

2009/2010 Tax Update

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EDUCATION PLANNING

Many of you are already familiar with the credits and deductions for education expenses, but the options have expanded in 2009. What follows is a review of what's available and some discussion about how to make the choice(s) that will work best for you and your family.

The cost of education continues to grow. In 2008/2009, there was a 6.4% increase in the average annual cost of tuition and fees for a four-year public university. With the economy still in recession, people are looking for ways to cut those costs. Additional money is funneling down from the government, as well as from state and private sources to help make education more affordable for many people.

Here is a summary of what's available, with details on some to follow:

Description

Credits	<ol style="list-style-type: none">1. Hope Credit *2. American Opportunity Tax Credit *3. Lifetime Learning Credit *
Deductions	<ol style="list-style-type: none">1. Higher Education Expense Deduction *2. Student Loan Interest Deduction3. Ordinary and Necessary Business Expense4. Working Condition Fringe Benefits
Exclusions	<ol style="list-style-type: none">1. Employer-provided Education Assistance2. Scholarships, Fellowships, Grants and Tuition Reductions
Exclusions/ Investments	<ol style="list-style-type: none">1. Education Savings Bond2. Traditional & Roth IRA Distributions for Education3. Qualified Tuition Programs (529 Plans)

* A comparison must be made between the Hope Credit, American Opportunity Tax Credit, the Lifetime Learning Credit and Higher Education Expense Deduction to determine which one is of greater benefit, since only one can be used.

I. CREDITS

Hope Credit & American Opportunity Tax Credit

The Hope Credit has been renamed the American Opportunity Tax Credit (AOTC) for 2009 and 2010 and offers better provisions. Here are some highlights:

- \$2,500 maximum credit per student, per year (up from \$1,800 under the Hope Credit)
- Allowed for the first four years of postsecondary education (up from two years under the Hope Credit)
- Qualified education expense has been expanded under the AOTC to include course materials
- Modified AGI range for phasing out the AOTC has been increased over the Hope Credit by \$60,000 (married, filing joint) and \$30,000 (single and head of household); new phase outs are:

Filing Status	2009 AGI Phase-Out
Married Filing Joint and Surviving Spouse	\$160,000 - \$180,000
Single and Head of Household	\$80,000 - \$90,000

- 40% of the credit is refundable; that is, whatever amount of the credit exceeds tax due will result in an additional refund.

Lifetime Learning Credit

No changes here, but the beauty of this credit is that it can be used to offset the costs of any sort of education for any family member, up to a maximum annual credit of \$2,000 for each family. You want to take a Spanish Class? The tuition and fees for the class can be offset by the lifetime learning credit. There is no requirement for full or half-time attendance, or being in a degree or certificate program. Phase-outs on Modified AGI for 2009 are:

Filing Status	2009 AGI Phase-Out
Married Filing Joint and Surviving Spouse	\$100,000 - \$120,000
Single and Head of Household	\$50,000 - \$60,000

Planning Opportunities:

1. *If the parents' income is too high to qualify for the credit, they should arrange for their student to take the credit. This is only possible if the child is not claimed as a dependent and has sufficient taxable income to benefit from the credit.*
2. *In a divorce situation, make sure the parent who makes the tuition payment is also eligible to claim the child as a dependent.*

II. DEDUCTIONS

Higher Education Expense Deduction (HEED)

An above-the-line deduction (lowering AGI), the HEED was extended for 2008 and 2009, and will hopefully be extended to 2010, as well.

The deduction is not available for Married Filing Separate returns. There are AGI limits, as follows:

Filing Status	AGI Limits	Deduction for 2009
Single, Head of Household	Up to \$65,000	\$4,000
Single, Head of Household	\$65,001 - \$80,000	\$2,000
MFJ and Surviving Spouse	Up to \$130,000	\$4,000
MFJ and Surviving Spouse	\$130,001 - \$160,000	\$2,000

Student Loan Interest Deduction

No change to this deduction in 2009 & 2010. The deduction is above-the-line (on page 1 of the Form 1040). The maximum amount deductible is \$2,500, and is ratably phased out as follows:

Filing Status	2009 AGI Phase-Out
Married Filing Joint and Surviving Spouse	\$120,000 - \$150,000
Single and Head of Household	\$60,000 - \$75,000

The AGI phase-out is adjusted annually for inflation in \$5,000 increments.

A revolving credit line is qualified if used solely for the purpose of paying qualified educational expenses.

Planning Opportunity: If parents' income exceeds the AGI limits, taxpayers should consider taking out the loans in the student's name to ensure a deduction. Recent college graduates generally will not exceed the limits.

III. EXCLUSIONS/INVESTMENTS

Qualified Tuition Programs (QTP, Section 529)

The QTP is a pre-paid college investment program. Anyone can contribute to a 529 Plan for anyone else.

Qualified expenses include tuition, fees, books, supplies & equipment, as well as room and board if the student is enrolled at least half time. Computer expenses (equipment, technology, internet access) were added to the list in 2009.

Advantages of the QTP:

- ❖ There are no AGI limitations imposed on the contributor to a beneficiary.
- ❖ The contributor retains control of the assets until distributions are made to beneficiaries.
- ❖ The contributor can change the beneficiary.
- ❖ The contribution is eligible for the gift tax exclusion.
- ❖ Large contributions are permitted in most states' plans.
- ❖ There is no time limit on withdrawals in most states' plans. Distributions that are not used for education are not included in income if rolled over within 60 days to another 529 plan benefiting another family member.

Distributions and earnings from 529 Plans are excluded from the income of the beneficiary and the contributor if used for qualified education expenses.

Planning Opportunity: The funds contributed by grandparents who are account owners on a 529 Plan, do not show up as an asset for financial aid purposes.

HEALTH SAVINGS ACCOUNT

A Health Savings Account (HSA) is a tax-favored medical savings vehicle. In other words, contributions are deductible when they are made and distributions from the account are tax-free if they meet certain criteria. The HSA has grown in popularity since its inception in 2004. Individuals participating in 2004 numbered ~ 48,000. In 2008, that count rose to an estimated 6.1 million.

Here is a summary of the benefits of an HSA:

1. Contributions to the account are tax deductible.
2. Balances in the account are rolled over from year to year and remain with the beneficiary.
3. Distributions from the account are not taxable as long as they are used to pay for qualified medical expenses.
4. After age 65, distributions for any purpose can be taken from the balance in the account without incurring a penalty (much like an IRA); however, distributions for other than medical purposes are taxable.

What makes a person eligible to contribute to an HSA? They need to:

- √ Be covered by a High Deductible Health Plan (HDHP)
- √ Not be a dependent of another taxpayer
- √ Not covered by other health insurance
- √ Not enrolled in Medicare Parts A or B

What medical expenses are covered under the HSA?

- Medical care
- Certain over-the-counter medical items

What is the process to enroll in an HSA?

First – Contact a trusted insurance broker that specializes in health insurance

Second – Establish a High Deductible Health Plan (HDHP)

Third – Establish a Health Savings Account (HSA)

High Deductible Health Plan (HDHP)

An HDHP must require a minimum deductible amount and a maximum annual out-of-pocket amount. HDHP deductibles for 2009 and 2010 are as follows:

	2010 Minimum Deductible	2010 Maximum Out-of-Pocket		2009 Minimum Deductible	2009 Maximum Out-of-Pocket
Self	\$1,200	\$ 5,950		\$1,150	\$ 5,800
Family	\$2,400	\$11,900		\$2,300	\$11,600

NOTES:

- ❶ To qualify, an HDHP must apply costs of prescription drugs to the annual deductible.
- ❷ If a taxpayer is age 55 or older on or before December 31st of a particular tax year, then that individual is eligible for the additional catch-up contribution amount (\$1,000); if both spouses are 55 or older and both want to make catch-up contributions, then each spouse must own a separate HSA.

Establishing a Health Savings Account (HSA)

The HSA is like a trust or custodial account, similar to an IRA, except that it is established to pay qualified medical expenses of the account beneficiary, including spouse and dependents under a Family HSA account.

Any institution qualified to provide an IRA is authorized to provide an HSA, including insurance companies, banks, investment companies, etc. Some insurance companies provide both the HDHP and the HSA.

Where to Go For More Information: There are several online guides, but two of the most useful are:

- ❖ eHealthInsurance; www.eHealthInsurance.com
- ❖ HSA Insider; www.HSAinsider.com

Distributions

The individual beneficiary must retain records to prove that distributions taken from the HSA are qualified. Distributions must be used exclusively to pay or reimburse for qualified medical expenses. Those expenses must not have been previously paid or reimbursed from another source, nor can the same expenses be taken as an itemized deduction. In addition, the assets in the HSA may not be used as security for a loan.

The account will cease to be an HSA if prohibited transactions are discovered. If that happens, the fair market value of the assets in the account would be recognized as ordinary income to the beneficiary and taxed accordingly. In addition, a 10% penalty will apply.

Planning Opportunities:

- √ *Eligible taxpayers can make a one-time transfer from a traditional IRA or a Roth IRA to an HSA. These distributions are generally considered a roll-over and are excluded from gross income. The amount transferred counts towards the taxpayer's maximum annual HSA contribution but is not allowed to reduce income for that year.*
- √ *One-time rollovers from FSAs and HRAs into an HSA are also allowed.*

Reporting of HSA Contributions

Contributions made by an employer on behalf of employees is reported on Form W-2 in Box 12 with a Code W. These contributions are not included in Boxes 1, 3, or 5 and are tax free for the employee.

If an employee makes a contribution to his or her HSA as a payroll deduction, it is includable in income as wages and is subject to all employment taxes. That inclusion is reversed on the individual's tax return for income tax purposes.

COBRA PREMIUM ASSISTANCE

The American Recovery and Reinvestment Act (ARRA) of 2009 provides a nine-month COBRA subsidy for workers. As you may already suspect, COBRA is an acronym for a set of words, in this case Consolidated Omnibus Reconciliation Act of 1985, which made it possible for employees and their eligible beneficiaries, who are covered by group health insurance provided by employers with at least 20 employees, to elect ongoing coverage after leaving employment. The coverage can continue for 18 months at the former employee's expense.

The subsidy authorized by the ARRA is available to individuals who:

1. become eligible for COBRA at any time from September 1, 2008 – December 31, 2009;
2. elect COBRA coverage; and
3. were involuntarily terminated between September 1, 2008 and December 31, 2009.

The amount of the subsidy is 65% of the premium and is tax-free to the employee; however, a subsidy does not include coverage under a cafeteria plan or flexible spending account.

EXAMPLE: Wayne is involuntarily terminated on April 16, 2009, and has elected COBRA coverage. In other words, he wants to continue the group health insurance coverage that was provided to him while an employee. Normally, Wayne would be required to pay 100% of the premium during the COBRA period (18 months maximum). Under the subsidy, Wayne is only required to pay 35% of the premium for the first nine months. So, if the monthly premium for him and his family is \$1,000, he will only have to pay \$350. The government will subsidize the balance of \$650 by reimbursing the employer as a credit on their quarterly payroll report.

Involuntary Termination

The obvious types of involuntary termination include being laid off or fired, but there are less obvious situations that would qualify someone for this subsidy. For example, someone who quits or retires under duress is involuntarily terminated. Perhaps, as an example, an employee quits because s/he will be terminated if s/he does not change geographic locations.

Recapture

The premium subsidy has to be paid back if the employee's modified adjusted gross income is between the following levels:

MFJ (married filing joint)	\$250,000 - \$290,000
Other filers	\$125,000 - \$145,000

PERSONAL TAX CREDITS

A number of personal tax credits are available for those that qualify. Remember that a credit is actually better than a deduction. A deduction lowers your income before the tax is calculated. A credit lowers the tax due.

A few of the personal tax credits are fairly new and deserve some discussion. Here are the ones that we think may be most newsworthy:

- Credit for First-Time Homebuyer
- Credit for Long-Time Residents of the Same Principal Residence (NEW as of 11/6/09)
- Plug-in Electric Vehicle Credit
- Residential Energy-Efficient Property
- Personal Energy Credit

Credit for First-Time Homebuyer

This credit is refundable for first-time homebuyers. Refundable credits can result in an additional refund over and above tax due on income earned. For example:

EXAMPLE: The tax on Betty's income is \$5,000. She has not paid any tax during the year. She qualifies for a First-Time Homebuyer Credit, which means that she will receive a refund of \$3,000 after applying the credit (\$8,000) against the income tax owed (\$5,000). So, she has a refund even though she hasn't paid any taxes!

A *first-time home buyer* is defined as someone who did not own any other principal residence during the three-year period ending on the date of purchase. In the case of a constructed home, the three-year period ends on the date that the residence is occupied. A *main home or principal residence* can be a house, house trailer, houseboat, condominium or other type of residence.

Some situations are not allowed. A taxpayer will not qualify if:

- S/he is a non-resident alien
- The home is located outside the United States
- The home is acquired by gift or inheritance
- The home is acquired from a related person

There are two versions of the First-Time Homebuyer Credit, depending on when the home was purchased:

Version I: 2008

- Main home (principal residence) purchased between April 8, 2008 and before January 1, 2009

- The credit offered for these home buyers is actually an interest-free loan, rather than a real credit. The credit is repaid over the course of 15 years or in the year the home is sold, whichever comes first.

There are some exceptions to the repayment rules, including:

- ✓ death of the homeowner
- ✓ the home is destroyed or condemned
- ✓ the home is transferred as part of a divorce settlement
- ✓ the home is not sold for a gain

Version II: 2009 & 2010

- Main home (principal residence) purchased after December 31, 2008 and before April 30, 2010.
- The credit is never repaid, unless the home ceases to be a main home within 36 months of the purchase date.

The 2009/2010 version was originally scheduled to sunset on November 30, 2009, but was extended on November 6, 2009, to include homes purchased as of April 30, 2010. Also allowed are homes that may not have closed by 4/30/2010, but for which there is a binding contract and a closing of no later than June 30, 2010.

Planning Opportunity: The first-time homebuyer credit can be claimed in either the year of purchase of the new home or in the prior tax year

Credit for Long-Time Residents of the Same Principal Residence

Signed into law on November 6, 2009, as part of the *Worker, Homeownership, and Business Assistance Act of 2009*, this new credit rewards taxpayers who have lived in the same home for five consecutive years out of the last eight years and who purchase another residence. The *Act* allows for a \$6,500 (\$3,250 for married filing separately) credit.

Plug-In Electric Vehicle Credit

For someone who has a short commute to work, this new credit may be quite advantageous. To visualize a plug-in electric vehicle, think of a golf cart, except that these vehicles must be manufactured or converted to be used primarily on public streets, roads & highways. The maximum amount of the credit varies depending, in part, on weight:

Up to 10,000 lbs.	\$ 7,500
10,000 – 14,000 lbs.	\$10,000
14,001 – 26,000 lbs.	\$12,500
More than 26,000 lbs.	\$15,000

The base credit is \$2,500 plus \$417 for each kilowatt in excess of 4 kilowatts.

EXAMPLE:	
Base Amount	\$2,500
Add for each kilowatt in excess of 4kW:	
Chevy Volt Battery 16kW	
(16 – 4) X \$417 =	<u>\$5,004</u>
\$5,004 + \$2,500 base amt =	\$7,504
Maximum Credit	\$7,500

Phase Out: The credit phases out after 250,000 cars are sold in 2009 and after 200,000 cars are sold in 2010.

After 2009: Vehicles acquired after 2009 have the same base amount; however, only kW exceeding 5 are added to the credit.

Qualifications: To qualify as a Plug-In Vehicle for this credit, it must meet the following requirements:

1. Must be original use with the taxpayer (no used vehicles)
2. The vehicle is not for resale
3. The vehicle is made by a “manufacturer”
4. The vehicle is manufactured primarily for use on public streets, roads and highways
5. The vehicle has a gross vehicle weight rating of < 14,000 pounds
6. The vehicle is propelled by an electric motor that draws electricity from a battery and has a capacity of at least 4 kilowatt-hours
7. The vehicle is capable of being recharged from an external source of electricity

Plug-In Conversion Credit: A credit is available for the cost of converting a vehicle to a qualified plug-in motor vehicle. The credit is limited to 10% of the first \$40,000 in conversion costs.

Residential Energy-Efficient Property

A credit is equal to 30% of the cost of certain qualified energy property expenditures is allowed and there is no limit on the amount of the credit! Qualified property includes:

- ◆ solar electric
- ◆ solar water heating
- ◆ fuel cells
- ◆ small wind and geothermal heat pumps

Personal Energy Credit

A credit of 30% of the cost of energy-efficient improvements made to a principal residence is allowed for 2009 and 2010, but is limited to an aggregate amount of \$1,500 for the two years combined. There is, however, no lifetime maximum as with earlier versions of this credit.

Qualified improvements to the building envelope include:

1. insulation material
2. exterior windows or skylights
3. exterior doors
4. certain metal or asphalt roof
5. electric heat pumps (for space heating or water heating)
6. central air conditioning
7. natural gas, propane or oil heaters and furnaces
8. biomass fuel stoves
9. advanced air circulating fans

Other personal credits not covered in this section include:

- ✓ Earned Income Credit (IRC Section 32)
- ✓ Foreign Tax Credit (IRC Section 27)
- ✓ Adoption Credit and Income Exclusion (IRC Section 23)
- ✓ Child & Dependent Care Credits and Exclusion (IRC Section 21)
- ✓ Mortgage Interest Credit (IRC Section 25)
- ✓ Credit for the Elderly and/or Permanently Disabled (IRC Section 22)
- ✓ Child Tax Credit (IRC Section 24)
- ✓ Credit for Retirement Savings Contributions (IRC Section 25B)

Information on these credits can be researched on the IRS website, www.irs.gov, or by calling our office.

DEBT FORGIVENESS & FORECLOSURE

Legislation has been passed recently to help victims of the worst economic recession since the Great Depression. The *Hope for Homeowners Act of 2008* provided authority for the government to back cheaper mortgages for troubled homeowners, fix up foreclosed properties, expand low-income housing tax credits and create the first-time home buyer credit.

Despite these efforts, the number of Forms 1099-C issued is increasing dramatically. Form 1099-C is used to report income due to debt forgiveness or Cancellation of Debt (COD). If a taxpayer is able to negotiate a lower debt level or the debt is discharged, they will receive a 1099-C to report the amount that may be taxable, which is usually the difference between what they originally owed and the liability that remains after the lender forgives or decreases the debt.

Not all income reported on a 1099-C is necessarily taxable. One of the key determinants is whether the debt is “recourse” or “non-recourse”. Here are the definitions of those two terms:

Recourse debt = debt for which someone is personally liable

Non-recourse debt = debt for which someone is not personally liable

If you have a mortgage on a home and the loan is collateralized by the property, that debt may be either recourse or non-recourse. If the taxpayer defaults on payment of the loan and the loan is non-recourse, the only thing the taxpayer can lose is the property that is used as collateral on the loan. If the loan is recourse, the lender can sue the taxpayer for any other assets he/she may have to help satisfy the loan balance due at the time of default or foreclosure.

So, if you receive a 1099-C, you need to first establish whether the debt is recourse or non-recourse. If it is non-recourse, the debt forgiveness is not taxable. If it is recourse, then the debt forgiveness is taxed as ordinary income, unless:

- It is forgiven as part of a bankruptcy
- The taxpayer is insolvent (see description below) prior to the cancellation or forgiveness of debt
- It is qualified farm debt
- It is qualified real property business indebtedness
- It is qualified principal residence indebtedness (see description below)

Planning Tips for Recourse Debt Forgiveness:

1. *Get an Appraisal - the bid price in a foreclosure sale is presumed to be the property's fair market value (FMV) unless there is clear and convincing proof to the contrary; the lower the FMV, the more income is reported on the 1099-C.*
2. *Follow Up with Lenders – don't take their word for the amount reported on the 1099-C as taxable income; find out how they determined the amount and make sure you agree.*

Insolvency

In general, insolvency occurs when the taxpayer's assets (everything he owns) are valued at less than his/her liabilities (everything he owes to lenders, credit card companies, etc.). The burden of proof of insolvency is on the taxpayer. He/she must have evidence adequate to convince the court of insolvency.

If a taxpayer is proved insolvent, he/she may be able to exclude most if not all the debt forgiveness from income. There are some cases where this is not possible.

Special Rules for Principal Residence Debt

The **2007 Mortgage Relief Act** allows taxpayers to exclude from gross income a discharge (in whole or in part) of qualified principal residence indebtedness if it occurs in the calendar years 2007 – 2012.

Principal residence indebtedness acquired due to a refinance of the mortgage that was used to pay off credit card debt may not be qualified, depending upon whether or not the loan was recourse.

Planning Tip for Principal Residence Debt Forgiveness & Insolvency – *it may be that an insolvent taxpayer is better off relying on the exclusion for insolvent taxpayers rather than electing to use the mortgage forgiveness exclusion. Advice from a professional is recommended.*

OPTIONS FOR PAYING TAXES

With the current economic situation, many people may not readily have the money to meet their tax obligations. Naturally, paying taxes as you go is the best choice, but that's not always possible. So, if you or someone you know is struggling to make ends meet and simply can't come up with the cash for taxes that are due, here are some alternatives.

I. Extensions of Time to Pay

It is a carefully guarded secret that a taxpayer may request a short-term extension of time to pay a tax debt, and the request will generally be granted by the IRS! The extension is generally 60 days in length, and during that time, the IRS is not to:

- A. Issue a notice of intent to levy
- B. Issue a notice of hearing
- C. Issue a levy
- D. Request any financial disclosure
- E. Require any payment

But don't burn those bridges. If making such a request does not result in a payment being made at the end of the extension, it's likely that future contact from the IRS will be much more aggressive.

II. Installment Agreements

The IRS is authorized to enter into installment agreements with the taxpayer. This is usually done when the revenue officer is convinced that the taxpayer does not have any or enough assets to pay the tax. At that point, the officer analyzes the taxpayer's income and expenses to determine what amount he/she can afford to apply towards the tax liability.

There are four basic types of installment agreements that require different levels of analysis by the IRS:

Type of Installment Agreement	Amount Due	Description
Statutory	Taxpayer owes no more than \$10,000	Taxpayer must be allowed to make installment payments and no financial disclosure is required. Taxpayer has not failed to file a return, failed to pay tax or entered into an installment agreement in the past five years.

Type of Installment Agreement	Amount Due	Description
Streamlined	Owes between \$10,000 and \$25,000 (including interest & penalties)	Total balance due must be paid within five years; no financial disclosure is required.
Full Pay	Owes more than \$25,000	Taxpayer must pay all balances due within 10 years; this agreement <u>requires</u> a full financial disclosure
Partial Pay	Owes more than \$25,000	Taxpayer is subjected to a full financial disclosure and it is determined that a payment in the amount necessary under Full Pay would present a financial hardship to the taxpayer.

Planning Opportunity: If the taxpayer owes more than \$25,000, but can make a payment to bring the liability below \$25,000, he/she can enter into a streamlined installment agreement and can, therefore, avoid making any kind of full financial disclosure. The payment required will be based on the balance due, even if the taxpayer can afford more based on his/her finances.

III. Offer in Compromise (OIC)

The taxpayer must initiate a specific proposal for compromise. Full financial disclosure is required and the OIC is usually allowed only for people who have few or no assets and minimal cash flow. The process to apply for the OIC is quite complicated and great care should be taken in completing the forms required.