ECONOMIC STIMULUS PAYMENTS AND RECOVERY REBATE CREDIT

Economic stimulus payments received by your clients in 2008 are not taxable, and they are not reported on their 2008 tax returns. However, the stimulus payment does affect whether a taxpayer can claim the Recovery Rebate Credit and how much he or she can get. The credit is calculated like last year's economic stimulus payment except that the amounts are based on tax year 2008 instead of 2007.

The Recovery Rebate Credit is a one-time benefit for taxpayers who didn't receive the full economic stimulus payment last year and whose circumstances may have changed, making them eligible now for some or all of the unpaid portion.

Generally a credit adds to the amount of the taxpayer's tax refund or lowers the amount of taxes owed. Therefore, the amount the taxpayer receives for the Recovery Rebate Credit will be included as part of his or her refund as shown on the taxpayer's tax return.

Taxpayers who fall into the categories described below may be eligible for the Recovery Rebate Credit for 2008:

- ✓ Individuals who did not receive an economic stimulus payment.
- ✓ Those who received less than the maximum economic stimulus payment in 2008 ($600 per taxpayer; $1,200 if married filing jointly) because their qualifying or gross income was either too high or too low.
- ✓ Families who gained an additional qualifying child in 2008.
- ✓ Individuals who could be claimed as a dependent on someone else's tax return in 2007, but who cannot be claimed as a dependent on another return in 2008.
- ✓ Individuals who did not have a valid Social Security number in 2007, but who did receive one in 2008.

In order to receive the Recovery Rebate Credit, the taxpayer must file Form 1040, 1040A or 1040EZ. Unlike the economic stimulus payment, the Recovery Rebate Credit will be included in the taxpayer's refund for 2008 and will not be issued as a separate payment.

In order to determine if a taxpayer is eligible for the Recovery Rebate Credit, you will need to know the amount of the stimulus payment he or she received in 2007. Even if the taxpayer's stimulus payment was reduced to satisfy other debts, as would be stated in Notice 1378 received by the taxpayer, you still need to include the total on the 2008 tax return. If the taxpayer received more than one payment – and more than one Notice 1378 – the total of all payments received by the taxpayer must be included.

If your client is unable to provide Notice 1378, you can go to the IRS website and retrieve this information by clicking on "How Much Was My 2008 Stimulus Payment?" In order to retrieve the information you will need the taxpayer's Social Security number and filing status used on **his or her 2007 tax return.**

RECOVERY REBATE CREDIT

You may be eligible for a Recovery Rebate Credit when filing your 2008 tax return if you fall into the categories described below:

- Individuals who did not receive an economic stimulus payment.
- Individuals who received less than the maximum economic stimulus payment in 2008 - $600 per taxpayer; $1,200 if married filing jointly – because your qualifying or gross income was either too high or too low.
- Families who gained an additional qualifying child in 2008.
- Individuals who could be claimed as a dependent on someone else’s tax return in 2007, but who cannot be claimed as a dependent on another return in 2008.
- Individuals who did not have a valid Social Security number in 2007, but who did receive one in 2008.

In order to receive the Recovery Rebate Credit, you must file Form 1040, 1040A or 1040EZ.

EXPIRING TAX BREAKS RENEWED

Here are some selected elements from the *Emergency Economic Stabilization Act of 2008*.

State and Local Sales Tax Deduction

The American Jobs Creation Act of 2004 and subsequent legislation allowed an election for individuals to deduct state and local general sales taxes in lieu of state and local income taxes. This deduction expired at the end of 2007. The new law makes this deduction retroactive for 2008 and extends it through December 31, 2009.

Higher Education Tuition Deduction

The new law extends through December 31, 2009, the above-the-line higher tuition deduction. This deduction allows eligible taxpayers to deduct the costs of qualified higher education expenses paid during the tax year for themselves, a spouse, or a dependent. However, this deduction is not available to taxpayers whose filing status is married filing separately or if another person can claim an exemption for the taxpayer as a dependent.

The maximum deductible amount is $4,000 for taxpayers with adjusted gross income not exceeding $65,000 ($130,000 for joint filers). Taxpayers whose income exceeds that limit but does not exceed $80,000 ($160,000 for joint filers) may deduct up to $2,000 in qualified expenses. Remember that the HOPE or Lifetime Learning credit is also an option.

Additional Standard Deduction for Real Property Taxes

The new law extends the additional standard deduction for real property taxes for non-itemizers through 2009. Congress authorized a maximum of $500 additional standard deduction ($1,000 for joint filers) in the Housing Assistance Tax Act of 2008 but made it available only for the 2008 tax year. The deduction is in addition to the standard deduction. It is not an above-the-line deduction that will lower a taxpayer's adjusted gross income.

For 2008 for non-itemizers:

Joint Filers - $10,900 standard deduction becomes $11,900
Single Filers - $5,450 standard deduction becomes $5,950
Head of Household Filers - $8,000 standard deduction becomes $8,500

Teachers' Classroom Expense Deduction

For 2008 and 2009, teachers and other education professionals can deduct up to $250 as an adjustment to adjusted gross income (above-the-line). First introduced in 2002 for certain out-of-pocket expenses for books, supplies, equipment and software used in the classroom, this deduction is available regardless of whether or not the taxpayer itemizes their deductions. For those who do itemize, expenses that exceed the $250 and non-classroom supplies may be deducted as an employment-related miscellaneous deduction subject to the 2% floor.

Tax-Free Distributions form IRAs for Charitable Purposes
This popular option which expired on January 1, 2008 is extended through December 31, 2009. The maximum contribution limit for 2008 and 2009 is $100,000. The treatment applies to both traditional IRAs and Roth IRAs. However, there is no charitable deduction allowed for any portion of these withdrawals that would have otherwise been taxable.

Child Tax Credit Enhanced
Currently, this credit is refundable to the extent of 15 percent of a taxpayer's earned income in excess of $12,050 (reflecting inflation adjustments from the original $10,000 floor). Under the new law the floor falls to $8,500.

Energy Incentives
The non-business energy credit for insulation, exterior windows, exterior doors, furnaces, water heaters and other energy-saving improvements to a main home is **not available** for **2008** but **will return** for **2009**.

The residential energy-efficient property credit is extended through 2016. Generally, solar electric, solar water heating and fuel cell property qualify for this credit. Starting in 2008, small wind energy and geothermal heat pump property also qualify. Use Form 5695 to claim the credit.

NEW TAX CREDIT FOR HOMEBUYERS

If you are a first time homebuyer or haven't owned a home during the last 3 years, Congress has enacted a new homebuyer credit you may want to use. The credit is for homes purchased after April 8, 2008 and prior to July 1, 2009. A tax credit can either reduce your tax liability or increase your refund dollar for dollar. This credit is fully refundable, meaning; the credit will be refunded even if you don't owe any tax.

The credit is 10 percent of the purchase price for homes priced from $75,000 to $750,000. The amount of the credit is the **lesser** of $7500 or 10% of the home's purchase price. If you are married filing separately, the credit is reduced by half.

This credit sounds too good to be true, and unfortunately, it is. Taxpayers who take advantage of this credit must pay it back over a 15 year period starting 2 years after the credit is taken, making this credit no more than an interest free loan. For example, if you claimed the credit in 2008, you must begin repaying the credit when you file your 2010 tax return.

The credit is phased out for married taxpayers with modified adjusted gross incomes between $150.000 and $170,000. For all other taxpayers the credit is phased out for modified adjusted gross incomes between $75,000 and $95,000.

Should you take the new homebuyer credit? In reality, the credit is simply an interest-free loan which must be paid back. The repayments result in additional tax on the tax return when the repayments are made. For example, if you claimed the maximum credit of $7,500 in 2008, you would begin paying $500 per year back on your 2010 tax return, with a final payment in 2024. You should discuss with your tax preparer your particular income tax situation to see if this credit is for you.

Practitioners Notes:
The credit is equivalent to an interest-free loan of 10% of the home's purchase price, up to $7,500.

Taxpayers who purchase a residence after December 31, 2008 and before July 1, 2009 **may elect** to treat the purchase as **made** on December 31, 2008. Making this election allows taxpayers to claim the credit on their 2008 tax returns. Taxpayers may amend their returns for this purpose. The election also establishes the beginning of the recapture period.

For example: A first time homebuyer buys a principle residence in May 2009. He elects to treat the purchase as made on December 31, 2008. By making this election, the taxpayer will be able to claim the credit on his 2008 tax return. If he has already filed his 2008 return, he can file an amended return to make the election and claim the credit. The recapture period will run from 2010-2024 instead of 2011-2025. In effect one of the recapture payments (6 2/3% of the total credit) will be accelerated by 15 years (from 2025 to 2010).

Accelerated recapture:
If the taxpayer disposes of the principal residence before the end of the recapture period, the taxpayer's tax for the year of disposition is increased by the excess of the credit allowed over the amount recaptured in previous years ("accelerated recapture"). No further recapture is required. Accelerated recapture is also required in the year in which the residence ceases to be the taxpayer's principal residence and, if the taxpayer is married, the principal residence of the taxpayer's spouse.

If the principal residence is sold to a person who is not related to the taxpayer, the amount of accelerated recapture is limited to the amount of gain (if any) on the sale. Solely for this purpose, gain is determined by reducing the residence's adjusted basis by the amount of the credit not previously recaptured. This basis reduction means that if the taxpayer breaks even on the sale (before applying the basis reduction) or sells at a gain, the entire credit will be recaptured. Only if the sale is at a loss will the taxpayer avoid recapture of some or all of the credit.

Neither regular nor accelerated recapture is required in any tax year ending after the date of the taxpayer's death. Thus, no amount is recaptured after a taxpayer's death.

Recapture isn't accelerated if the residence is compulsorily or involuntarily converted, and the taxpayer acquires a new principal residence during the two year period beginning on the date of the disposition of the residence or its cessation to be the taxpayer's principal residence.

IRS Issues Guidance On First-Time Homebuyer Credit For Unmarried Taxpayers
The IRS has issued Notice 2009-12, providing guidance under Section 36(b)(1)(C) of the Internal Revenue Code for allocating the first-time homebuyer credit between taxpayers who are not married. A copy of the Notice may be found at the following weblink: http://www.irs.gov/pub/irs-drop/n-09-12.pdf

2009 REQUIRED MINIMUM DISTRIBUTIONS FROM RETIREMENT ACCOUNTS

The Worker, Retiree, and Employer Recovery Act of 2008 suspended the required minimum distributions for 2009 from most retirement accounts. Section 201 of the Act waives any RMDs for 2009 from individual retirement arrangements (IRAs) and retirement plans that hold participant benefits in individual accounts such as 401(k) plans, 403(b) plans and certain 457 (b) plans. This suspension of RMDs for 2009 does not permit those individuals who postponed taking their first RMD in 2008 and deferred it to 2009 from taking their distributions. These individuals must still withdraw their RMD by April 1, 2009. Likewise those individuals who will first turn 70 ½ in 2009 must either take the distribution in 2009 or defer it until April 1, 2010. Also, beneficiaries receiving distributions over a 5-year period cannot waive their 2009 payments and create a 6-year distribution process. Please note that the 2008 rules were not changed by this legislation.

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Congress has suspended the requirements for mandatory retirement account withdrawals during 2009 for most retirement accounts. For individuals who deferred their 2008 withdrawals to 2009, you must still make your withdrawal by April 1, 2009. Those individuals who will first turn 70 ½ during 2009, the general rules have not changed. You will either take a distribution in 2009 or defer it to no later than April 1, 2010. No exemption or deferral is allowed for beneficiaries who are receiving 5-year payouts from a retirement account. Those withdrawals must continue as in prior years.

VACATION HOME OWNERS LOSE TAX BREAKS

Starting in tax year 2009, owners of second or vacation homes will lose some of the tax benefits of being able to convert their property to a primary residence, sell in, and benefit from the capital-gains exclusion afforded a primary home. To benefit from the primary home gain exclusion of up to $500,000 for married taxpayers, or $250,000 for single taxpayers, all that was necessary was for the taxpayer to move in and convert the second home to a primary home for at least two years.

Under the new rules, the gain exclusion will be prorated by the amount of time the owner actually uses the property as a primary residence. For example, if you owned a second (vacation) home for 10 years and during the last two years you moved into and converted the property to your primary residence you would only exclude 2 tenths of the gain on your tax return.

The new rules won't begin until January 1, 2009 so if you have owned a second or vacation home prior to the effective date those years of ownership won't be included in the calculations.

Practitioners Notes: Gain from the Sale of Principal Residence Allocated to Nonqualified Use Not Excluded from Income.

Gain from the sale of a principal residence allocated to nonqualified use is not excluded from income, but certain usage is not treated as nonqualified, including leaving the home vacant and temporary absences because of a change in employment, health, or unforeseen circumstances. This law change closes a loophole; it is no longer possible to convert a vacation home into a main home after 2008 and use the full home sale exclusion. However, the partial home sale exclusion that results after applying the apportionment rule may still be sufficient to offset the gain, depending on the circumstances.

Gain is allocated between the periods of qualified and nonqualified use on the basis of the respective amounts of time the property is utilized for qualified and nonqualified uses. Specifically, the Code provides that gain is allocated to periods of nonqualified use based on the ratio which the aggregate periods of non-qualified use during the period the property was owned by the taxpayer bears to the total period of time the property was owned by the taxpayer.

A period of non-qualified use with respect to a piece of property is any period (other than before January 1, 2009) during which the property is not used as a principal residence of the taxpayer, the taxpayer's spouse or the taxpayer's former spouse.

Exceptions to the general definition of “period of nonqualified uses:”

1. Any portion of the five-year period ending on the date the property is sold that is after the last date that the property is used as the principal residence of the taxpayer or the taxpayer’s spouse is NOT considered a period of nonqualified use.

2. Another exception applies to any period (not exceeding an aggregate period of 10 years) during which the taxpayer or the taxpayer’s spouse is serving on “qualified official extended duty” as a member of the armed forces, as a Foreign Service Officer, or as an employee of the intelligence community.

3. A final exception exists for other periods of temporary absence from the taxpayer’s principal residence-that do not exceed two years in total-because of a change of employment, health conditions, or other unforeseen circumstances be the IRS code.

The old rule that depreciation attributable to periods of business use is subject to recapture, and is taxed, is not changed, but the new rules that go into effect for sales after 2008 also will not exclude from income any gain allocated to periods when the taxpayer did not use the home as a principal residence. Besides affecting persons who rent out their homes before converting them to their personal residence, the rule will hit owners of second or vacation homes especially hard. A common tax planning strategy has been to sell the principal residence, take advantage of the exclusion, then move into the second home as a principal residence for two years. The gain on the sale of the second home would then be eligible for the exclusion. After this year, that will no longer be the case. Fortunately, because nonqualified use will not include any time before 2009, the full impact of the new rules will take time to be felt. Also, anytime after a home ceases to be a principal residence will no be considered a period of nonqualified use under the new rules.