In other contexts, a fixed number of hours, such as 500, is used to define substantial services, but at this point we have no basis upon which to determine what this is.

In addition, the partner must be a limited partner. The proposed self-employment tax regulations would treat a partner not as a limited partner if the partner participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year (and performing service would seem to be participation). It would seem that if substantiality required 500 hours of service, the partner would no longer be a limited partner anyway, so the Rangel provision would not be necessary.

Taxpayers invested in a partnership or LLC who are engaged in its operations -- not a limited partner or "limited" member -- generally cannot avoid the self-employment tax on pass-through income of the business; such entity business is considered self-employment income even if not actually received by the investor. By contrast, an S corporation is an employer that pays wages to its employees, which includes all of its shareholder-employees. With respect to employees only wages are subject to FICA, and in general only amounts actually paid to the shareholder-employee can be characterized as wages.<sup>26</sup> In other words, amounts that pass-through to shareholders but are not distributed are not subject to FICA. Case law established that such income is not self-employment income. The standard response by such taxpayers is to roll up partnership or LLC businesses to an S corporation where they can retain flexibility as to the timing and amount of Social Security tax by controlling compensation payments. This would be further indicated with the potential rate change to Social Security.

### **3. Rangel proposal -- S corporations**

In the case of an S corporation, only amounts paid are subject to Social Security; the pass-through of S corporation items is not subject to FICA or to self-employment tax. One popular strategy then to avoid Social Security tax has been not to pay wages but ultimately to make a distribution denominated as a dividend.

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<sup>26</sup> As some taxpayers -- in point of fact, accountants -- have found out, the Service may be able to recharacterize a nominal "dividend" distribution as compensation subject to Social Security. See *Radtke v. United States*, 712 F. Supp. 143 (D. Wi. 1989) and *Spicer Accounting, Inc. v. United States*, 918 F2d 90 (9<sup>th</sup> Cir. 1990).

**Planning point:**

The Service has achieved success in several cases in recharacterizing as wages payments made to the shareholder-employee designated by the corporation as a dividend. The cases at this point share the following common characteristics. First, there were actual payments made to the shareholder-employee equal to or approximately equal to the corporation's net income. The shareholder-employees received no payments denominated as wages during the taxable year. In each case, the shareholder-employees were denominated as wages during the taxable year. In each case, the shareholder-employees were denominated as wages during the taxable year. In each case, the shareholder-employees were denominated as wages during the taxable year. In each case, the shareholder-employees were denominated as wages during the taxable year. It is the combination of these facts that has led courts to conclude that such arrangements are artifices for the purpose of avoiding employment tax.

The accountant is no doubt aware that, in general, the Service has won unreasonable-compensation cases where the opposite was true; no dividends were paid to the shareholder-employee of a corporation generally engaged in a capital-intensive activity. In effect, it does not comport to economic reality that an investor receives no return on capital investment. So, the flip side of the coin is that it does not conform to economic reality that an employee would receive no return on services performed. Many a corporation has won an unreasonable-compensation case by regularly paying some small and recurring dividend payment to the shareholder. In most instances, the double taxation on such dividends is a relatively small cost compared to the typical loss in having a significant portion of "compensation" subject to double tax. The courts are far more likely to respect the corporation's business strategy of small dividends to finance future corporate growth than a strategy of no dividends.

The first point is that the Service is less likely to raise the unreasonably low compensation issue in capital-intensive S corporations or those on the accrual method of accounting by reason of the corporation's business. It is much more likely to do so in the case where the compensation for services rendered predominates the return on invested capital. Service companies that hold real estate both for their own use and for leasing out to tenants will improve their position by buying or building bigger than the service business to ratchet up the invested capital. Doctors and dentists may already have sufficient capital to afford their professional S corporation's protection against the Service attack, although there are no cases or rulings on point.

The second point is that the professionals or other service organization should adopt a balanced approach in making payments to shareholder-employees. Rather than trying to evade all employment taxes, it is recommended in most cases that the shareholder-employee receive some amounts denominated as wages and pay along with the corporation employment tax. The nonpayment of any employment taxes is clearly a red flag triggering an audit by the Service.

The third point is that the Service **cannot recharacterize as wages amounts that are not paid to the shareholder-employee**. In other words, there can be no wages subject to employment taxes for amounts that are not distributed. If the shareholder can afford it, the income should be retained in the corporation. For those who cannot afford that strategy, a more aggressive approach is for the corporation to loan money to the shareholder in a fully documented transaction complete with notes calling for regular interest payments at a market rate of interest, which are, in fact, payments made by the shareholder-employee.

**Example:** A is the sole shareholder of S Corporation. Each year, the corporation has \$106,800 of taxable income before payment of compensation to A. For 2009, 2010, and 2011, A takes no money out of the corporation, but receives \$427,200 in 2012. Assuming the taxable wage base remains constant, no employment taxes other than the 2.9-percent Medicare tax is payable with respect to \$320,400. Thus, neither the corporation nor the shareholder pays 12.4 percent x \$106,800, an annual savings of \$13,243.20 in each of 2009, 2010, and 2011.

**Note:**

While the IRS is struggling to develop a comprehensive strategy to address S corporation noncompliance, taxpayers are burdened by the S corporation election process and K-1 matching program errors. In addition, a significant number of S corporations classify all payments to their officers as "distributions" rather than "wages," effectively avoiding employment-tax liabilities. The National Taxpayer Advocate has urged the IRS to establish a **tracking system** to assess the final tax effect of S corporation adjustments and related issues such as **employment-tax** results. The IRS also should establish an outreach campaign and a soft-contact letter test to address the **officer-compensation issue**. **Employment taxes** attributable to S corporation shareholder wages that are treated as distributions accounted for an estimated \$5.7 billion of the tax-year 2000 tax gap.

Shareholders earn compensation from services to the corporation and reap the benefits of profitability through corporate distributions. Shareholders of S corporations may serve in key roles of the business, providing management, sales, or service functions, control the day to day activities of the company, and make decisions affecting its future. Most S corporations are owned by one or two shareholders,<sup>27</sup> which indicates that sole proprietorships may incorporate to gain limited liability, and that they favor the flow-through reporting structure. The earnings of an S corporation are taxed as ordinary income to its shareholders. Unlike partnership or sole proprietor earnings, however, S corporation earnings are not subject to self-employment tax.<sup>28</sup> This difference in treatment gave rise to a tax planning strategy that treats shareholder compensation payments as distributions of profit to avoid payroll taxes. Under this approach, officer/shareholders take no salary or a nominal salary and receive the remaining compensation as tax-free distributions. The corporation saves payroll taxes, and the shareholder ultimately pays only income taxes on his or her share of the corporate profits and avoids paying Social Security and Medicare taxes.

In tax-year 2005 almost one million S corporations with one shareholder paid no officers' compensation.<sup>29</sup> Had all profitable S corporations that reported no officers' compensation been Schedule C businesses, they would have paid an estimated \$4.9 billion in self-employment tax.<sup>30</sup> This disparity is part of the employment tax gap. The Treasury Inspector General for Tax Administration (TIGTA) reported this strategy in its report on filing characteristics and examination results for partnerships and S corporations: "As we have previously reported, single ownership in an S corporation has the benefit of allowing owners to pay employment taxes on only the portion of profits they decide to pay themselves as salary."<sup>31</sup>

<sup>27</sup> Eighty-four percent of processing year 2006 S corporation returns had one or two shareholders. IRS Compliance Data Warehouse, Business Returns Transaction File (Processing Year 2006).

<sup>28</sup> Rev. Rul. 59-221, 1959-1 C.B.

<sup>29</sup> IRS Compliance Data Warehouse, Business Returns Transaction File (Processing Year 2006). The total count of tax year 2005 one shareholder S corporations with no officer's compensation is 982,480.

<sup>30</sup> The estimated total additional self-employment tax for profitable S corporations with no officer's compensation is \$4,898,673,874.

<sup>31</sup> Treasury Inspector General for Tax Administration, Ref. No.2006-30-114, Filing Characteristics and Examination Results for Partnerships and S Corporations 6 (Aug. 2006).

The IRS continues to audit returns based on this issue and **reclassify distributions as wages** subject to employment taxes. Establishing a fair and reasonable wage is difficult, time consuming, and requires the IRS examiner to consider:

- The financial condition of the corporation;
- The time worked by the shareholder;
- The company's compensation policy for other workers;
- The salary structure in companies in similar industries; and
- The return on investment.

The IRS acknowledges the wage issue as a special compliance problem and features it in corporate classification guidelines for Form 1120S.<sup>32</sup> In addition, the IRS now includes a reference to the issue in its notice of acceptance of an S corporation.<sup>33</sup> The IRS has repeatedly litigated the issue and won numerous Tax Court cases relative to reasonable compensation.<sup>34</sup> In each case, the company president and majority shareholder received distributions that were recharacterized as wages subject to employment taxes. The economic impact of the employment-tax strategy affects the tax gap and erodes the Social Security and Medicare tax base.<sup>35</sup> Actions are needed to reverse the trend of electing S corporation status to avoid Social Security taxes.

An additional potential change is treating the pass-through income of **service S corporations** as self-employment income of its shareholders. Representative Rangel, Chairman of the House Ways and Means Committee, got wind of the S corporation strategy outlined above and in order to prevent taxpayers from succeeding has proposed in his tax reform proposals a fundamental change in the way S corporation shareholder-employees are taxed for Social Security purposes. Under the Rangel proposal, in the case of any S corporation that is engaged in a trade or business consisting **primarily of the performance of services** (service S corporation), any shareholder of such S corporation who provides **substantial services** with respect to such trade or business takes into account pass-through income in determining the shareholder's net earnings from self-employment.

**Note:**

This provision uses the phrase "performance of services" not personal services, so the definitions, regulations, and case law that have interpreted that term are not availing. Presumably, primarily for the performance of services is a broader concept than personal services.

**Example:** A is the sole shareholder of S Corporation. Each year, the corporation has \$106,800 of taxable income before payment of compensation to A. For 2009, 2010, and 2011, A takes no money out of the corporation, but receives \$427,200 in 2012. Assuming the taxable wage base remains constant, and that this represents all of A's gross income, no employment taxes other than the 2.9-percent Medicare tax is payable with respect to \$320,400 and the two-percent additional Social Security tax on \$177,200 (\$427,200 - \$250,000). Thus, neither the corporation nor the shareholder pays 12.4 percent x \$106,800, an annual savings of \$13,243.20 in each of 2009, 2010, and 2011, but now picks up an additional \$3,544.00, a net savings of \$9,699.20.

If instead, A is paid \$266,200 in 2012 and 2013, A only picks up the additional two percent on the \$32,400 excess in those years, or \$648, a net of \$12,595.20, but over a five-year period, rather than a four-year period.

<sup>32</sup> IRM 4.1.5.1.14 (Oct. 24, 2006).

<sup>33</sup> IRS Notice CP 261 (Sept. 2006).

<sup>34</sup> See *Veterinary Surgical Consultants, P.C. v. Commissioner*, TC Memo 2003-48; *Nu-Look Design, Inc., v. Commissioner*, T.C. Memo 2003-52; *Superior Proside, Inc. v. Commissioner*, T.C. Memo 2003-50.

<sup>35</sup> Treasury Inspector General for Tax Administration, Ref. No. 2005-30-080, *Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations* 5 (May 2005).

What if A already has \$250,000 of income without regard to the S corporation? Now when the \$427,200 is paid to A in 2012, the entire amount is both wages and above the dollar threshold. Thus, the two-percent tax will apply to \$320,400 (\$427,400 - \$106,800), triggering a \$6,408 liability. If the amount is paid out over two years, the amount each year subject to tax is \$106,900 (\$213,700 - \$106,800), generating a total tax of \$4,276 (2 x .02 x \$106,900).

**Note:**

The discrepancy in these results suggests tax planning that can push more income into a year when the Social Security will not be imposed to limit the additional Social Security tax.

If A is subject to the Rangel proposal by the S corporation being a service S corporation, A will be subject to the full 15.3-percent tax in each year, but because the amount of wages does not exceed the taxable wage base, none of the pass-through amounts will ever be subject to the two-percent tax.

**4. What planning opportunities arise from the proposed change in Social Security?**

Social Security consists of two components: the Old Age and Supplemental Disability Income (funded by the 12.4-percent joint rate on wages), and Medicare (funded by the 2.9-percent joint rate on health insurance). Under current projections, Medicare may go bust by 2019 and retirement income by 2041, and these dates have been getting closer each year. A major fix of Medicare must be taken within the next few years even if politicians stave off an overhaul of the retirement benefits for another decade or more. The refund of Social Security tax for the middle class has been estimated to accelerate the bankruptcy by up to 18 months.

**Planning point:**

There are several ways to attack the problem. First is to structure to the extent possible income that is not itself wages subject to Social Security or self-employment income so as to avoid or minimize the FICA-taxable addition above the taxable wage base. Second is to structure the deployment of income within an economic unit so as to allow the taxpayer not to exceed or to minimize the excess of the taxpayer's income above the middle-class threshold.

- a. Taxpayers invested in a partnership or LLC generally cannot avoid the self-employment tax on pass-through income of the business; such entity business is considered self-employment income even if not actually received by the investor. By contrast, an S corporation is an employer that pays wages to its employees, which includes all of its shareholder-employees. With respect to employees only wages are subject to FICA, and in general only amounts actually paid to the shareholder-employee can be characterized as wages.<sup>36</sup> In other words, amounts that pass-through to shareholders but are not distributed are not subject to FICA. Case law established that such income is not self-employment income. The standard response by such taxpayers is to roll up partnership or LLC businesses into an S corporation where they can retain flexibility as to the timing and amount of Social Security tax by controlling compensation payments. This would be further indicated with the potential rate change to Social Security discussed earlier.

<sup>36</sup> As some taxpayers – in point of fact, accountants – have found out, the Service may be able to recharacterize a nominal “dividend” distribution as compensation subject to Social Security. See *Radtke v. United States*, 712 F. Supp. 143 (D. Wi. 1989) and *Spicer Accounting, Inc. v. United States*, 918 F2d 90 (9<sup>th</sup> Cir. 1990).

**Note:**

Another alternative to the S corporation is the positioning of the taxpayer as a limited partner in a partnership or a "limited" member in a manager-managed LLC. But as noted above, if the Rangel proposal is enacted, many such members may still be subject to Social Security or self-employment tax if the partnership is engaged in a trade or business that is primarily engaged in the performance of services.

- b. The additional Social Security tax likewise cannot be avoided in an S corporation, assuming the Rangel proposal is enacted, merely by limiting compensation to the taxable wage base if the S corporation is primarily engaged in the performance of services if the shareholder provides substantial services.

**Planning point:**

However, as the proposal would not apply to the shareholder-employees of an S corporation that is not engaged in a trade or business consisting primarily of the performance of services (a "non-service S corporation"), taxpayers should still consider the conversion of a non-service LLC, partnership, or sole proprietorship to an S corporation to create pass-through income not subject to self-employment tax for taxpayers who otherwise would have income in excess of \$250,000; a shareholder-employee can receive up to the taxable wage base as wages and take the balance as pass-through income not subject to Social Security so that even if the shareholder's income exceeds the \$250,000 threshold, the shareholder does not have excess wages that would be exposed to the added Social Security tax.

- c. To the extent income may be directed to others in the economic unit, such as children, whose income or wages are not attributable to the taxpayer may enable the taxpayer to avoid the enhanced Social Security tax. BUT one should consider that the dollars shifted to the child **as wages** are generally fully taxable at the 15.3-percent combined rate, while the taxpayer is only saving the net two-percent increase in the Social Security tax. In many respects, it would be better that some income that might be earned income to the taxpayer be transformed into unearned income in the hands of the child.

**Note:**

Such income would typify the income of a limited partner or a shareholder of an S corporation who performs no services for the partnership or corporation. However, each of these business entities has certain roadblocks to realizing such shifts that must be taken into account.

In the case of a partnership, a person will be recognized as a partner if he **owns** a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person. In the case of a partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, **except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor**, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. An interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The "family" of any individual includes only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons.

Similarly, the Service is authorized to reallocate income among family members if one or more of them is not paid reasonable compensation for services rendered to an S corporation.<sup>37</sup> The principal purpose of the provision is to prevent the payment of inadequate compensation to a high-tax-bracket family member in an effort to shift income to a low-tax-bracket family member. For planning purposes, compensation should be based on the low end of reasonable compensation for the older-generation shareholders. Even if there is a readjustment for income-tax purposes, the allocable shares of income are passed to the other younger-generation shareholders without any apparent incidence of transfer (estate or gift) tax. If unreasonable compensation is paid, the Service may make adjustments to the income of the employee and any member of the employee's family who is a **shareholder** of the S corporation.<sup>38</sup> The power of the Service to reallocate income among members of a family group is broad. Specifically, if an individual who is a "member of the family of one or more shareholders of an S corporation performs services for the corporation or furnishes capital to the corporation without receiving reasonable compensation therefor, adjustments may be made in the items of income, losses, deductions, and credits taken into account by such individuals and shareholders to properly reflect the value of such services or capital."<sup>39</sup>

## E. Potential health reform

### 1. Agenda

The Senate Finance Committee Chairman, Senator Max Baucus, D-Mont., has indicated that the committee will probably take up tax issues related to healthcare reform by the end of May, and it will consider a healthcare reform package aimed at a reform of the delivery system, coverage, and cost-containment and revenue issues (where tax provisions will be considered). He has suggested that a full healthcare reform package could be marked up as early as June, with legislation moving to the Senate floor by July.

### 2. What may emerge

As noted elsewhere this will have to be meshed with President Obama's suggested tax policy of capping itemized deductions for higher-income earners to help pay for a healthcare reform fund. That proposal has already met resistance from both sides of the aisle, discussed later. Senator Baucus is more likely to cap the dollar amount of employer-provided health care benefits that can be excluded from an employee's income for tax purposes.

- a. A Republican proposal, the Long-Term Care Affordability and Security Act of 2007, would have allowed employers to offer qualified long-term care insurance under cafeteria plans and flexible spending agreements (FSAs) amending current law which explicitly states employees are prohibited from paying for the cost of long-term care tax-free.
- b. Obama on the 2008 stump proposed a refundable small-business health tax credit to a small business that offers insurance to all employees to claim up to 50 percent on premiums. It may have undergone evolution since that time as none of the broad outlines have been addressed in a policy statement of the administration.
  - (i) To be eligible for the credit, small businesses will have to offer a quality health plan to all of their employees, and cover a meaningful share of the cost of employee health premiums.

<sup>37</sup> I.R.C. §1366(e) also authorizes the Service to reallocate income among family members if one of them furnishes capital without receiving reasonable compensation therefor.

<sup>38</sup> I.R.C. §1366(e).

<sup>39</sup> I.R.C. §1366(e).

- (ii) The credit would be fully available to small firms, and would be phased out for medium-sized firms. It would also be phased out for small firms with high-income employees.
  - (iii) The Obama health care plan will provide small businesses with new opportunities to buy low-cost, high-quality health plans for their employees through a national exchange similar to what is offered to members of Congress. This exchange will allow small businesses to get the same benefits of spreading risk and administrative costs over a large pool that larger businesses currently enjoy.
  - (iv) The Obama plan will reimburse employer health plans for a portion of the catastrophic costs they incur above a threshold if they guarantee such savings are used to reduce the cost of workers' premiums. This reimbursement (often called reinsurance) is particularly important for small business plans, which can be overwhelmed by the costs of catastrophic expenditures for even a single employee. Through this provision, the Obama plan will reduce the volatility of premiums and help lower health costs for small employers and their employees.
  - (v) The Obama plan will aggressively lower health costs by facilitating broad adoption of standards-based electronic health information systems, and other value-increasing innovations improving chronic care management, and increasing insurance market competition.
- c. Senator Baucus has already set out a significant paper outlining the scope of health care reform, "A Call to Action," a white paper outlining his goals for healthcare reform. The paper also highlights the importance of keeping current employer-based coverage and suggests the system could be improved with §125 plans for employees (per the Republican 2007 proposal) and a targeted small-business tax credit to help cover the cost of providing coverage.
- (i) To strengthen the connection of insurance to the workplace, all except the smallest employers would offer a §125 plan under the Baucus plan. Section 125 plans allow employees to pay their health insurance premiums through their employer's payroll deduction and with pre-tax dollars. Premiums paid with pre-tax dollars are not subject to federal and state taxes. By offering §125 plans, employers would make it easier and cheaper for their workers to purchase insurance.
    - Large employers – especially firms paying high wages – have the greatest capability to provide coverage to their employees. The vast majority of American employers in this category would probably continue to provide coverage as a competitive benefit to recruit employees. If these employers choose not to provide coverage, under the Baucus plan they would have to contribute to a fund that would help to cover those who remained uninsured. The contribution would likely be based on a percentage of payroll that took into account the size and annual revenues of each firm. Mid-sized and small employers would also have the option of providing adequate coverage or paying into the general coverage fund, but the required contribution would be less for them than that for larger firms.
    - Businesses with the fewest workers and the lowest wages would be offered a new tax credit to purchase health insurance for their employees (described below), and would be exempt from contributions to the

general coverage fund if they were still unable to offer insurance to employees.

- (ii) As health care coverage becomes more expensive, many small businesses simply cannot bear the additional cost of providing health coverage for their employees. And for this reason, the number of small businesses offering their employees health care coverage is declining. To help small businesses, the Baucus plan would provide a targeted tax credit that small firms could use towards the cost of purchasing health care coverage.
- There are a number of ways that such a tax credit could be structured. One option is to make the tax credit available to any small business, for both individual and family coverage. After the initial implementation, the tax credit would be available to small businesses that purchase coverage for all of their employees in the Health Insurance Exchange and make a meaningful contribution towards the cost of the premium for their employees' health care.
  - In order to target the tax credit most efficiently, the **credit would be based on a firm's size and earnings per employee**. The smallest firms with the lowest average earnings will be eligible to receive a credit equal to half of the average total premium cost for employer-sponsored insurance in the firm's state. This credit will be phased down as firm size and average earnings increase. The employee and earnings phaseouts work together, until the credit is fully phased out.
- (iii) To fill the gap in coverage, the Baucus plan would also allow individuals aged 55 to 64 to buy Medicare coverage. The option would be available to any individual in this age group who otherwise did not have access to health coverage through a public plan or a group health plan. The benefits would be the same as those available to current Medicare beneficiaries. This new Medicare buy-in option is temporary. It would be available until the Health Insurance Exchange was established. Once that new infrastructure is in place, Americans 55 to 64 years old who had not obtained coverage through the Medicare buy-in would be able to buy insurance in the new marketplace. Those already enrolled in the Medicare buy-in would have the option to remain in Medicare. Medicare would charge enrollees electing the buy-in option an annual premium.
- (iv) Baucus is committed to balance any tax reforms in this area with the desire of Americans to maintain employer-based health coverage. Current tax law favors individuals who receive health insurance through their employer.
- The employer's contribution to health care and premiums is excluded from an individual's income for both income and payroll tax purposes. In addition, an employee's share of the premium cost can be excluded if it is made through what is called a cafeteria benefit plan. This means workers are not taxed on the value of their health premiums, even though the premiums are part of the worker's total compensation package. There is no limit on the amount of premiums that can be excluded from wages. The tax exclusion fosters employment-based health coverage, because it lowers the cost of buying insurance through an employer.

- In addition to the employee exclusion, other incentives to purchase health care and health coverage are available through the tax code. An employee's pre-tax contributions for health insurance or medical expenses through a Flexible Spending Account (FSA) are excluded from income and therefore not subject to tax. There are no limits on the amount of wages an employee can contribute on a pre-tax basis to an FSA. For individuals who qualify to contribute to a Health Savings Account (HSA) by enrolling in a high-deductible health plan, up to \$2,900 of those contributions for individuals and \$5,800 for families are deductible in tax year 2008.
- Self-employed individuals can deduct the cost of health insurance premiums for themselves, their spouse, and their dependents for income tax purposes, but they must pay self-employment tax on these amounts. This is less favorable treatment than employer-provided health insurance. And finally, those who purchase health insurance through the individual market, and those who have out-of-pocket medical expenses, may deduct their spending to the extent that it exceeds 7.5 percent of their adjusted gross income and they itemize their deductions.

**Note:**

Many economists argue that the incentives are inequitable because the amount of tax benefit received differs based on how health coverage is received: those covered through their employers are rewarded with the largest tax breaks, while those who must obtain coverage on the individual market receive a much smaller tax break, or none at all. Current incentives are also regressive because they are, for the most part, more valuable to taxpayers who are subject to higher marginal rates. As such, they give larger subsidies to higher-income workers, instead of to the lower-income Americans who need more help buying insurance.

The unlimited employee tax exclusion probably leads to increased health spending. The unlimited tax benefit for the exclusion encourages workers to purchase more expensive coverage to avoid co-payments and deductibles. This lower cost sharing can lead to higher use of services that are considered non-urgent and discretionary. Additionally, employees who have different health insurance options from which to choose may spend health care dollars unnecessarily to simply buy the most expensive plan they can afford, instead of looking at the amount of coverage that they actually need.

**Planning point:**

Targeted reforms of the exclusion that make the incentive more equitable and reduce spending: One option for reform is to cap the amount of health care premiums that can be excluded from employee wages for income and payroll tax purposes, by **limiting or capping the tax exclusion based on the value of health benefits** or, as an alternative, based on a **person's income** -- or **both**. Employees could be allowed to **exclude**, for example, **up to a specific dollar amount** in health benefits from their wages each year. If they purchase health plans with greater benefits, the difference between a more generous plan and the cap could be subject to federal and state income taxes.

Alternatively, the exclusion could be made available on a **sliding scale based on income**: people with low wages could be allowed to exclude 100 percent of the premiums offered through their employers, with the **percent** allowed phasing down or out with income.

### **3. The House version**

Already discounted as inoperable as a result of various town hall meetings and negative blowback from constituency groups, the House has passed, in Committee, various forms of a legislation that seeks to finance a “public option on health care reform. Current political parlance has eliminated the phrase “health care reform” to “health insurance reform.”

- a. The House Ways and Means Committee has proposed and approved a surtax on certain taxpayers in addition to the tax determined by the ordinary income tax rates. The America's Affordable Health Choices Act of 2009 would, beginning in 2010, imposes up to three separate surtaxes: (1) a 1 percent surtax on joint filers on modified adjusted gross income in excess of \$350,000 but not in excess of \$500,000 (\$175,000 and \$250,000 for married filing separately; \$280,000 and \$400,000 for all other taxpayers); a 1.5 percent surtax on joint filers on modified adjusted gross income in excess of \$500,000 but not in excess of \$1,000,000 (\$250,000 and \$500,000 for married filing separately; \$400,000 and \$800,000 for all other taxpayers); and a 5.4 percent surtax on joint filers on modified adjusted gross income in excess of \$1,000,000 (\$500,000 for married filing separately; \$800,000 for all other taxpayers). The 1 and 1.5 percent surtax rates would double in 2013 if the Office of Management and Budget determined by December 1, 2012 that the projected amount of healthcare savings for fiscal 2010 to 2019 did not reach a certain benchmark (\$150 billion). If another benchmark (at least \$175 billion) is attained the two lower surtax rates would be eliminated in 2013. Between these two benchmarks the surtax for the two lower levels of modified adjusted gross income would remain at the original levels.
- b. The effect of this and the sunset of the 2001 tax rates for higher-income taxpayers means that taxpayers in highest bracket could have effective federal marginal rates of 36 percent, 36.5 percent, and 40.4 percent in 2010 and 40.6, 41.1 percent, and 45 percent in 2011 (when the 35 percent ordinary income tax rate increases to 39.6 percent). When state taxes are factored in, taxpayers in nearly half of the jurisdictions could have effective marginal tax rates in excess of 50 percent.
- c. Employers will be deterred from not offering health insurance by the imposition of an 8 percent excise tax on payroll wages. The rate disappears if the employer has no fewer than \$250,000 of payroll wages. It ratchets up in 2 percent rate increase for the \$50,000 brackets above this level and reaches the 8 percent rate once social security wages exceed \$400,000. Employees would likewise face up to a 2.5 percent surtax on their adjusted gross income in excess of the sum of their personal exemptions and standard deduction if they failed to secure adequate coverage.
- d. To encourage employers to provide health insurance. small businesses with fewer than 25 employees could claim a tax credit worth as much as 50 percent of the cost to provide health insurance. The credit would phase out for companies with 10 to 25 employees and would exempt earners making more than \$80,000 from counting toward the credit.
- e. The Blue Dog Democrats in the House and the Senate generally have expressed opposition to the House plan at this point, delaying legislation until after the August recess at the earliest. The Senate has generally proposed a less ambitious program requiring less in explicit tax increases. The current debate there has centered on possible capping of the exclusion for employer-provided health coverage that is unlimited under current law, or an additional tax on insurers who provide Cadillac plans, a limitation on flexible spending accounts, or some combination of them. The administration has indicated it would veto any legislation that capped the exclusion.

## II. Current law opportunities

### A. Cancellation of indebtedness income

#### 1. Permanent exclusion from gross income of discharged home mortgage indebtedness

Prior to enactment, taxpayers were required to include discharges of mortgage indebtedness as income and to pay tax on this income. For all taxpayers, the amount of discharge of indebtedness is generally equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. In almost all cases, any sale of the residence will ordinarily result in a nondeductible personal loss (so §121 has no gain against which to apply).

**Example:** Assume a taxpayer who is not in bankruptcy and is not insolvent owns a principal residence subject to a \$200,000 mortgage debt for which the taxpayer has personal liability. If the creditor forecloses and the home is sold for \$180,000 in satisfaction of the debt, the debtor has \$20,000 income from the discharge of indebtedness which is includable in gross income. Likewise, if the creditor restructures the loan and reduces the principal amount to \$180,000, the debtor has \$20,000 includable in gross income. Note in this case there is no disposition of the qualified residence to which the §121 exclusion could apply even if there were a gain.

The Mortgage Debt Relief Act of 2007 Act provides a permanent exclusion<sup>40</sup> for any discharge of **qualified principal residence indebtedness** (on or after January 1, 2007 and before January 1, 2010)<sup>41</sup> which is secured by a principal residence<sup>42</sup> and which is incurred in the acquisition, construction, or substantial improvement of the principal residence. Instead of including this amount as income, the basis of the individual's principal residence is reduced (but not below zero) by the amount excluded from income.<sup>43</sup>

- a. For these purposes, the term qualified principal residence indebtedness means acquisition indebtedness (under the interest deduction provisions with respect to the principal residence), applied by substituting "\$2,000,000" for "\$1,000,000" ("\$1,000,000 for "\$500,000" for married taxpayers filing separately).<sup>44</sup>
- b. If any loan is discharged, in whole or in part, and only a portion of such loan is qualified principal residence indebtedness, the exclusion applies only to so much of the amount discharged as exceeds the amount of the loan (as determined immediately before such discharge) that is not qualified principal residence indebtedness.<sup>45</sup>

**Example:** Assume that a principal residence is secured by a recourse indebtedness of \$1 million, of which \$800,000 is qualified principal residence indebtedness. If the residence is sold for \$700,000 and \$300,000 debt is discharged, then only \$100,000 of the amount discharged may be excluded from gross income.

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<sup>40</sup> The exclusion does not apply in any case in which the discharge of a loan is on account of services performed for the lender or any other factor not directly related to a **decline in the value of the residence** or to the **financial condition of the taxpayer**. I.R.C. §108(h)(3).

<sup>41</sup> I.R.C. §108(a)(1)(E).

<sup>42</sup> I.R.C. §108(h)(5) defines this as having the same meaning as when it is used for the §121 exclusion

<sup>43</sup> I.R.C. §108(h)(1).

<sup>44</sup> I.R.C. §108(h)(2).

<sup>45</sup> I.R.C. §108(h)(4).

- c. The exclusion for taxpayer insolvency does not apply to the discharge of a qualified principal residence indebtedness unless the taxpayer elects to have it, rather than the exclusion for qualified principal residence indebtedness, apply.<sup>46</sup>

**Note:**

There is a subtle advantage to the qualified principal residence indebtedness discharge even where insolvency applies. In insolvency, any basis reduction is made subject to §1017. A basis reduction under that section with respect to nondepreciable property causes basis reductions to be recaptured as §1245 previously taken depreciation.<sup>47</sup> Such gain is recognized notwithstanding any other provision of the income tax.<sup>48</sup> But the basis reduction not for insolvency but for qualified principal residence indebtedness is not made under or subject to §1017, but solely under §108 itself. The latter provision has no recapture provision. Imagine the surprise of a homeowner who, after discharge of the indebtedness, later sells the home for a gain less than the dollar maximum under §121 (\$500,000 or \$250,000, depending on use factors), has never used any part of the house for business or home office, yet finds that a substantial portion – even all – of the gain is nonetheless taxable, and as ordinary income, because he elected to use insolvency rather than qualified principal residence indebtedness exclusion on discharge. Had he used the new exclusion, gain up to the amount of the maximum dollar amount would have escaped taxation.

**2. Prior law (and post 2009 law)**

The Tax Court has held that an individual failed to report the income he received from a discharge of indebtedness.<sup>49</sup> Taxpayers purchased real property, a two-story residence in need of rehabilitation, for investment purposes and intended to rehabilitate the dwelling and either rent the property or sell it thereafter. They financed the purchase by borrowing money and executed a note and deed of trust/mortgage. Later finding themselves unable to make the mortgage payments on the property, they decided to sell the property in a short sale in order to avoid a foreclosure, which would have adversely affected their credit rating.<sup>50</sup>

- a. The mortgage holder approved the short sale at a price less than the remaining balance of the mortgage. Following the closing of the short sale, the mortgage holder subsequently mailed a Form 1099-C to taxpayer at his previous address, where only his now separated spouse then lived. She notified him that she was in receipt of his copy. Neither included the income resulting from the cancellation of mortgage loan debt in income when they filed their respective federal income tax returns. Further, neither reported the sale of the property.
- b. Generally, a taxpayer must include income from the discharge of indebtedness. However, there are exceptions to this general rule. A taxpayer may exclude income from the discharge of indebtedness if the discharge occurs in a bankruptcy case, or when the taxpayer is insolvent, or if the indebtedness is qualified farm or business real estate debt. Although the real estate property was held as investment property for the production of income, there were insufficient facts to determine whether the exclusion for qualified real property indebtedness might apply.<sup>51</sup> Likewise, there were insufficient facts upon which to determine whether the exclusion for insolvency might apply.
- c. Where property subject to **recourse debt** is disposed of in satisfaction of the debt, the debt is deemed discharged. The disposition by the mortgagor of the property for a

<sup>46</sup> I.R.C. §108(a)(2)(C).

<sup>47</sup> I.R.C. §1017(d)(1).

<sup>48</sup> I.R.C. §1245(a)(1). I.R.C. §1250(a)(1)(A).

<sup>49</sup> Stevens v. Commissioner; T.C. Summ. Op. 2008-61.

<sup>50</sup> A "short sale" in real estate occurs when the outstanding loans against a property are greater than what the property is worth and the lender agrees to accept less than it is owed to permit a sale of the property that secures its note.

<sup>51</sup> I.R.C. §108(a)(1)(D).

release of liability is treated as a sale or exchange upon which gain or loss is realized.<sup>52</sup>

The amount of gain realized is the excess of the amount realized over the taxpayer's adjusted basis in the property, and correspondingly the amount of loss realized is the excess of the adjusted basis over the amount realized. The amount realized is defined as the sum of any money received plus the fair market value of the property received.

- d. The gain or loss on the short sale of the property is computed pursuant to §1001. As a general rule, the amount realized includes the full amount of the remaining debt if the debt is nonrecourse. However, the amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness. This regulation actually bifurcates a transaction such as this one into a taxable sale of property and a taxable discharge of indebtedness.<sup>53</sup> Accordingly, each part should be treated as a separate transaction for tax purposes. The amount realized, which would have included the mortgage debt is reduced by the amount of income received from discharge of indebtedness.<sup>54</sup>

### 3. *Compromised credit card debt*

The Tax Court, in a summary opinion, has held that a solvent couple received discharge of indebtedness income when they settled the outstanding balance on a credit card account with a credit company.<sup>55</sup> The taxpayers had three joint credit cards issued to them by MBNA America Bank N. A. (MBNA). A statement of accounts showed the balance due MBNA on these accounts consisting of credit card charges, balance transfers, checks, interest, operation charges, and penalties totaled \$20,645.39. They secured a loan from a bank to pay off their credit card debt, in an attempt to consolidate their liabilities. They made a payment of \$14,937.26 to MBNA for settlement of their accounts. As a result of this settlement transaction, MBNA issued a Form 1099-C, *Cancellation of Debt*, which reported \$6,583.34 as the amount of debt canceled. The taxpayers were not then insolvent nor did they file for bankruptcy. They did not report any CODI.

- a. The taxpayers argued that the instructions in the IRS guidance booklet for filing a 1099-C require that only the principal of a lending transaction be taken into income as discharge of indebtedness income. Consequently, their outstanding credit card liability, which included interest, operation charges, and penalties, should be reduced pursuant to the instructions in the IRS guidance booklet. The pertinent instructions stated that a debt is any amount owed to taxpayer including stated principal, stated interest, fees, penalties, administrative costs, and fines. The amount of debt canceled may be all or only part of the total amount owed. However, **for a lending transaction**, taxpayers are required to report only the stated principal.

#### **Note:**

For a lending transaction, you are not required to report any amount other than stated principal. A lending transaction occurs when a lender loans money to, or makes advances on behalf of, a borrower (including revolving credit and lines of credit). Nonprincipal amounts include penalties, fines, fees, and administrative costs. However, for a nonlending transaction, report any of these amounts that are included in the debt." This guidance is provided by the IRS to assist parties in preparing a Form 1099-C.

<sup>52</sup> *Frazier v. Commissioner*, 111 T.C. 243 (1998).

<sup>53</sup> Cf. *Michaels v. Commissioner*, 87 T.C. 1412 (1986).

<sup>54</sup> 1.1001-2(a)(2).

<sup>55</sup> *Scott v. Commissioner*, T.C. Summ. Op. 2006-16.

- b. The taxpayers had not shown the total amount of interest, operation charges, and penalties that they claimed should reduce their outstanding credit card liability. Also, in a nonlending transaction, such as occurred here, any nonprincipal amounts are included in the debt. Thus, the taxpayers were incorrectly interpreting the above-referenced instructions or were incorrectly categorizing their transaction as a lending transaction.
- c. Further, applicable case law establishes that in situations where the facts and circumstances are such that indebtedness from a credit card account is being discharged, the amount of income as a result of the discharge of this indebtedness is an amount equal to the difference between the amount due on the obligation and the amount paid for the discharge, or if no consideration is paid for the discharge, then the entire amount of the debt is considered the amount of income that the debtor must include in income.<sup>56</sup> Accordingly, the taxpayers received discharge of indebtedness income of \$6,583.
- d. The taxpayers alternatively argued that the amount was a reduction of charges agreed to by MBNA in exchange for their prompt payment of \$14,937.26. In other words, the taxpayers argued that they contested the amount of the debt with MBNA and that, through negotiations, it was established that \$14,937.26 was the total amount of the credit card debt. Nothing in the record indicated that they had contested the amount of the credit card debt with MBNA. In fact, MBNA's action of issuing a Form 1099-C was contrary to that contention. It found that the amount was not a reduction of charges but was, in fact, a discharge of indebtedness.

**Note:**

Cancellation of indebtedness income is present in the foreclosure of a home mortgage where the lender has recourse against the homeowner (check the state laws and the mortgage interest). In today's climate of subprime loans now in trouble the Administration is promising some relief on the tax side of the looming foreclosures. This may take the form of an extension of the qualified real property business interest that qualifies for the exclusion. Many taxpayers who may be facing cancellation of indebtedness issues will not be insolvent or in bankruptcy, the more common avenues to the exclusion of such income.

#### **4. Settlement of credit card debt**

The Tax Court, sustaining an IRS deficiency determination against a couple, held that the couple received income through the settlement of credit card debt and failed to report the resulting discharge of indebtedness as income on their tax return.<sup>57</sup> Taxpayers ran up credit card charges, both principal and interest, that the card company compromised by accepting \$4,592 as a full settlement of the account balance of \$21,270, payable in installments over four months. The card company issued him a Form 1099-C, Cancellation of Debt, reporting \$16,678 of discharge of indebtedness income. At the time taxpayers were not insolvent and did not file for bankruptcy. They did not report any income relating to this transaction on their income tax return.

- a. Section 61(a)(12) specifically provides that gross income includes income from the discharge of indebtedness.<sup>58</sup>
- b. Taxpayers claimed that their settlement with MBNA did not result in the discharge of indebtedness but was rather a retroactive reduction of the rate of interest charged by

<sup>56</sup> See *Earnshaw v. Commissioner*, T.C. Memo. 2002-191, affd. 150 Fed. Appx. 745 (10<sup>th</sup> Cir. 2005).

<sup>57</sup> *Payne v. Commissioner*, T.C. Memo. 2008-66.

<sup>58</sup> See also *Gitlitz v. Commissioner*, 531 U.S. 206 (2001); *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931).

MBNA and thus a reduction of the "purchase price" of the loans. They presented calculations showing the amounts actually paid on the account and determined that by the time of their settlement they had paid back all of the principal they had borrowed from MBNA. Unfortunately, this rule applies only to a sale of property and the lending of money in a generic credit card transaction does not constitute the sale of property.<sup>59</sup> Section 108(e)(5) provides an exception where the buyer of property negotiates with the seller/creditor for a discharge of all or part of the purchase money indebtedness. Commonly such a discharge reflects a decline in the value of the property. The resulting discharge of indebtedness is characterized not as taxable income but in effect as a retroactive reduction of the purchase price. The only relationship between the parties was that of debtor and creditor, and thus §108(e)(5) did not apply.

- c. Taxpayers also alleged that no income arose from the discharge of indebtedness for interest payments.<sup>60</sup> Even though there was a legitimate dispute between the debtor and creditor regarding the amount of the debtor's obligation, the Court held that the taxpayer recognized discharge of indebtedness income from the settlement, but the amount was based on the account balance that the taxpayer admitted to rather than the higher amount the Commissioner alleged. That case could not stand for the principle that discharge of indebtedness income does not include the cancellation of debt attributable to interest payments.

**Note:**

The Service treats debt forgiveness in third-party lender cases as a purchase price adjustment only if the forgiveness is directly related to an aspect of the sale, as where a seller inflates the purchase price by misrepresentation.<sup>61</sup>

### **5. Measuring insolvency**

The Tax Court has determined that a couple was not insolvent before or after a credit card company discharged their debt, finding that the value of their home is an includable asset under §108 and that they must include the discharged debt in their gross income.<sup>62</sup> The only issue was whether taxpayers may exclude the value of their residence, which is exempt property for State bankruptcy law purposes, in determining whether they were insolvent for purposes, pertaining to exclusion from discharge of indebtedness income.<sup>63</sup>

- a. Taxpayers encountered financial difficulty stemming from an unrelated party's default on an unsecured loan of \$100,000 made by them. In connection with such loan, they incurred substantial amounts of credit card debt, believing that they would be able to repay their debts to the credit card companies when their debtor repaid the loan owed to them. By the time they realized that the loan they had made would never be repaid, they had incurred more than \$100,000 in credit card debt. They decided to negotiate with the credit card companies to extinguish their debts by paying a lesser sum than was owed. Taxpayers did not include the amount by which their credit card debt exceeded their actual payment (i.e., the amount of relief from indebtedness) in income. The Service determined that such discharge of indebtedness should have been included in income.

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<sup>59</sup> I.R.C. §108(e)(5).

<sup>60</sup> *Earnshaw v. Commissioner*, T.C. Memo. 2002-191.

<sup>61</sup> Rev. Rul. 92-99, 1992-2 C.B. 35.

<sup>62</sup> *Quartemont v. Commissioner*, T.C. Summ. Op. 2007-19.

<sup>63</sup> I.R.C. §108(a)(1)(B).

- b. The increases in net worth from forgiveness or cancellation of indebtedness give rise to gross income,<sup>64</sup> but there are recognized exceptions to this general principle, the most important one of which is the insolvency exception<sup>65</sup>, because this relief from indebtedness does not result in the debtor acquiring something of exchangeable value in addition to what he had before. There is a reduction or extinguishment of liabilities without any increase of assets. The Code also provides this exclusion where the discharge (in whole or in part) or indebtedness of the taxpayer occurs when the debtor is insolvent.
- c. Insolvency is defined in section as the excess of liabilities over the fair market value of assets.<sup>66</sup> Taxpayers contend that property that would be exempt from creditors' claims under State law in bankruptcy proceedings is not taken into account in determining the value of one's "assets" for these purposes. The only such exempt property in this case was their house. If their house was included as an asset (and the encumbering debt is included as a liability) in the insolvency calculation, then they were not insolvent either before or after the forgiveness of debt, and such discharge of indebtedness is includable in their gross income. If, on the other hand, the house is not included as an asset (and any debt thereon is not included as a liability), then they were insolvent both before and after the forgiveness of debt, and the discharge of indebtedness was not includable in their gross income.
- d. The Tax Court had previously decided the word "assets" includes assets exempt from the claims of creditors under applicable State law.<sup>67</sup> Since they were not insolvent either before or after their debt was discharged, the discharge of indebtedness income was includable in their gross income.

**Note:**

Gross income does not include any amount which would be includable in gross income by reason of the discharge of indebtedness if the discharge occurs in a title 11 case.<sup>68</sup> A taxpayer who declared bankruptcy would not be required to include discharge of indebtedness in gross income, whereas a taxpayer seeking to pay his debts and avoid bankruptcy would potentially find himself burdened with additional tax as a consequence.

## **6. Cancellation of indebtedness income**

The Tax Court has held that a couple must include the husband's cancellation of education-related debt in their gross income, finding that they failed to show that the loan had been discharged in bankruptcy or that the loan repayment was not their responsibility.<sup>69</sup> Taxpayer, while taking classes at a local community college, borrowed \$10,030 to purchase an Apple computer (the Apple loan). His mother-in-law applied for the loan on his behalf, and both he and his mother-in-law signed the Application & Promissory Note, agreeing to be jointly and severally liable for the loan. The following year he filed a Chapter 13 bankruptcy petition and a discharge was granted that did not include the Apple loan.<sup>70</sup> In a subsequent year the Apple loan debt was canceled and the creditor mailed Taxpayer a Form 1099-C reporting the discharge of indebtedness.

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<sup>64</sup> *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931).

<sup>65</sup> *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95 (5<sup>th</sup> Cir. 1934), revg. 27 B.T.A. 651 (1933).

<sup>66</sup> I.R.C. §108(d)(3).

<sup>67</sup> *Carlson v. Commissioner*, 116 T.C. 87 (2001).

<sup>68</sup> I.R.C. §108(a)(1)(A).

<sup>69</sup> *Schachner v. Commissioner*, T.C. Summ. Op. 2006-188.

<sup>70</sup> The Application & Promissory Note makes it clear that the Apple loan was not dischargeable in bankruptcy during the first 7 years of repayment.

- a. Gross income does not include cancellation of indebtedness income if the discharge occurs in a title 11 case.<sup>71</sup> While title 11 contains the provisions relating to bankruptcy, including the rules related to Chapter 13. Yet the Apple loan was specifically not discharged -- nor was it dischargeable -- in the bankruptcy proceedings. The loan remained on the books until it was written off. The exclusion does not apply.
- b. Taxpayer attempted to argue that since he was not the "applicant", the debt was not his. However, the simple fact remained that he signed the Application & Promissory Note, promising to be held jointly and severally liable for the debt. He received the proceeds of the loan directly. Further, the sole purpose in obtaining the loan was to enable him to purchase a computer and further his education.
- c. As no exclusion applies and the debt was clearly his responsibility, taxpayers should have included the cancellation of indebtedness income in their gross income on their tax return.<sup>72</sup>

## B. Motor vehicles

### 1. In general

- a. In the case of a taxpayer other than a corporation, no deduction is allowed for personal interest paid or accrued during the taxable year. Personal interest is all interest other than: i) interest paid or accrued on indebtedness properly allocable to a trade or business; ii) investment interest; iii) interest which is taken into account in computing income or loss from a passive activity of the taxpayer; iv) qualified home mortgage interest; v) certain estate tax-related interest; and vi) certain interest on educational loans.

**Note:**

The Senate attempted to give the ailing automotive industry a kick-start by providing an above-the-line deduction for qualified motor vehicle interest. Qualified motor vehicle interest means any interest paid or accrued during the taxable year on any indebtedness incurred after November 12, 2008 and before January 1, 2010 to acquire a qualified motor vehicle and secured by such vehicle. It also includes interest on any indebtedness secured by such qualified motor vehicle resulting from the refinancing of otherwise qualified motor vehicle interest. The amount of qualified indebtedness is limited to \$49,500 (\$24,750 in the case of a married individual filing separately). The deduction is phased out for taxpayers with modified adjusted gross income between \$125,000 and \$135,000 (\$250,000 and \$260,000 in the case of a joint return). This was, however, **not enacted**.

- b. In general, a deduction from gross income is allowed for certain taxes for the taxable year within which the taxes are paid or accrued. These include state, local, and foreign real property taxes; state and local personal property taxes; state, local, and foreign income, war profits, and excess profit taxes; generation skipping transfer taxes; environmental taxes;<sup>73</sup> and taxes paid or accrued within the taxable year in carrying on a trade or business or an activity described in §212 (relating to the expenses for production of income). At the election of the taxpayer for the taxable year, a taxpayer may deduct state and local sales taxes in lieu of state and local income taxes. No deduction is allowed for

<sup>71</sup> I.R.C. §108(a)(1)(A).

<sup>72</sup> Taxpayers were not insolvent at the time the debt was discharged, the debt was not qualified farm indebtedness, and the debt was not qualified real property business indebtedness.

<sup>73</sup> I.R.C. §59A.

any general sales tax imposed with respect to an item at a rate other than the general rate of tax, except in the case of a lower rate of tax applicable to items of food, clothing, medical supplies, and motor vehicles. In the case of motor vehicles, if the rate of tax exceeds the general rate, such excess shall be disregarded and the general rate shall be treated as the rate of tax.

## 2. Qualified motor vehicle sales tax

Applicable to purchases on or after February 17, 2009 in taxable years ending after such date,<sup>74</sup> and before January 1, 2010,<sup>75</sup> the Act permits the deduction of **qualified motor vehicle taxes**.<sup>76</sup>

- a. Qualified motor vehicle taxes means any state or local sales or excise tax imposed on the purchase of a **qualified motor vehicle**.<sup>77</sup> However, the amount of any state or local sales or excise tax imposed on the purchase of a qualified motor vehicle taken into account may not exceed the portion of such tax attributable to so much of the purchase price as does not exceed \$49,500.<sup>78</sup>
- b. Such motor vehicle taxes as so computed and limited for any taxable year are reduced (but not below zero) by the amount that bears the same ratio to the amount which is so treated as the excess (if any) of the taxpayer's modified adjusted gross income<sup>79</sup> for such taxable year,<sup>80</sup> over \$125,000 (\$250,000 in the case of a joint return),<sup>81</sup> bears to \$10,000.<sup>82</sup>
- c. A **qualified motor vehicle** means:
  - A passenger automobile or light truck which is treated as a motor vehicle for purposes of Title II of the Clean Air Act, the gross vehicle weight rating of which is **not more than 8,500 pounds**, and the **original use** of which commences with the taxpayer;<sup>83</sup>
  - A motorcycle the gross vehicle weight rating of which is not more than 8,500 pounds and the **original use** of which commences with the taxpayer;<sup>84</sup> and
  - A motor home the **original use** of which commences with the taxpayer.<sup>85</sup>

### Note:

For these purposes, **motorcycle** and **motor home** have the meanings given such terms under §571.3 of Title 49, Code of Federal Regulations (as in effect on February 17, 2009).

- d. Any qualified motor vehicle tax that is paid or accrued by the taxpayer in connection with an acquisition or disposition of property is not treated as part of the cost of the acquired property.<sup>86</sup> Thus, potentially more gain is recovered on its disposition than under current law where such tax was capitalized into the vehicle's basis.

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<sup>74</sup> Act §1007(e).  
<sup>75</sup> I.R.C. §164(b)(6)(G).  
<sup>76</sup> I.R.C. §164(a)(6).  
<sup>77</sup> I.R.C. §164(b)(6)(A).  
<sup>78</sup> I.R.C. §164(b)(6)(B).  
<sup>79</sup> I.R.C. §164(b)(6)(C)[flush language] defines this as the adjusted gross income of the taxpayer for the taxable year (determined without regard to §911, §931, and §933).  
<sup>80</sup> I.R.C. §164(b)(6)(C)(i)(I).  
<sup>81</sup> I.R.C. §164(b)(6)(C)(i)(II).  
<sup>82</sup> I.R.C. §164(b)(6)(C)(ii).  
<sup>83</sup> I.R.C. §164(b)(6)(D)(i)(I).  
<sup>84</sup> I.R.C. §164(b)(6)(D)(i)(II).  
<sup>85</sup> I.R.C. §164(b)(6)(D)(i)(III).  
<sup>86</sup> I.R.C. §164(b)(6)(E).

- e. A taxpayer who itemizes and makes an election to deduct state and local sales taxes for qualified motor vehicles for the taxable year is not allowed the increased standard deduction for qualified motor vehicle taxes.<sup>87</sup>
- f. The deduction is an itemized deduction except to the extent allocable to a trade or business. However, for nonitemizers, the standard deduction includes the basic standard deduction, the additional standard deduction, the real property tax deduction, the disaster loss deduction, and the motor vehicle sales tax deduction (to the extent not allocable above-the-line to a trade or business).<sup>88</sup>

**Example:** Roger purchases in 2009 a new vehicle for \$55,000 on which a six percent sales tax is paid. His MAGI is \$130,000. Of the \$3,300 (.06 x \$55,000) motor vehicle sales tax, \$2,970 (\$3,300 x \$49,500/\$55,000) is attributable to the first \$49,500 of the vehicle's cost. Because his MAGI exceeds the threshold, Roger must reduce this by one-half ( $[\$130,000 - \$125,000]/\$10,000$ ), so the deduction he can claim is \$1,485.

**Note:**

The portion of the standard deduction attributable to motor vehicle sales tax is deductible in computing AMTI.<sup>89</sup> However, the motor vehicle sales tax that is **itemized** is not deductible in computing AMTI.

**Note:**

In addressing the sales tax issue, advisors must consider these possibilities:

- If the taxpayer has minimal itemized deductions, so that the sum of such deductions and the sales tax does not exceed the standard deduction; the taxpayer simply takes the standard "plus" deduction.
- If the taxpayer has other itemized deductions, one must compare the sum of the state and local income tax and the qualified motor vehicle sales tax, with the state and local sales tax amount.

Taxpayers are given two options for determining the optional deductible sales tax amount: (i) actual sales tax paid if receipts are maintained for IRS verification; or (ii) approximate sales tax paid as estimated in tables provided by the Secretary of the Treasury plus sales taxes paid on major purchases, such as a boat or car.

Remember that the optional sales tax is the sum of the table amount (based on income) AND the actual sales tax on specified items, including an automobile. The actual sales tax on an automobile is NOT limited by cost as the separate motor vehicle tax is. There will therefore be cases where the sales tax option will include a larger amount of deductible sales tax attributable to the motor vehicle than the qualified motor vehicle sales tax. In addition, the motor vehicle sales tax component of the itemized deduction for state and local sales tax is NOT subject to the AGI phase out, which can, even for moderately priced vehicles produce a higher optional sales tax for the automobile than the qualified motor vehicle sales tax.

**Example 1:** Roger, a married Pennsylvania resident, purchases a qualified motor vehicle for \$40,000, generating a \$2,400 sales tax. His income is \$200,000 and he has four exemptions. His table amount, determined by Roger's AGI plus certain items, including tax-exempt interest that is not included in AGI is \$1,861. His Pennsylvania income tax is \$X.

<sup>87</sup> I.R.C. §164(b)(6)(F).

<sup>88</sup> I.R.C. §63(c)(1)(E). For these purposes, motor vehicle sales tax deduction means the amount allowable as a deduction under I.R.C. §164(a)(6). Such term shall not include any amount taken into account under I.R.C. §62(a). I.R.C. §63(c)(9).

<sup>89</sup> I.R.C. §56(b)(1)(E).

The motor vehicle sales tax (.06 x \$40,000) is added to the state and local income tax to reach  $\$X + \$2,400$ . Compare this to the sales tax —  $\$1,861 + \$2,400$ . So long as  $\$X + \$2,400 > \$1,861 + \$2,400$ , one should make the qualified motor sales tax election. Thus, is the Pennsylvania income tax more than  $\$1,861$ ? Disregarding local taxes, and assuming the state tax rate is three percent on Pennsylvania income, Roger must have at least  $\$62,033$  of Pennsylvania taxable income for this to be true. Only in the rare case where Roger's enhanced AGI consists of more than  $\$137,967$  of tax-exempt interest, would Roger be justified in electing the sales tax route.

**Example 2:** Suppose instead Roger purchases a motor vehicle for  $\$70,000$  and pays sales tax of  $\$4,200$ . The motor vehicle tax is limited to  $\$2,970$  (.06 x  $\$49,500$ ), so now that election yields a total deduction of  $\$2,970 + \$X$ , while the sales tax deduction is  $\$1,861$  table amount plus the full  $\$4,200$  of sales tax, or  $\$6,061$ . So long as  $\$X + \$2,970 > \$6,061$ , or put another way,  $\$X > \$3,091$ , the motor vehicle sales tax deduction will be superior. Disregarding local taxes, and assuming the state tax rate is three percent on Pennsylvania income, Roger must have at least  $\$103,700$  of Pennsylvania taxable income.

**Note:**

Only in the remotest of situations will an **itemizer in a state that has an income tax** not choose the state income taxes in lieu of the sales tax option. The reason is that the table amount ends at income of  $\$200,000$ , and therefore state income tax continues to rise even as the table sales tax does not. Yet to purchase vehicles that substantially increase the sales tax above that of the  $\$49,500$  automobile requires having such income.

**Example:** Robert, a married Florida resident, purchases a qualified motor vehicle for  $\$40,000$ , generating a  $\$2,400$  sales tax. Florida does not have an income tax, but does have a six percent sales tax. Robert's AGI plus is  $\$1,000,000$ . With four exemptions, Robert's table amount is  $\$2,154$ . His total sales tax is  $\$4,554$ . He chooses the sales tax because this permits him to deduct  $\$4,554$  rather than the  $\$2,400$  he would be limited to by claiming the qualified motor vehicle sales tax method.

**Note:**

Taxpayers who purchase a new motor vehicle in states that do not impose state sales or excise taxes are entitled to deduct other fees or taxes imposed by the state or local government that are based on the vehicle's sales price or as a per unit fee. According to the IRS and Treasury, the intent of the provision is that these other fees or taxes could qualify for purposes of the special tax deduction.<sup>90</sup>

### 3. Additional first-year depreciation

- a. An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property placed in service during 2008 (and 2009 for certain longer-lived and transportation property).<sup>91</sup> The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service.<sup>92</sup> The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are no adjustments to the allowable amount of depreciation for purposes of computing a

<sup>90</sup> TG-167 (June 11, 2009).

<sup>91</sup> I.R.C. §168(k). The additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible under §162 or instead is subject to capitalization under §263 or §263A.

<sup>92</sup> However, the additional first-year depreciation deduction is not allowed for purposes of computing earnings and profits.

taxpayer's alternative minimum taxable income with respect to property to which the provision applies. The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.

**Example:** The interaction of the additional first-year depreciation allowance with the otherwise applicable depreciation allowance may be illustrated as follows. Assume that in 2008, a taxpayer purchases new depreciable property (which is not eligible for §179 expensing) and places it in service. The property's cost is \$1,000, and it is five-year property subject to the half-year convention. The amount of additional first-year depreciation allowed is \$500. The remaining \$500 of the cost of the property is deductible under the rules applicable to five-year property. Thus, 20 percent, or \$100, is also allowed as a depreciation deduction in 2008. The total depreciation deduction with respect to the property for 2008 is \$600. The remaining \$400 cost of the property is recovered under otherwise applicable rules for computing depreciation.

- b. In order for property to qualify for the additional first-year depreciation deduction it must meet all of the following requirements.
- (i) First, the property must be:
    - Property to which MACRS applies with an applicable recovery period of 20 years or less;
    - Water utility property;<sup>93</sup>
    - Computer software other than computer software covered by §197; or
    - Qualified leasehold improvement property.<sup>94</sup>
  - (ii) Second, the original use<sup>95</sup> of the property must commence with the taxpayer after December 31, 2007.<sup>96</sup>
  - (iii) Third, the taxpayer must purchase the property within the applicable time period.
  - (iv) Finally, the property must be placed in service after December 31, 2007, and before January 1, 2009. An extension of the placed-in-service date of one year (i.e., to January 1, 2010) is provided for certain property with a recovery period of ten years or longer ("longer-lived") and certain transportation property.<sup>97</sup>  
Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.
- c. Property does not qualify for the additional first-year depreciation deduction when the user of such property (or a related party) would not have been eligible for the additional first year depreciation deduction if the user (or a related party) were treated as the owner.

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<sup>93</sup> See I.R.C. §168(e)(5).

<sup>94</sup> A special rule precludes the additional first-year depreciation deduction for any property that is required to be depreciated under the alternative depreciation system of MACRS. See I.R.C. §168(k)(3) for the definition of qualified leasehold improvement property.

<sup>95</sup> Original use means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (i.e., each fractional owner is considered the original user of its proportionate share of the property).

<sup>96</sup> A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback. If property is originally placed in service by a lessor (including by operation of §168(k)(2)(D)(i), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale.

<sup>97</sup> In order for property to qualify for the extended placed-in-service date, the property is required to have an estimated production period exceeding one year and a cost exceeding \$1 million.

**Example 1:** If a taxpayer sells to a related party property that was under construction prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction. Similarly, if a taxpayer sells to a related party property that was subject to a binding written contract prior to January 1, 2008, the property does not qualify for the additional first-year depreciation deduction.

**Example 2:** If a taxpayer (the lessee) sells property in a sale-leaseback arrangement, and the property otherwise would not have qualified for the additional first-year depreciation deduction if it were owned by the taxpayer-lessee, then the lessor is not entitled to the additional first-year depreciation deduction.

**Note:**

The limitation on the amount of depreciation deductions allowed with respect to certain passenger automobiles<sup>98</sup> is increased in the first year by \$8,000 for automobiles that qualify (and do not elect out of the increased first-year deduction). The \$8,000 increase is not indexed for inflation.

d. ARRA extends the **additional first-year depreciation deduction** for one year, generally **through 2009** (through 2010 for certain longer-lived and transportation property). The extension of the additional first-year depreciation deduction is generally effective for property placed in service after December 31, 2008.

- (i) The limitation on the amount of depreciation deductions allowed, with respect to certain passenger automobiles, is increased by \$8,000 for automobiles that qualify (and do not elect out of the increased deduction).<sup>99</sup>
- (ii) Depreciation limitations for passenger automobiles (that are not trucks or vans) placed in service by the taxpayer in calendar year 2009, for which the 50-percent additional first-year depreciation deduction does not apply:

Tax Year	Amount
1st Tax Year	\$ 2,960
2nd Tax Year	\$ 4,800
3rd Tax Year	\$ 2,850
Each Succeeding Year	\$ 1,775

- (iii) Depreciation limitations for passenger automobiles (that are not trucks or vans) placed in service by the taxpayer in calendar year 2009, for which the 50-percent additional first-year depreciation deduction applies:

Tax Year	Amount
1st Tax Year	\$10,960
2nd Tax Year	\$ 4,800
3rd Tax Year	\$ 2,850
Each Succeeding Year	\$ 1,775

- (iv) Depreciation limitations for trucks and vans placed in service by the taxpayer in calendar year 2009 (the numbers are now available), for which the 50-percent additional first-year depreciation deduction does not apply:

<sup>98</sup> I.R.C. §280F.  
<sup>99</sup> Rev. Proc. 2009-24, 2009-17 I.R.B. 1, Tables 1 through 4.

Tax Year	Amount
1st Tax Year	\$ 3,060
2nd Tax Year	\$ 4,900
3rd Tax Year	\$ 2,950
Each Succeeding Year	\$ 1,775

- (v) Depreciation limitations for trucks and vans placed in service by the taxpayer in calendar year 2009 (the numbers are now available), for which the 50-percent additional first-year depreciation deduction will apply:

Tax Year	Amount
1st Tax Year	\$11,060
2nd Tax Year	\$ 4,900
3rd Tax Year	\$ 2,950
Each Succeeding Year	\$ 1,775

- The additional \$8,000 applies to both §179 expensing and depreciation.
- The §179 expense does not require that the purchased property have its original use with the taxpayer. The purchase of a used car does not qualify for additional first-year depreciation.
- There is no AMT depreciation adjustment for qualified property for the entire recovery period of qualified property.
- Certain SUVs are not listed property, making them qualified property but not listed property. As a result, they are entitled to an additional depreciation deduction in the placed-in-service year equal to 50 percent of the adjusted basis of the SUV. Such vehicles are also eligible for expensing under §179. If expensing is claimed, the amount expensed will reduce the cost basis on which the additional 50-percent first-year depreciation is computed. Since first-year depreciation is in addition to regular depreciation, the amount of such deduction as a percentage of cost can be quite high.

***Planning point:***

Only businesses with significant profits in 2009 or recent earlier years will get full benefit of the depreciation in 2009, as excess amounts may represent a net operating loss that is carried forward. Companies that are in relatively low tax brackets now or in carryback years may have a lesser tax benefit than deferring depreciation benefits to later years when their tax brackets are higher, despite the deferral. Similarly, companies that have expiring net operating losses may waste some of the carryforward if the depreciation charges reduce taxable income too much to absorb it fully.

***Note:***

A compromise solution to front-loading too much of the depreciation deduction where deferral might be indicated is to claim bonus depreciation, but elect slower (150-percent declining balance); if made, it applies to all property within a recovery class placed in service within the year.

- Expense old property because only new qualifies for bonus.

- While regular depreciation may result in AMT adjustments if 200-percent declining balance is used, this does not apply to any property for which bonus depreciation is taken, and not just the bonus depreciation itself.
- There is no phaseout of the bonus depreciation based on the amount of capital investment.
- There is no taxable income limitation, so it may be carried forward more effectively than a §179 expense.

## C. American Opportunity tax credit

### 1. Pre-Act Hope credit

The Hope credit permits individual taxpayers to claim a nonrefundable credit against federal income taxes of up to \$1,800 (for 2009) per eligible student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program. The Hope credit rate is 100 percent on the first \$1,200<sup>100</sup> of qualified tuition and related expenses, and 50 percent on the next \$1,200 of qualified tuition and related expenses; these dollar amounts are indexed for inflation, with the amount rounded down to the next lowest multiple of \$100. Thus, for example, a taxpayer who incurs \$1,200 of qualified tuition and related expenses for an eligible student is eligible (subject to an adjusted gross income phaseout described below) for a \$1,200 Hope credit. If a taxpayer incurs \$2,400 of qualified tuition and related expenses for an eligible student, then he or she is eligible for a \$1,800 Hope credit.

- The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified adjusted gross income<sup>101</sup> in excess of threshold amounts, as indexed for inflation. In the case of a joint return, the threshold was set at \$100,000<sup>102</sup> in 2009 and the phaseout range of \$20,000 resulting in complete phaseout when MAGI reaches \$120,000; for all other taxpayers, the threshold was set at \$50,000<sup>103</sup> and the phaseout range of \$10,000 resulting in a complete phaseout at \$60,000 of MAGI.
- The Hope credit generally may not be claimed against a taxpayer's alternative minimum tax liability. However, the credit and other personal credits have been allowed against a taxpayer's alternative minimum tax liability for taxable years beginning prior to January 1, 2009 (and were extended to 2009 by this Act).
- The credit was only available for two taxable years,<sup>104</sup> and it was allowable only in respect of the first two years of post-secondary education.<sup>105</sup>
- The base for determination of the credit is the **qualified tuition and related expenses** incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer.<sup>106</sup> Such expenses generally mean tuition and fees required for the enrollment or attendance; however, they do not include student activity fees, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of

<sup>100</sup> This is a base amount of \$1,000, indexed by inflation based on calendar year 2000. I.R.C. §25A(h)(1)(A). This is rounded to the next lowest multiple of \$100 if the amount is not an exact multiple of \$100. I.R.C. §25A(h)(1)(B).

<sup>101</sup> This is the taxpayer's adjusted gross income for the taxable year increased by any amount excluded as foreign earned income, or certain income from Puerto Rico or certain U.S. territories. I.R.C. §25A(d)(3).

<sup>102</sup> This is a base amount of \$80,000, indexed by inflation based on calendar year 2000. I.R.C. §25A(h)(2)(A). This is rounded to the next lowest multiple of \$1,000 if the amount is not an exact multiple of \$1,000. I.R.C. §25A(h)(2)(B).

<sup>103</sup> This is a base amount of \$80,000, indexed by inflation based on calendar year 2000. I.R.C. §25A(h)(2)(A). This is rounded to the next lowest multiple of \$1,000 if the amount is not an exact multiple of \$1,000. I.R.C. §25A(h)(2)(B).

<sup>104</sup> I.R.C. §25A(b)(2)(A).

<sup>105</sup> I.R.C. §25A(b)(2)(C). No credit is allowed in any taxable year after the year in which the student completed the first two years of post-secondary education at an eligible educational institution.

<sup>106</sup> I.R.C. §25A(f)(1)(A).

instruction.<sup>107</sup> Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program.<sup>108</sup>

- (i) Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition and related expenses do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under §117 and any other tax-free educational benefits received by the student (or the taxpayer claiming the credit) during the taxable year.
  - (ii) The Hope credit is not allowed with respect to any education expense for which a deduction is claimed under §162 or any other section of the Code.
- e. The Hope credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during an academic period beginning during the first three months of the next taxable year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Hope credit. The repayment of a loan itself is not a qualified tuition or related expense.

**Note:**

A taxpayer may claim the Hope credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (e.g., in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent, the student is not entitled to claim a Hope credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of determining the amount of qualified tuition and related expenses paid by such parent (or other taxpayer) under the provision. In addition, for each taxable year, a taxpayer may elect either the Hope credit, the Lifetime Learning credit, or an above-the-line deduction for qualified tuition and related expenses with respect to an eligible student.

- f. An eligible student for purposes of the Hope credit is an individual who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a half-time basis. A student is considered to pursue a course of study on at least a half-time basis if the student carries at least one half the normal full-time work load for the course of study the student is pursuing for at least one academic period that begins during the taxable year. To be eligible for the Hope credit, the student must not have been convicted of a federal or state felony consisting of the possession or distribution of a controlled substance.
- g. Eligible educational institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary

<sup>107</sup>

I.R.C. §25A(f)(1)(C).

<sup>108</sup>

I.R.C. §25A(f)(1)(B).

vocational institutions also are eligible educational institutions. To qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

**Note:**

Effective for taxable years beginning after December 31, 2010, the changes to the Hope credit made by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") no longer apply. The principal EGTRRA change scheduled to expire is the change that permitted a taxpayer to claim a Hope credit in the same year that he or she claimed an exclusion from a Coverdell education savings account. Thus, after 2010, a taxpayer cannot claim a Hope credit in the same year he or she claims an exclusion from a Coverdell education savings account.

**2. Temporary substitute for the Hope Scholarship credit – the American Opportunity credit**

For any taxable year beginning in 2009 or 2010, the Hope Scholarship credit is an amount equal to the sum of<sup>109</sup> 100 percent of so much of the qualified tuition and related expenses paid by the taxpayer during the taxable year (for education furnished to the eligible student during any academic period beginning in such taxable year) as does not exceed \$2,000,<sup>110</sup> plus 25 percent of such expenses so paid as exceeds \$2,000 but does not exceed \$4,000.<sup>111</sup>

This generally increases the amount of the credit:

Qualified expenses	Hope Scholarship credit (as if still in force in 2009 and 2010)	American Opportunity credit (in force for 2009 and 2010)	Lifetime Learning credit
\$500	\$500	\$500	\$100
\$1,000	\$1,000	\$1,000	\$200
\$1,200	\$1,200	\$1,200	\$240
\$1,500	\$1,350	\$1,500	\$300
\$2,000	\$1,600	\$2,000	\$400
\$2,400	\$1,800	\$2,100	\$480
\$2,500	\$1,800	\$2,125	\$500
\$3,000	\$1,800	\$2,250	\$600
\$3,500	\$1,800	\$2,375	\$700
\$4,000	\$1,800	\$2,500	\$800
\$5,000	\$1,800	\$2,500	\$1,000
\$9,000	\$1,800	\$2,500	\$1,800
\$10,000	\$1,800	\$2,500	\$2,000

**3. Extended period of application and later years**

The Act extends the period during which the credit applies. It not only applies to as many as four years of post-secondary education (provided that the student has not completed the first four years of post-secondary education before the beginning of the fourth taxable year),<sup>112</sup> but also to all four years of post-secondary education.<sup>113</sup>

<sup>109</sup> I.R.C. §25A(i)(1).  
<sup>110</sup> I.R.C. §25A(i)(1)(A).  
<sup>111</sup> I.R.C. §25A(i)(1)(B).  
<sup>112</sup> I.R.C. §25A(b)(2)(A). I.R.C. §25A(i)(2).  
<sup>113</sup> I.R.C. §25A(b)(2)(C). I.R.C. §25A(i)(2).

**Planning point:**

Looking at the above table, the American Opportunity tax credit exceeds the Lifetime Learning credit at all levels of qualified expense. Formerly, one could squeeze an additional \$200 (.20 x \$10,000) at expense levels of or more than \$10,000. The Lifetime Learning credit was larger for qualified expenses above \$9,000. The effect of the provision is to limit Lifetime Learning credits to situations in which the taxpayer (or taxpayer's dependent) is a less-than-half-time student or has been convicted of a federal or state felony offense consisting of the possession or distribution of a controlled substance before the end of the taxable year within which such period ends, since in either case an individual does not qualify for the Hope Scholarship (or its surrogate, the American Opportunity, for 2009 and 2010) credit.<sup>114</sup>

**4. Qualified tuition and related expenses**

The Act broadens the base of expenses against which the credit may be claimed to course materials.<sup>115</sup> This brings it into equality with the Lifetime Learning credit, which has always included the costs of books in its qualified expenses.<sup>116</sup>

**5. Phaseout limits for the credit**

The Act increases the limitation for the phaseout of the Hope/American Opportunity credit (but not the Lifetime Learning credit). The credit as computed is reduced (but not below zero) by the amount which bears the same ratio to such credit (as so determined) as the excess of the taxpayer's **modified adjusted gross income** for such taxable year,<sup>117</sup> over \$80,000 (\$160,000 in the case of a joint return),<sup>118</sup> bears to \$10,000 (\$20,000 in the case of a joint return).<sup>119</sup> This increases the thresholds from \$50,000 (\$100,000 in the case of a joint return).

**Example:** Married Taxpayer has MAGI of \$110,000 and has graduate school Lifetime Learning expenses of \$10,000 and \$5,000 of qualifying undergraduate expenses. Before the Act, Taxpayer would compute a \$2,000 Lifetime Learning credit and a \$1,800 Hope credit. The \$3,800 total credit would be reduced by 50 percent (\$110,000 MAGI - \$100,000 threshold)/\$20,000, leaving \$1,900. As a result of the Act, the Lifetime Learning credit is still reduced by 50 percent to \$1,000, but the American Opportunity credit first increases to \$2,500 and is not reduced because Taxpayer's MAGI is below the phaseout MAGI range for that credit. Hence, Taxpayer may claim \$3,500 (\$1,000 + \$2,500).

**6. AMT implications**

In general, the personal credits are applicable only to the excess of the regular tax liability over the tentative tax; it is not applicable against any AMT, i.e., the excess of the tentative tax over the regular tax liability as reduced by the personal nonrefundable credits.<sup>120</sup> However, since 2000, the Congress has enabled this and other such nonrefundable personal credits to be applied against the sum of the regular tax liability (reduced by the foreign tax credit) and the AMT (essentially the tentative tax).<sup>121</sup> As noted later in these materials this has been extended through 2009. However, the American Opportunity tax credit may be applied against the excess of the sum of the regular tax liability plus the AMT<sup>122</sup> over the sum of the nonrefundable personal credits other than the American Opportunity tax credit itself.<sup>123</sup> This in effect permits this credit to offset and reduce an AMT liability. Thus, although the Lifetime Learning credit may be applied against the AMT liability in 2009, its use in 2010 will require enactment of another AMT patch

<sup>114</sup> I.R.C. §25A(b)(2)(B) and §25A(b)(2)(D).

<sup>115</sup> I.R.C. §25A(i)(3); I.R.C. §25A(f)(1)(A).

<sup>116</sup> I.R.C. §25A(c)(2)(B).

<sup>117</sup> I.R.C. §25A(i)(4)(A)(i).

<sup>118</sup> I.R.C. §25A(i)(4)(A)(ii). These income limitations are indexed for inflation. I.R.C. §25A(h)(2)(A).

<sup>119</sup> I.R.C. §25A(i)(4)(B).

program. The American Opportunity credit can be so applied without further Congressional action in 2010.

### **7. Partial refundability**

The Hope credit is a nonrefundable personal credit. However, the Act treats 40 percent of so much of the education credit allowed as is attributable to the Hope Scholarship (American Opportunity) credit (after taking into account the income phaseout, but without regard to the limitation of the credit against the AMT or regular tax liability, as the case may be) as a refundable credit.<sup>124</sup>

#### **Note:**

This means that the American Opportunity tax credit must be bifurcated into the refundable and nonrefundable portions after computing the aggregate amount after income phase out, then the nonrefundable portion of the credit must be applied against the AMT or the regular tax liability in excess of tentative tax<sup>125</sup> and then the refundable portion must be applied as other refundable credits are.

However, no portion of the modified credit is refundable if the taxpayer claiming the credit is a child to whom the kiddie tax applies for such taxable year (generally, any child under age 18 or any child under age 24 who is a student providing less than one-half of his or her own support who has at least one living parent and does not file a joint return).

**Example 1:** Same as above except that Taxpayer's MAGI is \$170,000. In this case, the Lifetime Learning credit is completely phased out and the \$2,500 American Opportunity credit as tentatively calculated is phased out 50 percent ( $\$170,000 \text{ MAGI} - \$160,000 \text{ threshold}$ )/\$20,000 to \$1,250.

**Example 2:** Same as above except that Taxpayer's MAGI is \$30,000 and he has an income tax liability of \$3,000. Neither the Lifetime Learning credit nor the American Opportunity credit is phased out. He may apply the \$2,000 as a credit against the income tax. Of the \$2,500 American Opportunity credit, \$1,000 ( $.4 \times \$2,500$ ) is refundable. Taxpayer applies the first \$1,000 of the credit against income tax liability, reducing it to zero, and \$1,000 refundable portion of the credit as an overpayment of tax subject to refund. Taxpayer loses any benefit with respect to the \$500 excess of the nonrefundable portion of the credit over the income tax liability.

### **8. Possessions**

Bona fide residents of the U.S. possessions (American Samoa, Commonwealth of the Northern Mariana Islands, Commonwealth of Puerto Rico, Guam, Virgin Islands) are not permitted to claim the refundable portion of the American Opportunity credit in the United States. Rather, a bona fide resident of a mirror code possession (Commonwealth of the Northern Mariana Islands, Guam, Virgin Islands) may claim the refundable portion of the credit in the possession in which the individual is a resident. Similarly, a bona fide resident of a non-mirror code possession (Commonwealth of Puerto Rico, American Samoa) may claim the refundable portion of the credit in the possession in which the individual is a resident, but only if that possession establishes a plan for permitting the claim under its internal law.

<sup>120</sup> I.R.C. §26(a)(1).

<sup>121</sup> I.R.C. §26(a)(2).

<sup>122</sup> I.R.C. §25A(i)(5)(A).

<sup>123</sup> I.R.C. §25A(i)(5)(B).

<sup>124</sup> I.R.C. §25A(i)(6). It is not treated as a Hope credit, so the limitations (other than the income phase out) of §25A do not apply.

<sup>125</sup> Any reference in §25A or §§24, 25, 26, 25B, 904, or 1400C to a credit allowable under this subsection shall be treated as a reference to so much of the credit allowable as is attributable to the Hope Scholarship Credit.

The following table summarizes the limits and conditions of the education credits, and reflects the characteristics of each credit that are similar as well as those that differ. It includes a quick reference for coordination of these education credits with other current tax incentives.

<b>The HOPE Scholarship credit and Lifetime Learning credit Summary and Comparison</b>		
	<b>The HOPE Scholarship credit</b>	<b>The Lifetime Learning credit</b>
<b>Credit amount</b>	Up to \$2,500/student/year.	Up to \$2,000/year for 2003 and thereafter.
<b>Concurrent use</b>	Same taxpayer may elect both credits in the same year <b>provided</b> credits are not used for the same student's expenses.	
<b>Application of expense limit</b>	Per-student basis	Per-taxpayer basis
<b>Phaseout</b>	Married filing jointly: phaseout range between \$160,000 and \$180,000 MAGI. Single: phaseout range is between \$80,000 and \$90,000.	Married filing jointly: phaseout range between \$100,000 and \$120,000 MAGI. Single: phaseout range is between \$50,000 and \$60,000.
<b>Qualified expenses</b>	Qualified tuition and related expenses for the attendance by the taxpayer, taxpayer's spouse, or taxpayer's dependents at a post-secondary educational institution offering credit toward a degree or other recognized post-secondary educational credential.  Does not include room and board or other living expenses.	Also includes qualified tuition and related expenses for course that is part of a nondegree program that is taken by the student to acquire or improve job skills.
<b>Eligibility limitations</b>	Up to four years of post-secondary education for any one student. Degree requirement Felony drug conviction restriction At least half-time attendance	All years of post-secondary education, graduate, and professional school. No degree requirement No felony drug conviction restriction No workload requirement
<b>Credit available</b>	For payments covering an academic period beginning in the same calendar year as the payment is made.  Exception: for payments made during the calendar year to cover academic period that begins in January, February, or March of the following taxable year.	
<b>Nature of credit</b>	40 percent refundable; applicable against AMT in 2009 and 2010	Nonrefundable; applicable against the AMT in 2009
<b>Coordination with other tax provisions</b>	Expenses excluded from gross income under an <b>employer-provided educational assistance plan</b> cannot be used in credit base.  Expenses claimed for the credits will reduce the amount of expenses eligible for <b>\$135 exclusion (U.S. savings bond interest)</b> used to pay for higher education).	
<b>Payments included</b>	Includes payments made with student's earnings, loan, gift, inheritance, savings (including savings from <b>qualified tuition program (QTP)</b> ).  Does <b>not</b> include payments made with <b>Pell Grant</b> or other tax-free scholarship, tax-free distribution from a <b>Coverdell education savings account (CESA)</b> , or tax-free <b>employer-provided educational assistance</b> .	

**Example:**

Theresa files as head of household. She and her two children, Peter and Albert, are all enrolled in graduate school. Peter and Albert live with Theresa and she pays all of their education expenses. However, they are not dependents on Theresa's tax return. In January 2009, Theresa paid \$5,000 tuition and \$1,000 for books, fees, and supplies to attend law school in the term starting in January 2009. In August 2009, Theresa also paid \$2,000 for tuition and \$500 for books and fees for Peter, and \$3,000 for tuition and \$600 for books and fees for Albert for the term starting in September 2009. Theresa's modified adjusted gross income is \$90,000. Can Theresa claim the HOPE Scholarship credit and/or the Lifetime Learning credit in 2009?<sup>126</sup>

The **HOPE Scholarship credit** is available for tuition costs incurred by qualified students during their four years of college. Since neither Theresa nor her children are in an undergraduate college, Theresa cannot claim the HOPE Scholarship credit for the qualified tuition expenses she paid on behalf of herself and her sons.

While the **Lifetime Learning credit** is available to taxpayers who take one or more courses at the graduate level, as well as the undergraduate level, Theresa may not claim this credit because her AGI (\$90,000) is above the phaseout range (\$50,000 - \$60,000 for single filers).

In addition, the credits can be claimed for tuition expenses paid on behalf of the taxpayer, the spouse, or the dependent. A dependent is a person for whom the taxpayer claims a dependency exemption, including a child under the age of 24 who is a full-time student. Since Theresa did not claim an exemption for her sons on her tax return, she cannot claim the credit. However, a child can claim the credit even if the parent pays the tuition so long as the child is not a dependent of the parent. Therefore, Theresa's sons may be able to claim the Lifetime Learning credit on their own individual tax returns for 2009 if their AGI does not exceed the phaseout range.

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This example and question is similar to a question on the 1999 IRS Special Enrollment Examination, which covers topics that the IRS expects tax practitioners to be extremely knowledgeable.

**Planning point:**

Sometimes these credits can be utilized by the child/student because the parents cannot qualify under the AGI phaseouts. In order to do so, the taxpayer who is eligible to claim the student as a dependent (usually the parent) must choose not to do so (and lose the dependency exemption). Then the student may claim the education credit for the student's qualified tuition and related expenses **even if** the tuition and expenses were paid by the parent. The surprise in the proposed regulations was the specific reference to the possibility of a parent to waive the exemption. Most practitioners believed that the exemption was mandatory because of "there shall be allowed" language.

In many cases, nothing is really given up as a tax benefit, because personal exemptions are phased out, starting at \$166,800 for singles and \$250,200 for married filing jointly in 2009.

This does not, however, permit the student to take the personal exemption for the child on the child's own return. If the child wants to take the personal exemption, the child must not qualify as a dependent. This requires the child to provide more than one-half of the child's own support. In addition, the credits only benefit the child if the child has some taxable income generating a tax liability against which they may be applied. To accomplish both goals – and to achieve some potential estate-planning goals as a bonus – the parents should consider annual transfers up to the annual exclusion amount to their child in order to shift income-tax liability (at least for the period after the child reaches age 18) that will generate enough income-tax liability for the years the educational expenses are paid **by the child** but not enough to cause the child to exceed the modified adjusted gross income limits for such periods at which the credits are phased out.

As a general rule, if the parents' adjusted gross income is less than \$160,000, the exemption should be claimed because the parents will be able to take the full amount of the credit. In contrast, if the parents' adjusted gross income exceeds \$372,700 in 2009, the parents should consider waiving the exemption if the child's value of the credits exceeds their residual use of the exemption; they cannot qualify for the credit because of the phaseout rule but the dependents' exemption is phased out by one-third to \$2,433. The residual value of this exemption is \$852. If the parents' adjusted gross income exceeds \$180,000 but not \$250,200, the parents cannot claim the credits but can claim the full amount of the exemption. Thus, the value of the exemption to them must be compared to the amount of the credit available to the student. Since the American Opportunity credit is now refundable, the entire \$2,500 credit is available to the student regardless of income level if the student is not a kiddie with respect to the parents; the refundability feature does not apply if the student is a kiddie, which would only be avoided if the student has sufficient earned income. By contrast, because the Lifetime Learning credit is nonrefundable, only \$835 of such Lifetime Learning tax credit is available to an individual in the lowest 10-percent bracket and the full \$2,000 tax credit is available only to the extent the student has at least \$16,117 of taxable income.

The value of the exemption to the parents depends on the tax bracket of the parents. Between \$120,000 and \$137,050, the parents are in the 25-percent bracket and the value of the exemption is \$913 ( $\$3,650 \times 25$  percent); between \$137,050 and \$208,850, the parents are in the 28-percent bracket and the value of the exemption is \$1,022 ( $\$3,650 \times 28$  percent); above \$208,850, the parents are in the 33-percent bracket and the value of the exemption is \$1,205 ( $\$3,650 \times 33$  percent). The break-even points of student taxable income for each situation are \$6,083, \$6,813, and \$8,030, respectively. Above \$250,200 but not above \$372,950, the parents' personal exemptions are being phased out and the parents are in the 33-percent bracket. The value of the personal exemption is  $\$3,650 \times [1 - .0067 \times (\text{AGI} - \$250,200)/\$2,500] \times 33$  percent approximately. (The last factor is actually a step function, since  $(\text{AGI} - \$250,200)/\$2,500$  is rounded up to a whole number only before multiplying.) Similarly, above \$372,950, the parents' personal exemptions are being phased out and the parents are in the 35-percent bracket. The value of the personal exemption is  $\$3,650 \times [1 - .0067 \times (\text{AGI} - \$250,200)/\$2,500] \times 35$  percent approximately.

### III. Energy incentives

#### A. Nonbusiness energy property

##### 1. In general

The Energy Act established a nonrefundable **10-percent credit** for the purchase of qualified energy-efficiency improvements to existing homes.<sup>127</sup>

- a. A qualified energy-efficiency improvement is any energy-efficiency **building envelope component**:
- (i) That meets or exceeds the **prescriptive criteria** for such a component established by the 2000 International Energy Conservation Code as supplemented and as in effect on August 8, 2005 (or, in the case of metal roofs with appropriate pigmented coatings, meets the Energy Star program requirements);
  - (ii) That is installed in or on a dwelling located in the United States that is owned and used by the taxpayer as the **taxpayer's principal residence**;
  - (iii) That the **original use** of which commences with the taxpayer; **and**
  - (iv) That reasonably can be expected to **remain in use** for **at least five years**.

**Note:**

Building envelope components are: (i) insulation materials or systems that are specifically and primarily designed to reduce the heat loss or gain for a dwelling; (ii) exterior windows (including skylights) and doors; and (iii) metal or asphalt roofs with appropriate pigmented coatings or cooling granules that are specifically and primarily designed to reduce the heat gain for a dwelling.

- b. Additionally, it provides specified credits for the purchase of specific energy efficient property. The allowable credit for the purchase of certain property is: (i) \$50 for each **advanced main air circulating fan**, (ii) \$150 for each **qualified natural gas, propane, or oil furnace or hot water boiler**, and (iii) \$300 for each item of **qualified energy-efficient property**.
- (i) An advanced main air circulating fan is a fan used in a natural gas, propane, or oil furnace originally placed in service by the taxpayer during the taxable year, and that has an **annual electricity use of no more than two percent of the total annual energy use of the furnace** (as determined in the standard Department of Energy test procedures).
  - (ii) A qualified natural gas, propane, or oil furnace or hot water boiler is a natural gas, propane, or oil furnace or hot water boiler with an **annual fuel utilization efficiency rate of at least 95**.
  - (iii) Qualified energy-efficient property is:
    - An electric heat pump water heater that yields an **energy factor of at least 2.0** in the standard Department of Energy test procedure;
    - An electric heat pump that has a **heating seasonal performance factor (HSPF)** of at least **9**, a **seasonal energy efficiency ratio (SEER)** of at least **15**, and an **energy efficiency ratio (EER)** of at least **13**;

<sup>127</sup>

I.R.C. §25C.

- A central air conditioner with energy efficiency of at least the highest efficiency tier established by the Consortium for Energy Efficiency as in effect on Jan. 1, 2006,
- A **natural gas, propane, or oil water heater** that has an **energy factor** of at least **0.80** or **thermal efficiency** of at least **90 percent**; and
- **Biomass fuel property.**

**Note:**

Biomass fuel property is a stove that burns biomass fuel to heat a dwelling unit located in the United States and used as a principal residence by the taxpayer, or to heat water for such dwelling unit, and that has a thermal efficiency rating of at least 75 percent. Biomass fuel is any plant-derived fuel available on a renewable or recurring basis, including agricultural crops and trees, wood and wood waste and residues (including wood pellets), and plants (including aquatic plants, grasses, residues, and fibers).

- c. The maximum credit for a taxpayer with respect to the same dwelling for all taxable years is \$500, and no more than \$200 of such credit may be attributable to expenditures on windows.
- d. The taxpayer's basis in the property is reduced by the amount of the credit. Special proration rules apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations. If less than 80 percent of the property is used for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account.

For purposes of determining the amount of expenditures made by any individual with respect to any dwelling unit, there shall not be taken into account expenditures that are made from subsidized energy financing, which is financing provided under a federal, state, or local program a principal purpose of which is to provide subsidized financing for projects designed to conserve or produce energy.

The credit applied to expenditures made after December 31, 2008 for property placed in service after December 31, 2008, and prior to January 1, 2010.

**2. Increased credit rate and standards**

- a. The Act raises the 10-percent credit rate to **30 percent**. Additionally, all energy property otherwise eligible for the \$50, \$150, or \$300 credit is **instead eligible for a 30-percent credit** on expenditures for such property.

**Planning point:**

The dollar caps have been eliminated, so those who already maxed out in any of the categories can start afresh in 2009 and 2010 for each of the former categories.

- b. The present-law rule related to subsidized energy financing is eliminated.
- c. The provision is effective for taxable years beginning after December 31, 2008. The Act additionally extends the provision for one year, through December 31, 2010.
- d. Finally, the \$500 lifetime cap on all categories (and the \$200 lifetime cap with respect to windows) is eliminated and replaced with an **aggregate cap of \$1,500** in the case of property placed in service after December 31, 2008 and prior to January 1, 2011.
- e. Efficiency standards changed apply to property placed in service after February 17, 2009:

- The building insulation requirements must follow the prescriptive criteria of the 2009 International Energy Conservation Code.
- Additionally, qualifying exterior windows, doors, and skylights must have a U-factor at or below 0.30 and a seasonal heat gain coefficient ("SHGC") at or below 0.30.
- Electric heat pumps must achieve the highest-efficiency tier of Consortium for Energy Efficiency, as in effect on January 1, 2009. These standards are a SEER greater than or equal to 15, EER greater than or equal to 12.5, and HSPF greater than or equal to 8.5 for split heat pumps, and SEER greater than or equal to 14, EER greater than or equal to 12, and HSPF greater than or equal to 8.0 for packaged heat pumps.
- Central air conditioners must achieve the highest-efficiency tier of Consortium for Energy Efficiency, as in effect on January 1, 2009. These standards are a SEER greater than or equal to 16 and EER greater than or equal to 13 for split systems, and SEER greater than or equal to 14 and EER greater than or equal to 12 for packaged systems.
- Natural gas, propane, or oil water heaters must have an energy factor greater than or equal to 0.82 or a thermal efficiency of greater than or equal to 90 percent. Natural gas, propane, or oil water boilers must achieve an annual fuel utilization efficiency rate of at least 90. Qualified oil furnaces must achieve an annual fuel utilization efficiency rate of at least 90.
- Lastly, the requirement that biomass fuel property have a thermal efficiency rating of at least 75 percent is modified to be a thermal efficiency rating of at least 75 percent as measured using a lower heating value. This modification with respect to biomass fuel property is effective for taxable years beginning after December 31, 2008.

**Note:**

Biomass stoves have been the subject of both press and consumer interest. These burn biomass fuel – renewable plant-derived fuel, such as wood, pellets, and other plants – to heat a dwelling unit used as a residence by the taxpayer, or to heat water for use in the residence.<sup>128</sup>

## B. Residential energy-efficient property credit

### 1. Present law

With respect to property placed in service prior to January 1, 2017,

- a. The Code provides a personal tax credit for the purchase of **qualified solar electric property** and **qualified solar water heating property** that is used exclusively for purposes **other than heating swimming pools and hot tubs**.<sup>129</sup>
  - (i) The credit is **nonrefundable**, and the **depreciable basis of the property is reduced by the amount of the credit**.
  - (ii) Expenditures for **labor costs** allocable to on-site preparation, assembly, or original installation of property eligible for the credit are eligible expenditures.
  - (iii) The credit is equal to 30 percent of qualifying expenditures, with a maximum credit of \$2,000 with respect to qualified solar water heating property.

<sup>128</sup>

*How Your Home May Qualify For Bailout Cash*, Wall Street Journal, March 18, 2009, D1.

<sup>129</sup>

I.R.C. §25D.

- (iv) There is no cap with respect to qualified solar electric property.

**Note:**

Qualified solar electric property is property that uses solar energy to generate electricity for use in a dwelling unit. Qualifying solar water heating property is property used to heat water for use in a dwelling unit located in the United States and used as a residence if at least half of the energy used by such property for such purpose is derived from the sun.

- b. The Code also provides a 30-percent credit for the purchase of **qualified geothermal heat pump property, qualified small wind energy property, and qualified fuel cell power plants**. The credit for geothermal heat pump property is capped at \$2,000; the credit for qualified small wind energy property is limited to \$500 with respect to each half kilowatt of capacity, not to exceed \$4,000; and the credit for any fuel cell may not exceed \$500 for each half kilowatt of capacity.
  - (i) A qualified fuel cell power plant is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that converts a fuel into electricity using electrochemical means, and has an electricity-only generation efficiency of greater than 30 percent. The qualified fuel cell power plant must be installed on or in connection with a dwelling unit located in the United States and used by the taxpayer as a principal residence.
  - (ii) Qualified small wind energy property is property that uses a wind turbine to generate electricity for use in a dwelling unit located in the U.S. and used as a residence by the taxpayer.
  - (iii) Qualified geothermal heat pump property means any equipment that: (i) uses the ground or ground water as a thermal energy source to heat the dwelling unit or as a thermal energy sink to cool such dwelling unit; (ii) meets the requirements of the Energy Star program which are in effect at the time that the expenditure for such equipment is made; and (iii) is installed on or in connection with a dwelling unit located in the United States and used as a residence by the taxpayer.
- c. The credit with respect to all qualifying property may be claimed against the alternative minimum tax.
- d. Special proration rules apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations. If less than 80 percent of the property is used for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account.

**Note:**

For purposes of determining the amount of expenditures made by any individual with respect to any dwelling unit, there shall not be taken into account expenditures that are made from subsidized energy financing. The term "subsidized energy financing" means financing provided under a federal, state, or local program a principal purpose of which is to provide subsidized financing for projects designed to conserve or produce energy.

## **2. No credit caps**

Effective for taxable years beginning after December 31, 2008, there are **no credit caps** for **solar hot water, geothermal, and wind property**. In addition, the **reduction in credits** for property using **subsidized energy financing** has been **eliminated**.

## C. Plug-in drive motor vehicle credit

### 1. Pre-Act law

- a. A credit is available for each new qualified fuel cell vehicle, hybrid vehicle, advanced lean burn technology vehicle, and alternative fuel vehicle placed in service by the taxpayer during the taxable year (the "alternative motor vehicle credit").<sup>130</sup> In general, the credit amount varies depending upon the type of technology used, the weight class of the vehicle, the amount by which the vehicle exceeds certain fuel economy standards, and, for some vehicles, the estimated lifetime fuel savings. The credit generally is available for vehicles purchased after 2005 and terminates after 2009, 2010, or 2014, depending on the type of vehicle. The alternative motor vehicle credit is not allowed against the alternative minimum tax.
- b. A credit is available for each qualified plug-in electric drive motor vehicle placed in service (the "plug-in electric drive motor vehicle credit"). A qualified plug-in electric drive motor vehicle is a motor vehicle that has at least four wheels, is manufactured for use on public roads, meets certain emissions standards (except for certain heavy vehicles), draws propulsion using a traction battery with at least four kilowatt hours of capacity, and is capable of being recharged from an external source of electricity.
  - (i) The base amount of the plug-in electric drive motor vehicle credit is \$2,500, plus another \$417 for each kilowatt-hour of battery capacity in excess of four kilowatt-hours.
  - (ii) The maximum credit for qualified vehicles weighing 10,000 pounds or less is \$7,500. This maximum amount increases to \$10,000 for vehicles weighing more than 10,000 pounds but not more than 14,000 pounds, to \$12,500 for vehicles weighing more than 14,000 pounds but not more than 26,000 pounds, and to \$15,000 for vehicles weighing more than 26,000 pounds.
  - (iii) In general, the credit is available to the vehicle owner, including the lesser of a vehicle subject to lease. If the qualified vehicle is used by certain tax-exempt organizations, governments, or foreign persons and is not subject to a lease, the seller of the vehicle may claim the credit so long as the seller clearly discloses to the user in a document the amount that is allowable as a credit.
  - (iv) A vehicle must be used predominantly in the United States to qualify for the credit.
- c. Once a total of 250,000 credit-eligible vehicles have been sold for use in the United States, the credit phases out over four calendar quarters. The phaseout period begins in the second calendar quarter following the quarter during which the vehicle cap has been reached. Taxpayers may claim one-half of the otherwise allowable credit during the first two calendar quarters of the phaseout period and twenty-five percent of the otherwise allowable credit during the next two quarters. After this, no credit is available. Regardless of the phaseout limitation, no credit is available for vehicles purchased after 2014.
- d. The basis of any qualified vehicle is reduced by the amount of the credit. To the extent a vehicle is eligible for credit as a qualified plug-in electric drive motor vehicle, it is not eligible for credit as a qualified hybrid vehicle under §30B. The portion of the credit attributable to vehicles of a character subject to an allowance for depreciation is treated as part of the general business credit; the nonbusiness portion of the credit is allowable

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<sup>130</sup>

I.R.C. §30B.

to the extent of the excess of the regular tax over the alternative minimum tax (reduced by certain other credits) for the taxable year.

## 2. Qualified plug-in electric drive motor vehicles

### Note:

In general, a motor vehicle is any vehicle that is manufactured primarily for use on public streets, roads, and highways (not including a vehicle operated exclusively on a rail or rails) and that has at least four wheels.<sup>131</sup>

For vehicles acquired **after December 31, 2009**,<sup>132</sup> a credit is allowed with respect to each new qualified plug-in electric drive motor vehicle placed in service by the taxpayer during the taxable year.<sup>133</sup>

- a. The amount with respect to any new qualified plug-in electric drive motor vehicle is the sum of<sup>134</sup> a base amount of \$2,500<sup>135</sup> and, in the case of a vehicle which draws propulsion energy from a battery with not less than five kilowatt hours of capacity, the amount of \$417, plus \$417 for each kilowatt hour of capacity in excess of five kilowatt hours.<sup>136</sup> The amount determined shall not exceed \$5,000 (which occurs when the battery capacity is 16 kilowatts).

### Note:

The credit is not dependent on the cost of the vehicle but rather on its character (base amount) and its performance (kilowatt-hour rating).

- (i) So much of the credit that would be allowed under this provision for any taxable year (determined without regard to this recharacterization) that is attributable to property of a character subject to an allowance for depreciation shall be treated as a general business credit<sup>137</sup> for such taxable year (and not allowed as a qualified plug-in electric drive motor vehicle credit).<sup>138</sup>
- (ii) The part of the credit not treated as a general business credit for any taxable year is treated as a nonrefundable personal credit allowable for such taxable year.<sup>139</sup> In the case of a taxable year to which the extension of the application of such credits against the alternative minimum tax does not apply,<sup>140</sup> the credit allowed as a plug-in motor vehicle credit for any taxable year shall not exceed the excess of:
  - The sum of the regular tax liability plus the alternative minimum tax;<sup>141</sup> over
  - The sum of the credits allowable as nonrefundable personal credit (other than this credit and that for residential energy-efficient property) and the foreign tax credit for the taxable year.<sup>142</sup>

<sup>131</sup> I.R.C. §30B(h)(1).

<sup>132</sup> Act §1141(c).

<sup>133</sup> I.R.C. §30D(a).

<sup>134</sup> I.R.C. §30D(b)(1).

<sup>135</sup> I.R.C. §30D(b)(2).

<sup>136</sup> I.R.C. §30D(b)(3).

<sup>137</sup> I.R.C. §38(b).

<sup>138</sup> I.R.C. §30D(c)(1).

<sup>139</sup> I.R.C. §30D(c)(2)(A).

<sup>140</sup> But this was extended to calendar year 2009 by the Act.

<sup>141</sup> I.R.C. §30D(c)(2)(B)(i).

<sup>142</sup> I.R.C. §30D(c)(2)(B)(ii).

- b. A **new qualified plug-in electric drive motor vehicle** means a motor vehicle:<sup>143</sup>
- (i) The original use of which commences with the taxpayer;<sup>144</sup>
  - (ii) That is acquired for use or lease by the taxpayer and not for resale;<sup>145</sup>
  - (iii) That is made by a manufacturer;<sup>146</sup>
  - (iv) That is treated as a motor vehicle for purposes of Title II of the Clean Air Act;<sup>147</sup>
  - (v) That has a gross vehicle weight rating of less than 14,000 pounds;<sup>148</sup> and
  - (vi) That is propelled to a significant extent by an electric motor which draws electricity from a battery that:
    - Has a capacity of not less than four kilowatt hours;<sup>149</sup> and
    - Is capable of being recharged from an external source of electricity.<sup>150</sup>
- c. In the case of a new qualified plug-in electric drive motor vehicle sold during the phaseout period, only the **applicable percentage of the credit** otherwise allowable is allowed.<sup>151</sup>
- (i) For these purposes, the phaseout period is the period beginning with the second calendar quarter following the calendar quarter that includes the first date on which the number of new qualified plug-in electric drive motor vehicles manufactured by the manufacturer of the vehicle sold for use in the United States after December 31, 2009, is at least 200,000.<sup>152</sup>
  - (ii) For these purposes, the applicable percentage is:
    - 50 percent for the first two calendar quarters of the phaseout period;<sup>153</sup>
    - 25 percent for the third and fourth calendar quarters of the phaseout period;<sup>154</sup> and
    - 0 percent for each calendar quarter thereafter.<sup>155</sup>
- d. The basis of any property for which a credit is allowable is reduced by the amount of such credit so allowed.<sup>156</sup>
- (i) The amount of any deduction or other credit allowable for a new qualified plug-in electric drive motor vehicle shall be reduced by the amount of credit allowed for such vehicle.<sup>157</sup>
  - (ii) No credit shall be allowable with respect to any property used outside the United States.<sup>158</sup>
  - (iii) The Secretary shall, by regulations, provide for recapturing the benefit of any credit allowable with respect to any property which ceases to be property eligible for such credit.<sup>159</sup>

<sup>143</sup> For these purposes, a motor vehicle means any vehicle which is manufactured primarily for use on public streets, roads, and highways (not including a vehicle operated exclusively on a rail or rails) and which has at least 4 wheels. I.R.C. §30D(d)(2).

<sup>144</sup> I.R.C. §30D(d)(1)(A).

<sup>145</sup> I.R.C. §30D(d)(1)(B).

<sup>146</sup> I.R.C. §30D(d)(1)(C). A manufacturer has the meaning given such term in regulations prescribed by the Administrator of the Environmental Protection Agency for purposes of the administration of title II of the Clean Air Act (42 U.S.C. 7521 et seq.). I.R.C. §30D(d)(3).

<sup>147</sup> I.R.C. §30D(d)(1)(D).

<sup>148</sup> I.R.C. §30D(d)(1)(E).

<sup>149</sup> I.R.C. §30D(d)(1)(F)(i). Capacity means, with respect to any battery, the quantity of electricity which the battery is capable of storing, expressed in kilowatt hours, as measured from a 100 percent state of charge to a 0 percent state of charge.

<sup>150</sup> I.R.C. §30D(d)(4).

<sup>151</sup> I.R.C. §30D(d)(1)(F)(ii).

<sup>152</sup> I.R.C. §30D(e)(1).

<sup>153</sup> I.R.C. §30D(e)(2).

<sup>154</sup> I.R.C. §30D(e)(3)(A).

<sup>155</sup> I.R.C. §30D(e)(3)(B).

<sup>156</sup> I.R.C. §30D(e)(3)(C).

<sup>157</sup> I.R.C. §30D(f)(1).

<sup>158</sup> I.R.C. §30D(f)(2).

<sup>159</sup> I.R.C. §30D(f)(4).

- (iv) No credit shall be allowed for any vehicle if the taxpayer elects to not have this apply to such vehicle.<sup>160</sup>
- (v) A motor vehicle shall not be considered eligible for a credit under this provision unless such vehicle is in compliance with the applicable provisions of the Clean Air Act for the applicable make and model year of the vehicle (or applicable air quality provisions of state law in the case of a state which has adopted such provision under a waiver under §209(b) of the Clean Air Act),<sup>161</sup> and the motor vehicle safety provisions of §30101 through §30169 of Title 49, United States Code.<sup>162</sup>

**Note:**

In the case of a vehicle the use of which is by a tax-exempt organization, governmental unit, or foreign person or entity and which is not subject to a lease, the person who sold such vehicle to the person or entity using such vehicle shall be treated as the taxpayer that placed such vehicle in service, but only if such person clearly discloses to such person or entity in a document the amount of any credit allowable with respect to such vehicle (determined without regard to recharacterization and limitation by tax liability).<sup>163</sup>

**3. Plug-in electric vehicles**

The Act provides, for vehicles acquired before January 1, 2012, the credit for electric vehicles with modifications.<sup>164</sup> The credit now applies to a **qualified plug-in electric vehicle**, and the basic credit remains **10 percent of its cost**.<sup>165</sup>

**Note:**

The first major difference between the two plug-in credits is that this one is based on cost alone. The second is that this credit is only available in 2009, 2010, and 2011 while the electric drive motor is only available beginning in 2010 but continues through 2014.

**Note:**

In the case of a vehicle acquired after February 17, 2009 and before January 1, 2010, no credit shall be allowed as a plug-in electric vehicle, as added by this provision, if a credit is allowable as a qualified electric drive motor vehicle with respect to such vehicle.

- a. The amount of the credit allowed with respect to any vehicle shall not exceed \$2,500.<sup>166</sup>
  - (i) So much of the credit which would be allowed for any taxable year (determined without regard to this recharacterization) that is attributable to property of a character subject to an allowance for depreciation shall be treated as a general business credit for such taxable year (and not allowed as a qualified plug-in electric vehicle).<sup>167</sup>
  - (ii) For these purposes, the credit allowed as a qualified plug-in electric vehicle credit and not as general business credit for any taxable year is treated as a

<sup>159</sup> I.R.C. §30D(f)(5).

<sup>160</sup> I.R.C. §30D(f)(6).

<sup>161</sup> I.R.C. §30D(f)(7)(A).

<sup>162</sup> I.R.C. §30D(f)(7)(B).

<sup>163</sup> I.R.C. §30D(f)(3).

<sup>164</sup> That credit expired for property placed in service after December 31, 2006.

<sup>165</sup> I.R.C. §30(a).

<sup>166</sup> I.R.C. §30(b).

<sup>167</sup> I.R.C. §30(c)(1).

nonrefundable personal credit.<sup>168</sup> In the case of a taxable year to which the extension of the application of such credits against the alternative minimum tax does not apply,<sup>169</sup> the credit allowed as a plug-in motor vehicle credit for any taxable year shall not exceed the excess of:

- The sum of the regular tax liability plus the alternative minimum tax;<sup>170</sup> over
- The sum of the credits allowable as nonrefundable personal credit (other than this credit and that for residential energy-efficient property) and the foreign tax credit for the taxable year.<sup>171</sup>

b. For these purposes, a qualified plug-in electric vehicle means a specified vehicle:<sup>172</sup>

**Note:**

The third major difference in the plug-in vehicles is that this credit only applies to a low speed (presumably four-or-more wheeled) or two- or three-wheeled vehicle. It is not required to be a motor vehicle under the Clean Air Act.

- (i) The original use of which commences with the taxpayer;<sup>173</sup>
- (ii) That is acquired for use or lease by the taxpayer and not for resale;<sup>174</sup>
- (iii) That is made by a manufacturer;<sup>175</sup>
- (iv) That is manufactured primarily for use on public streets, roads, and highways;<sup>176</sup>
- (v) That has a gross vehicle weight rating of less than 14,000 pounds;<sup>177</sup> and
- (vi) That is propelled to a significant extent by an electric motor which draws electricity from a battery that:

- Has a capacity<sup>178</sup> of not less than four kilowatt hours (2.5 kilowatt hours in the case of a vehicle with two or three wheels);<sup>179</sup> and
- Is capable of being recharged from an external source of electricity.<sup>180</sup>

c. The basis of any property for which a credit is allowable shall be reduced by the amount of such credit so allowed.<sup>181</sup>

- (i) The amount of any deduction or other credit allowable for a new qualified plug-in electric drive motor vehicle shall be reduced by the amount of credit allowable for such vehicle.<sup>182</sup>
- (ii) No credit shall be allowable with respect to any property used outside the United States.<sup>183</sup>

<sup>168</sup> I.R.C. §30(c)(2)(A).

<sup>169</sup> But this was extended to calendar year 2009 by the Act.

<sup>170</sup> I.R.C. §30(c)(2)(B)(i).

<sup>171</sup> I.R.C. §30(c)(2)(B)(ii).

<sup>172</sup> I.R.C. §30(d)(2) defines a specified vehicle as any vehicle which is a low speed vehicle within the meaning of section 571.3 of title 49, Code of Federal Regulations (as in effect on the date of the enactment of the American Recovery and Reinvestment Tax Act of 2009), or has 2 or 3 wheels.

<sup>173</sup> I.R.C. §30(d)(1)(A).

<sup>174</sup> I.R.C. §30(d)(1)(B).

<sup>175</sup> I.R.C. §30(d)(1)(C). Manufacturer has the meaning given such term in regulations prescribed by the Administrator of the Environmental Protection Agency for purposes of the administration of title II of the Clean Air Act (42 U.S.C. 7521 et seq.).

<sup>176</sup> I.R.C. §30(d)(3).

<sup>177</sup> I.R.C. §30(d)(1)(D).

<sup>178</sup> I.R.C. §30(d)(1)(E).

<sup>179</sup> Capacity means, with respect to any battery, the quantity of electricity which the battery is capable of storing, expressed in kilowatt hours, as measured from a 100 percent state of charge to a 0 percent state of charge. I.R.C. §30(d)(4).

<sup>180</sup> I.R.C. §30(d)(1)(F)(i).

<sup>181</sup> I.R.C. §30(d)(1)(F)(ii).

<sup>182</sup> I.R.C. §30(e)(1).

<sup>183</sup> I.R.C. §30(e)(2).

I.R.C. §30(e)(4).

- (iii) The Secretary shall, by regulations, provide for recapturing the benefit of any credit allowable with respect to any property that ceases to be property eligible for such credit.<sup>184</sup>
- (iv) No credit shall be allowed for any vehicle if the taxpayer elects to not have this apply to such vehicle.<sup>185</sup>

**Note:**

In the case of a vehicle the use of which is by a tax-exempt organization, governmental unit, or foreign person or entity and which is not subject to a lease, the person who sold such vehicle to the person or entity using such vehicle shall be treated as the taxpayer that placed such vehicle in service, but only if such person clearly discloses to such person or entity in a document the amount of any credit allowable with respect to such vehicle (determined without regard to recharacterization and limitation by tax liability).<sup>186</sup>

**4. Plug-in conversion kits**

For these purposes, the plug-in conversion credit determined with respect to any motor vehicle that is **converted to a qualified plug-in electric drive motor vehicle** before January 1, 2012<sup>187</sup> is **10 percent of so much of the cost of the converting such vehicle as does not exceed \$40,000**.<sup>188</sup>

- a. A qualified plug-in electric drive motor vehicle means any new qualified plug-in electric drive motor vehicle (as defined in §30D, determined without regard to whether such vehicle is made by a manufacturer or whether the original use of such vehicle commences with the taxpayer).<sup>189</sup>
- b. This credit is allowed with respect to a motor vehicle notwithstanding whether a credit has been allowed with respect to such motor vehicle under this provision (other than for a conversion to plug-in) in any preceding taxable year.<sup>190</sup>
- c. This plug-in conversion credit is treated as part of the alternative motor vehicle credit.<sup>191</sup>
- d. No benefit is recaptured if such property ceases to be eligible for such credit by reason of conversion to a qualified plug-in electric drive motor vehicle.<sup>192</sup>
- e. This applies only to property after February 17, 2009.<sup>193</sup>

**5. Alternative motor vehicle credit as a personal credit allowed against the AMT**

The alternative motor vehicle credit is a personal credit allowed against the alternative minimum tax effective for taxable years beginning after December 31, 2008.

## **IV. Passive activity losses**

### **A. Interest in LLC not subject to passive activity rules**

The Court of Federal Claims has granted an individual summary judgment and has ordered the IRS to pay him a tax refund for two tax years, finding that the individual did not hold a limited partnership interest

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<sup>184</sup> I.R.C. §30(e)(5).  
<sup>185</sup> I.R.C. §30(e)(6).  
<sup>186</sup> I.R.C. §30 (f)(3).  
<sup>187</sup> I.R.C. §30B(i)(4).  
<sup>188</sup> I.R.C. §30B(i)(1).  
<sup>189</sup> I.R.C. §30B(i)(2).  
<sup>190</sup> I.R.C. §30B(i)(3).  
<sup>191</sup> Act §1143(b), I.R.C. §30B(a)(5).  
<sup>192</sup> Act §1143(c), I.R.C. §30B(h)(8).  
<sup>193</sup> Act §1143(d).

in his limited liability company and therefore was not subject to the passive activity loss rules of §469.<sup>194</sup> The business was a manager-managed Texas LLC that had not opted out of pass-through taxation, and the taxpayer was a 99-percent member and the only manager designated by the operating agreement, the other one percent being owned by taxpayer's wholly-owned subchapter S corporation. The LLC owned and operated a single aircraft for on-demand air charter services. The member's share of the LLC losses exceeded taxpayer's passive activity income for the years in question. The member materially participated in the LLC, which ordinarily qualifies an activity as a nonpassive activity. One important exception is the Code's per se rule that the losses of a limited partner are passive.<sup>195</sup>

- a. The procedural aspect of this case is important to its holding. The parties stipulated that if the interest owned by the taxpayer was a limited partnership interest, the taxpayer's participation would be irrelevant and the LLC losses would be passive;<sup>196</sup> conversely, if the interest were deemed not to be a limited partnership interest, taxpayer could demonstrate his material participation in the LLC and §469 does not limit his losses. Thus, the court has only to decide whether the LLC member interest was a limited partnership interest. The tax code and the applicable regulations literally cannot be read to transfigure plaintiff's member interest in his LLC into one of a limited partnership.
- b. To the auditor, §1.469-5T, which sets forth the test for what constitutes taxpayer material participation for purposes of applying I.R.C. §469's passive activity rules, "explicitly treats interests in **any entity which limits liability as limited partnership interests.**" The auditor concluded that the plaintiff's interest was identical to a limited partnership interest. The IRS then deemed the plaintiff's share of LLC losses to be a passive activity loss.
  - (i) A "passive activity loss" occurs where "the aggregate losses from all passive activities for the taxable year, exceed the aggregate income from all passive activities for such year."<sup>197</sup>
  - (ii) A passive activity is "any activity which involves the conduct of a trade or business, and in which the taxpayer does not materially participate."<sup>198</sup>
- c. The Code treats limited partners differently because it **presumes that they do not materially participate in their limited partnerships.**<sup>199</sup>
  - (i) Under the temporary Treasury Regulations, if a taxpayer holds a limited partnership interest, only three of the seven tests described above – the more

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<sup>194</sup> *Thompson v. United States*; No. 1:06-cv-00211 (Clms. Ct. 2009).

<sup>195</sup> See Treas. Regs. § 1.469-5T(e)(2).

<sup>196</sup> I.R.C. §§469(a)(1), (d)(1).

<sup>197</sup> I.R.C. §469(d)(1) (emphasis added).

<sup>198</sup> I.R.C. §469(c)(1)(B) (emphasis added). A taxpayer materially participates in an activity only if he is involved in the activity's operations on a regular, continuous, and substantial basis. I.R.C. § 469(h)(1). Generally, an individual may establish his material participation for a given taxable year by demonstrating any of the following:

(1) The individual participate[d] in the activity for **more than 500 hours** during such year;

(2) The individual's participation in the activity for the taxable year constitute[d] substantially all of the participation in such activity of all individuals . . . for such year;

(3) The individual participate[d] in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year [was] not less than the participation in the activity of any other individual . . . for such year;

(4) The activity [was] a significant participation activity . . . for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceed[ed] 500 hours;

(5) The individual materially participated in the activity . . . for any five taxable years . . . during the ten taxable years that immediately precede[d] the taxable year;

(6) The activity is a **personal service activity** . . . , and the individual materially participated in the activity for any three taxable years . . . preceding the taxable year; or

(7) Based on all of the **facts and circumstances** . . . , the individual participate[d] in the activity on a regular, continuous, and substantial basis during such year.

Treas. Regs. § 1.469-5T(a).

<sup>199</sup> See I.R.C. § 469(h)(2) ("Except as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates.").

than 500 hours, personal service activity, and facts and circumstances -- are available to measure the taxpayer's material participation in the partnership.<sup>200</sup>

- (ii) The temporary regulations provide a methodology for determining whether the taxpayer is holding a limited partnership interest.<sup>201</sup> It provides that a **partnership interest** shall be treated as a limited partnership interest if either such interest is designated as a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable state law;<sup>202</sup> or the liability of the holder of such interest for obligations of the partnership is limited, under the law of the state in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder's capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership).<sup>203</sup> A partnership interest of an individual shall not be treated as a limited partnership interest for the individual's taxable year if the individual is a general partner in the partnership at all times during the partnership's taxable year ending with or within the individual's taxable year (or the portion of the partnership's taxable year during which the individual (directly or indirectly) owns such limited partnership interest).<sup>204</sup>
  - (iii) The nub issue here arises out of the simple fact that an LLC is not a partnership under state law. While LLC members may participate directly in the management of the company, all members enjoy limited liability regardless of their respective levels of involvement. Limited partnerships, on the other hand, must distinguish between: (1) their limited partners, who have limited liability but are unable to participate in the management of the partnership; and (2) their general partners, who may participate in the management of the partnership but are personally liable for its debts.
- d. The Service contended that because an LLC was a partnership for tax purposes and the taxpayer had limited liability, the regulations applied to the LLC interests. But because the LLC was not a limited partnership, the taxpayer contended that his ownership interest could not be that of a limited partner, and by analogy, his interest was more akin to a general partner's interest given the high degree of control he exerted over the LLC's business operations as its sole manager.
- (i) The plain language of the regulation literally requires that the ownership interest be in a business entity that is, in fact, a partnership under state law -- not merely taxed as such under the Code. This provision is unambiguous.
  - (ii) The Code states that except as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates.<sup>205</sup> Thus for this provision even to apply, the taxpayer must actually be a limited partner.<sup>206</sup>
  - (iii) Even if the regulation did apply and the court had to categorize his membership interest as either a limited or a general partner's interest, it would best be

<sup>200</sup> Temp. Regs. § 1.469-5T(e)(2).

<sup>201</sup> Temp. Regs. § 1.469-5T(e)(3).

<sup>202</sup> Temp. Regs. § 1.469-5T(e)(3)(i)(A).

<sup>203</sup> Temp. Regs. § 1.469-5T(e)(3)(i)(B).

<sup>204</sup> Temp. Regs. § 1.469-5T(e)(3)(ii).

<sup>205</sup> I.R.C. § 469(h)(2).

<sup>206</sup> See Garnett, 2009 WL 1883965, at \*5 ("The operative condition for applying § 469(h)(2) is not simply that there be an 'interest in a limited partnership' but an 'interest in a limited partnership as a limited partner.'").

categorized as a general partner's interest.<sup>207</sup> The Service wanted it both ways: that an LLC electing partnership taxation is a limited partnership and does not extend to the general partnership exception. The Service claimed that a limited partner was determined by the lack of unlimited liability, while the taxpayer contended it had to do with the prohibition on participation in the control of the business.

**Note:**

The Service argued that substantial deference is owed to an agency regulation promulgated in accordance with an express congressional mandate and to an agency's reasonable interpretation of such a regulation. However, there is no official IRS interpretation extending §1.469-5T(e)(3) to include membership interests in LLCs.<sup>208</sup>

The Service had to explain who was the "general" partner in the "limited partnership" of which taxpayer was a "limited partner." There were only two possibilities: taxpayer, who had sole management authority, and the S corporation, which had no management authority under the LLC's operating agreement. The Service admitted that taxpayer was the general partner in this hypothetical limited partnership but tried to argue that it was nonetheless a limited partner in the actual LLC, which did not have a general partner,<sup>209</sup> in the context of passive loss issues. It contended that the dividing line in that context was limited liability. Because the member had limited liability as a member of an LLC, he could not be a general partner but must be treated as a limited partner. It does not say so in the text of the regulation, but taxpayers are supposed to infer that from the fact that a general partner, who is free to participate, has absolutely unlimited liability, he should therefore be subject to a lower standard under the two standards of the seven tests.

- e. The ULPA provides that "[a] limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business." Likewise, the 1976 version of the RULPA provides that "a limited partner is not liable for the obligations of a limited partnership unless he is also a general partner or, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business." The 1985 version of the RULPA offers no material change, providing that "a limited partner is not liable for the obligations of a limited partnership unless he is also a general partner or, in addition to the exercise of his rights and powers as a limited partner, he participates in the control of the business."
- (i) When Congress enacted I.R.C. §469, there was general agreement among state laws that a limited partner would lose his limited liability status if he participated in the control of the business. Stated another way, a limited partner's level of participation in the business dictated whether or not he enjoyed limited liability.
  - (ii) However, the converse is not true. Under the ULPA, a limited partner who "takes part in the control of the business" becomes "liable as a general partner." The same is true under the RULPA, which makes a limited partner "liable for the obligations of a limited partnership" if "he participates in the control of the

<sup>207</sup> Accord *Garnett*, 2009 WL 1883965 (recognizing the legal "fiction of treating an . . . [LLC] as a 'limited partnership'" and holding that "the legislative purposes of the special rule of [ § ] 469(h)(2) are more nearly served by treating . . . [LLC] members as general partners").

<sup>208</sup> See *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204 (1988) (holding that where the agency itself has articulated no position on the question, "[d]eference to what appears to be nothing more than an agency's convenient litigating position would be entirely inappropriate"); see also *American Express Co. v. United States*, 262 F.3d 1376 (Fed. Cir. 2001) (holding that a "mere audit determination . . . may not draw deference").

<sup>209</sup> Of course, it does not have limited partners either, but the Service glossed over this fact.

business." To be sure, the loss of limited liability under state law likely deterred many limited partners from participating in the control of their businesses, but limited liability is not the sine qua non of a limited partnership interest.

- f. The court took note that the fact that the terms active participation, material participation and passive activity are primarily concerned with the taxpayer's level of involvement in the activity in question. If Congress desired a test that turned on a taxpayer's level of liability, it surely would have included the word "liability" somewhere in the statute, which it does not.
- (i) Congress was concerned with the use of limited liability pass-through entities as tax shelters, but not so much as to include a similar prohibition against S corporations, whose shareholders enjoy limited liability and pass-through taxation, and are not held to the same standard for demonstrating their material participation.
  - (ii) In general, a tax shelter is an investment in which a significant portion of the investor's return is derived from the realization of tax savings with respect to other income, as well as the receipt of tax-favored (or, potentially, tax-exempt) income from the investment itself. Generally tax shelters are passive investments in the sense that the investor is not involved in actively managing a business.<sup>210</sup> There are three "elements of a tax shelter," none of which involve limited liability. Taxpayers may: (1) defer tax liability to future years; (2) convert ordinary income to tax-favored income; and (3) leverage their investments to maximize the benefit of deductions. In addition, "the distinction that Congress determined should be drawn between activities on the basis of material participation was viewed as unrelated to the question of whether, and to what extent, the taxpayer was at risk with respect to the activities."
  - (iii) At-risk standards, although important in determining the maximum amount that is subject to being lost, were viewed as not a sufficient basis for determining whether or when net losses from an activity should be deductible against other sources of income, or for determining whether an ultimate economic loss has been realized. Congress concluded that its goal of making tax preferences available principally to active participants in substantial businesses, rather than to investors seeking to shelter unrelated income, was best accomplished by examining material participation, as opposed to the financial stake provided by an investor to purchase tax shelter benefits.<sup>211</sup>
  - (iv) The Service's interpretation turns the language of the Code upside down. Except as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates. This grant of regulatory authority was for the purpose of providing exceptions to the Code's presumption that limited partners do not materially participate in their limited partnerships.
- g. An LLC is not "substantially equivalent" to a limited partnership, because an LLC allows all members to participate in the business while retaining limited liability. It makes little sense, therefore, to extend the Code's presumption concerning limited partners' lack of participation in their limited partnerships to a member and his LLC.

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<sup>210</sup> STAFF OF J. COMM. ON TAXATION, 99TH CONG., TAX REFORM PROPOSALS: TAX SHELTERS AND MINIMUM TAX 2 (Comm. Print 1985) (emphasis added).

<sup>211</sup> GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986

**Note:**

The regulation does not apply to an LLC. In the absence of any regulation asserting that an LLC member should be treated as a limited partner of a limited partnership, the Service's conclusion is inappropriate. Therefore, the higher standard of material participation test for limited partners should not be applied to taxpayer, and he materially participated in the activity of his LLC "if and only if" he satisfies one of the seven tests set forth in the regulations. The stipulation determines that he did for these purposes.

**Note:**

This issue was previously considered in a medical service LLC, where the taxpayer was a member of an LLC "formed to create a network of credentialed alternative medicine practitioners."<sup>212</sup> He claimed an ordinary flow-through loss of \$230,723 on his income tax return, which the IRS disallowed on the basis that it should have been characterized as a passive activity loss. The plaintiff paid the resulting deficiency amount, filed a claim for refund, and ultimately brought suit in the Oregon district court. As in this instant case, the Service argued that the member's losses were passive activity losses because the plaintiff was a limited partner, and the court rejected this view.

**Note:**

The court noted that the Service raised the same argument in *Garnett*, discussed below, a case in which the petitioners owned interests in both LLCs and limited liability partnerships ("LLPs"). The Tax Court did not believe that this rationale properly extended to interests in LLPs and LLCs. Members of LLPs and LLCs, unlike limited partners in state law limited partnerships, are not barred by state law from materially participating in the entities' business. Accordingly, **it cannot be presumed that they do not materially participate**. Rather, it is necessary to examine the facts and circumstances to ascertain the nature and extent of their participation. That factual inquiry is appropriately made pursuant to the general tests for material participation under I.R.C. §469 and the regulations thereunder.

## B. Interest in limited liability partnerships

The Tax Court held that a couple's interests in several limited liability companies and limited liability partnerships were not limited partnership interests that would have precluded the activity from being treated as active for purposes of the passive activity loss limitations. Consequently, they were allowed to deduct the losses from such businesses without limitation based on passive income.<sup>213</sup> In determining whether the **general partner exception** applied to the business entities, the court said an inquiry into the nature and extent of a partner's authority to act on behalf of an entity would blur the special rule "in a manner that is at odds with the statutory framework and legislative intent." Statutory constraints on a limited partner's participation justified a presumption that the partner would not materially participate. Such a presumption, however, cannot be extended to LLCs and LLPs. The court said an inquiry under §469 to determine whether the taxpayers materially participated would probably occur at some point in the case, declining to fill in the gaps caused by "pigeonholing" ownership interests as either general or limited partner interests. The court then found that the ownership interests in the LLPs and LLCs fell under the **general partner exception** and did not qualify as limited partnership interests.

<sup>212</sup> See *Gregg v. United States*, 186 F. Supp. 2d 1123 (D. Ore. 2000), 87 AFTR 2d 2001-337 ("Plaintiffs argue that the limited partnership test, as set forth in . . . Treasury Regulation § 1.469-5T(e)(3)(i)(B) . . ., is obsolete when applied to LLCs and their members. . . I agree.")

<sup>213</sup> *Garnett v. Commissioner*, 132 T.C. No. 19 (2009).

## ***V. What are the rules for rollovers or conversions of regular IRAs and tax-qualified plans to Roth IRAs?***

### **A. In general**

An amount in a traditional IRA may be converted to an amount in a Roth IRA if two requirements are satisfied. First, in 2009, the IRA owner must satisfy a modified AGI limitation and, if married, the joint filing requirement. The modified AGI limitation is eliminated in 2010 and subsequent years.

Second, the amount contributed to the Roth IRA must satisfy the definition of a qualified rollover contribution (i.e., it must satisfy the requirements for a rollover contribution).

An amount can be converted by any of three methods:<sup>214</sup>

- An amount distributed from a traditional IRA is contributed (rolled over) to a Roth IRA within 60 days after the distribution;
- An amount in a traditional IRA is transferred in a trustee-to-trustee transfer from the trustee of the traditional IRA to the trustee of the Roth IRA; or
- An amount in a traditional IRA is transferred to a Roth IRA maintained by the same trustee. (For all practical purposes, this is essentially nothing more than a renaming of the account and a change of the plan documents from those for a regular IRA to those of a Roth IRA. The money does not actually “move” anywhere.)

Any converted amount is treated as a distribution from the traditional IRA and a qualified rollover contribution to the Roth IRA for purposes of §§408 and 408A, even if the conversion is accomplished by means of a trustee-to-trustee transfer or a transfer between IRAs of the same trustee.<sup>215</sup>

### **B. Which persons are eligible for Roth conversions in 2009?**

#### **1. Individuals**

Individuals with modified AGI in excess of \$100,000 for the 2009 taxable year are not permitted to convert an amount to a Roth IRA during the 2009 taxable year.

#### **2. Married persons**

If an individual meeting the AGI limitation is married, the individual is permitted to convert an amount to a Roth IRA during the 2009 taxable year **only if the individual and the individual’s spouse file a joint return for the taxable year during which the funds are paid from the traditional IRA**. In this case, the modified AGI subject to the \$100,000 limit is the modified AGI derived from the joint return using the couple’s combined income.

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<sup>214</sup> Treas. Regs. §1.408A-4, A-1(b).

<sup>215</sup> Treas. Regs. §1.408A-4, A-1(c).

**Note:**

The only exception to this joint-filing requirement is for an individual who has *lived apart from the individual's spouse for the entire taxable year*. If the married individual has lived apart from the spouse for the entire taxable year, then such individual's status is an unmarried person for these purposes; the individual can file a separate return and be subject to the \$100,000 limit on the separate modified AGI. In all other cases, a married individual filing a separate return in 2009 is not permitted to convert an amount to a Roth IRA, regardless of the individual's modified AGI.<sup>216</sup>

### 3. Age limits

There is no restriction on the age of a taxpayer who wishes to convert a regular IRA to a Roth IRA. Therefore, there is no special restriction on converting regular IRAs to Roth IRAs even when taxpayers are age 70-1/2 or older and are already in "payout status" under the minimum-required-distribution rules.

### C. What is modified AGI for purposes of the 2009 \$100,000 limitation?

Modified AGI for this purpose is the same as the definition of AGI used under §219(g)(3), which contains the income limits for making a deductible contribution to a regular IRA when the individual is also participating in an employer-sponsored plan. This definition includes the individual's taxable Social Security benefits, and takes into account the disallowance of "passive-activity losses,"<sup>217</sup> if applicable.<sup>218</sup> AGI for this purpose does **not** include the amount included in gross income because of the conversion of the regular IRA to a Roth IRA.<sup>219</sup> Also, the \$100,000 AGI limit applies to both married and single taxpayers.

Solely for purposes of the \$100,000 limitation applicable to conversions, modified AGI does not include any required minimum distributions from an IRA.<sup>220</sup>

**Note:**

For purposes of applying the \$100,000 AGI limit on IRA conversions into Roth IRAs, the 1998 Act provided that the conversion amount (to the extent otherwise includable in AGI) is subtracted from AGI as determined under the rules relating to IRAs for the year of distribution. Thus, for example, the AGI-based phaseout of the exemption from the disallowance for passive-activity losses from rental real estate activities would be applied taking into account the amount of the conversion that is includable in AGI, and then the amount of the conversion would be subtracted from AGI in determining whether a taxpayer is eligible to convert an IRA into a Roth IRA.

This \$100,000 limitation applies to the taxable year that the funds are paid from the traditional IRA, rather than the year they are contributed to the Roth IRA.<sup>221</sup> Therefore, if a distribution from a traditional IRA or qualified plan occurs in 2009 and is rolled over within 60 days to a Roth IRA, but not until 2010, the \$100,000 modified AGI limitation still applies.

<sup>216</sup> Treas. Regs. §1.408A-4, A-2(b).  
<sup>217</sup> I.R.C. §469.  
<sup>218</sup> I.R.C. §408(A)(c)(3)(C).  
<sup>219</sup> I.R.C. §408(A)(c)(3)(C)(i).  
<sup>220</sup> Treas. Regs. §1.408A-3, A-6.  
<sup>221</sup> Treas. Regs. §1.408A-4, A-2(a).

## D. What if a person fails the modified AGI test in 2009?

### 1. A person may recharacterize or “unconvert”

If a contribution is made by a person who is ineligible to make a contribution, the person may, in certain circumstances, recharacterize or “unconvert” the Roth. If the person satisfies the recharacterization requirements, the failed conversion amount will be treated as having been contributed to a traditional IRA and not to a Roth IRA.<sup>222</sup>

### 2. Consequences of failing to recharacterize

First, if a failed conversion is not recharacterized, the contribution will be treated as a regular contribution to the Roth IRA, and thus (to the extent the contribution amount exceeds the amount the person might be permitted to contribute to a Roth IRA under the yearly contribution limits for regular annual contributions), qualify as an excess contribution subject to the 6-percent excise tax under §4973 to the extent that it exceeds the individual’s regular annual contribution limit.<sup>223</sup>

#### **Planning note:**

The recharacterization rules do not apply solely to situations where an individual is ineligible to convert. Other planning implications and opportunities as regards the recharacterization rules are discussed in more detail later in this course.

Second, because the rollover is not completed, the rollover contribution amount (to the extent the contribution amount exceeds the amount the person might be permitted to contribute to a Roth IRA under the yearly contribution limits for regular annual contributions) will be treated as a taxable distribution subject to the regular income tax rules for such distributions and, if applicable, the 10-percent premature distribution penalty.

#### **Note:**

Later sections discuss tax rules for rollovers and distributions from regular IRAs and Roth IRAs in more detail.

## E. What are the modified AGI limitation rules for 2010 and subsequent years?

Under TIPRA, for tax years beginning after December 31, 2009, the \$100,000 modified AGI limit on conversions of traditional IRAs to Roth IRAs is eliminated. Therefore, beginning in 2010, taxpayers may make such conversions without regard to their AGI.

In addition, the TIPRA permits married taxpayers filing a separate return to convert amounts in a traditional IRA into a Roth IRA after 2009.<sup>224</sup>

## F. Are there any other changes in the rules regarding conversions after 2009?

### 1. Two-year tax reporting rule for 2010 only

While IRA to Roth IRA conversions occurring after 2010 are subject to the same income inclusion rules that apply under pre-Act law (that is, the income resulting from the conversion is included on the return for

<sup>222</sup> Treas. Regs. §1.408A-4, A-3(a).

<sup>223</sup> Treas. Regs. §1.408A-4, A-3(b).

<sup>224</sup> I.R.C. §408(c)(3), as amended by TIPRA §512(a).

the tax year in which funds are transferred or withdrawn from the IRA), a complicated income-inclusion rule applies for conversions occurring in 2010 only.

For 2010 only, unless a taxpayer elects otherwise (i.e., unless the taxpayer elects to include the entire conversion in income in 2010), none of the gross income from the conversion is included in income in 2010. Rather, half of the income resulting from the conversion is includable in gross income in 2011 and the other half in 2012.

***Planning point:***

Remember that the deferral may be disadvantageous if tax rates increase and the taxpayer pays substantially more tax, even though deferred, and may render the election out of deferral a better after-tax strategy.

**2. Taxpayers may have to include conversion income sooner in certain circumstances**

Conversion amount income deferred under the two-year rule is accelerated if converted amounts are distributed before 2012. In these cases the amount included in income in the year of distribution is increased by the amount distributed, and the amount included in income in 2012 (or 2011 and 2012 in the case of a distribution in 2010) is the lesser of: (i) one half of the amount includable in income as a result of the conversion; and (ii) the remaining portion of such amount not already included in income. For 2011 and thereafter, the income resulting from such conversions is included on the return for the tax year in which funds are transferred or withdrawn from the IRA.<sup>225</sup>

**Example:** Taxpayer A has a traditional IRA with a value of \$100, consisting of deductible contributions and earnings. A does not have a Roth IRA. A converts the traditional IRA to a Roth IRA in 2010, and, as a result of the conversion, \$100 is includable in gross income. Unless A elects otherwise, \$50 of the income resulting from the conversion is included in income in 2011 and \$50 in 2012. Later in 2010, A takes a \$20 distribution, which is not a qualified distribution and all of which, under the ordering rules, is attributable to amounts includable in gross income as a result of the conversion. Under the accelerated inclusion rule, \$20 is included in income in 2010. The amount included in income in 2011 is the lesser of: (i) \$50 (half of the income resulting from the conversion) or (ii) \$70 (the remaining income from the conversion); or \$50. The amount included in income in 2012 is the lesser of (i) \$50 (half of the income resulting from the conversion) or (ii) \$30 (the remaining income from the conversion, i.e., \$100 - \$70 (\$20 included in income in 2010 and \$50 included in income in 2011)); or \$30.

In addition, taxpayers may elect out of the two-year deferral and choose to have the entire taxable conversion amount included in income in 2010.

**G. Who should elect out of the two-year tax deferral for 2010 conversions?**

The elimination of the AGI limit under TIPRA for 2010 could give many more taxpayers the opportunity to convert and realize the benefits of the Roth IRA.

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<sup>225</sup> I.R.C. §408(c)(3), as amended by TIPRA §512(b).

**Planning note:**

The current tax-rate schedules are due to revert, under sunset legislation, to the 2001 rate schedules, as adjusted for inflation, after 2010. Legislation being discussed by the Obama administration and Congress (Senator Baucus, Senate Finance, *Taxpayer Certainty and Relief Act of 2009*<sup>226</sup>) may leave the lower tax rates in place, but lift the two current upper brackets of 33 percent and 35 percent to the 2001 levels of 36 percent and 39.6 percent, respectively.

What this may mean is that higher-income taxpayers who are considering regular IRA to Roth IRA conversions in 2010 may want to consider electing out of the deferral of tax into the 2011 and 2012 tax years. They will want to assess whether or not the time-value benefit of the tax deferral outweighs the cost of potentially higher effective tax rates on the conversion income in the later years.

The following table presents the minimum *after-tax* and the corresponding minimum *before-tax* rates of return taxpayers must earn to come out ahead by deferring the 2010 conversion-tax payment into 2011 and 2012 at higher tax rates in 2011 and 2012. The scenarios shown are based on the assumption that the Baucus/Obama tax proposals will be enacted leaving all the current tax brackets the same except the top two brackets of 33 percent and 35 percent. These two brackets are increased to 36 percent and 39.6 percent, respectively. Depending on the timing of the recovery of the economy and its impact on income levels, many taxpayers may find themselves in lower tax brackets in 2010 than they might expect to be in 2011, 2012, and subsequent years.

<b>Approximate After-Tax and Before-Tax Rates of Return Required to Break Even by Deferring the Conversion Tax from 2010 into 2011 and 2012 Assuming Various Tax Rates</b>				
<b>Assumed Tax Rates</b>			<b>AT ROR</b>	<b>BT ROR</b>
<b>2010</b>	<b>2011</b>	<b>2012</b>		
28.0%	28.0%	36.0%	9.0%	12.5%
28.0%	28.0%	39.6%	12.7%	17.7%
28.0%	36.0%	28.0%	9.8%	14.1%
28.0%	36.0%	36.0%	18.5%	26.7%
28.0%	36.0%	39.6%	22.2%	31.9%
28.0%	39.6%	28.0%	14.4%	21.0%
28.0%	39.6%	36.0%	23.0%	33.6%
28.0%	39.6%	39.6%	26.6%	38.9%
33.0%	36.0%	36.0%	6.0%	9.1%
33.0%	36.0%	39.6%	9.4%	14.2%
33.0%	39.6%	36.0%	9.7%	15.0%
33.0%	39.6%	39.6%	13.1%	20.1%
35.0%	36.0%	36.0%	1.9%	2.9%
35.0%	36.0%	39.6%	5.2%	8.0%
35.0%	39.6%	36.0%	5.4%	8.5%
35.0%	39.6%	39.6%	8.6%	13.6%

<sup>226</sup>

This proposed legislation is discussed further later in the reading.

**Example:** A taxpayer who's income would put her in the upper half of the 33-percent tax bracket in 2010 reasonably might expect to be taxed in the 36-percent bracket in 2011 and 2012, even if her income does not increase in inflation-adjusted terms. Assuming that becomes the case, the table shows she would have to earn a compound rate of return of at least 6 percent, after tax, or 9.1 percent, before tax, over the two deferral years in order to make it profitable for her to defer the payment of the tax.

Given the current interest-rate environment and the types of investments/savings vehicles that are typically used for one to two year horizons, not many people can reasonably expect to earn 9.1 percent before tax or 6.0 percent after tax for that two-year deferral period.

**Planning note:**

Depending on how the lower-income levels of the 35-percent and 39.6 percent brackets line up, it may be impossible for a person who is in the 35-percent bracket in 2010 and who earns the same inflation-adjusted income in 2010 and 2011 to be in the 36-percent bracket in 2011. In other words, if the lower-income level of the 35-percent bracket would have been, say, X dollars in 2011 without a change in tax rates and the new 39.6-percent bracket's lower income level is set at X dollars, then everyone with what otherwise would have been 35-percent-bracket-level income will fall into the 39.6-percent bracket in 2011. If this becomes the case, a 35-percent bracket taxpayer in 2010 will actually have to have lower inflation-adjusted income in 2011 than in 2010 to "only" have his marginal tax rate rise to 36 percent.

The before-tax rates of returns necessary to make the two-year deferral profitable despite higher tax rates in 2011 and 2012 than in 2010 range from only 2.9 percent up to an astronomical 38.9 percent. Except for taxpayers who expect to be in the 35-percent bracket in 2010 and only in the 36-percent bracket in 2011 and 2012 (1.9 percent break-even rate of return after tax; 2.9 percent before tax), deferral of the conversion tax does not appear to be a good idea under most of the tax-rate-increase scenarios presented in the table.

For taxpayers who expect to be in the 28 percent bracket or lower in 2010 and who do not expect their income to push them into higher brackets in 2011 and 2012, deferring the payment of the conversion tax is unambiguously the better choice.

**Example:** Assume Stacy will remain in the same tax bracket in 2011 and 2012 as she will be in 2010 with regard to the tax on conversion amounts allocate to those tax years. For illustration, assume a 33-percent average tax rate on the conversion amount. Also, assume that she can reasonably expect to save/invest the deferred taxes at 4 percent before tax (about a 2.7 percent *after-tax* rate of return in her tax bracket) over the 2-year deferral period. The deferral of the tax is effectively equivalent to just under a 4-percent reduction in the relative tax cost of the conversion. By deferring the payment of tax over the two years, the taxpayer's effective tax rate falls from 33 percent to 31.7 percent or by 3.94 percent ( $1 - 31.7\% / 33\% = 3.94\%$ ) relative to the 33-percent rate she would have paid in 2010. In effect, the tax deferral is equivalent to having reduced the tax and the effective tax rate that would otherwise have been paid on the conversion in 2010 by almost 4 percent.

The table below shows the effective average tax rates on conversions resulting from the two-year tax deferral for potential marginal tax rates on a conversion in 2010 ranging from 10 percent to 35 percent, for before-tax rates of return ranging from 3 percent to 8 percent, and assuming the taxpayer remains in the same tax bracket in 2011 and 2012 as in 2010.

Effective Tax Rates on 2010 Conversions Using 2-year Tax Deferral Rule*						
Actual Tax Rate	Before-Tax Rate of Return					
	3.0%	4.0%	5.0%	6.0%	7.0%	8.0%
10.0%	9.6%	9.5%	9.4%	9.2%	9.1%	9.0%
15.0%	14.4%	14.3%	14.1%	13.9%	13.7%	13.6%
20.0%	19.3%	19.1%	18.9%	18.6%	18.4%	18.2%
25.0%	24.2%	23.9%	23.6%	23.4%	23.1%	22.9%
28.0%	27.1%	26.8%	26.5%	26.3%	26.0%	25.7%
30.0%	29.1%	28.8%	28.5%	28.2%	27.9%	27.6%
33.0%	32.0%	31.7%	31.4%	31.1%	30.8%	30.5%
35.0%	34.0%	33.7%	33.3%	33.0%	32.7%	32.4%

\*Assumes taxpayer remains in same tax bracket in 2010 and 2011

The effective tax rate gets smaller as the opportunity cost rate of return increases, which makes intuitive sense because the deferred taxes earn higher rates of return. The relative improvement is greater at the lower tax rates. For instance, any taxpayer whose conversion would be taxed at 10 percent in 2010 and who can invest over the next two years at an 8-percent before-tax rate of return will have an effective tax rate on the conversion of 9 percent, which is a 10-percent lower tax rate than the actual 10 percent tax rate. However, in absolute terms it represents a 1-percent reduction in the effective out of pocket tax cost.

In contrast, the taxpayer in the 35-percent bracket whose before-tax opportunity cost rate of return is as high as 8 percent sees his effective tax rate fall by 2.6 percentage point to 32.4 percent. Relative to the 35 percent tax rate he would have paid in 2010, this represents about a 7.4 percent reduction in his tax rate. So relatively speaking, the higher tax-bracket taxpayers benefits less than the lower tax-bracket taxpayers by deferring the tax. However, in absolute term, the high tax-bracket taxpayers save 2.6 percent of the tax cost of the conversion by deferring as compared to only one percent for the low tax-bracket taxpayers.

## H. May a person convert balances from SEP IRAs and SIMPLE IRAs to Roth IRAs?

In general, an individual may convert amounts in the individual's SEP IRA or SIMPLE IRA to a Roth IRA on the same terms as amounts in any other traditional IRA.<sup>227</sup>

- a. The one exception to this rule is that employees may not take distributions from a SIMPLE IRA during the two-year period that begins on the date that the individual first participated in any SIMPLE IRA plan maintained by the individual's employer and roll it over to a Roth IRA (or to any traditional IRA or qualified plan whatsoever). A distribution of an amount from an individual's SIMPLE IRA during this two-year period is not eligible to be rolled over into an IRA that is not a SIMPLE IRA and thus cannot be a qualified rollover contribution.<sup>228</sup> This two-year period applies separately to the contributions of

<sup>227</sup> Treas. Regs. §1.408A-4, A-4(a).  
<sup>228</sup> I.R.C. §408(d)(3)(G).

each of an individual's employers maintaining a SIMPLE IRA plan.<sup>229</sup> Failure to heed this rule will subject the owner to a **25-percent** penalty on the distribution. In addition, the amount contributed (rolled over) to the Roth IRA (or regular IRA) is treated as an excess contribution subject to a 6-percent excise tax each year until the excess contribution is corrected.

- b. Once an amount in a SEP IRA or SIMPLE IRA has been converted to a Roth IRA (after the initial 2-year period), it is treated as a contribution to a Roth IRA for all purposes. Future contributions under the SEP or under the SIMPLE IRA plan may not be made to the Roth IRA.<sup>230</sup> However, the participant may roll over future amounts that are contributed to the SEP or SIMPLE IRA under the employer plan to a Roth IRA or regular IRA.

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<sup>229</sup> Treas. Regs. §1.408A-4, A-4(b).  
<sup>230</sup> Treas. Regs. §1.408A-4, A-4(c).