TOP FEDERAL TAX ISSUES FOR 2010

CPE COURSE

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CCH Editorial Staff Publication

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ISBN 978-0-8080-2162-9

4025 W. Peterson Ave.
Chicago, IL 60646-6085
1 800 248 3248
www.CCHGroup.com

Printed in the United States of America

Mixed Sources
Product group from well-managed forests, controlled sources and recycled wood or fiber
FSC
www.fsc.org Cert no. SCS-COC-00648
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Introduction

Each year, a handful of tax issues typically requires special attention by tax practitioners. The reasons vary, from a particularly complicated new provision in the Internal Revenue Code, to a planning technique opened up by a new regulation or ruling, or the availability of a significant tax benefit with a short window of opportunity. Sometimes a developing business need creates a new set of tax problems, or pressure exerted by Congress or the Administration puts more heat on some taxpayers while giving others more slack. All these share in creating a unique mix that in turn creates special opportunities and pitfalls in the coming year. The past year has seen more than its share of these developments.

CCH's *Top Federal Tax Issues for 2010 CPE Course* identifies the events of the past year that have developed into "hot" issues. These tax issues have been selected as particularly relevant to tax practice in 2010. They have been selected not only because of their impact on return preparation during the 2009 tax season but also because of the important role they play in developing effective tax strategies for 2010. Some issues are outgrowths of several years of developments; others have burst onto the tax scene unexpectedly. Among the latter are issues directly related to the recent economic downturn. Some have been emphasized in IRS publications and notices; others are too new or too controversial to be noted by the IRS either in depth or at all.

This course is designed to help reassure the tax practitioner that he or she is not missing out on advising clients about a hot, new tax opportunity or is not susceptible to being blindsided by a brewing controversy. In short, it is designed to give the tax practitioner a closer look into the opportunities and pitfalls presented by the changes. Among the topics examined in the *Top Federal Tax Issues for 2010 CPE Course* are:

- Tax Relief and Incentives for Individuals
- Tax Relief and Incentives for Businesses
- Preparer Restrictions and Other New Taxpayer Privacy Issues
- Working with Tax Losses
- Cancellation of Indebtedness Income: Rules and Exclusions
- Innocent Spouse Tax Issues
- Same-Sex Marriage/Domestic Partner Tax Issues
- Rebuilding Retirement Savings: Tax Strategies

Throughout the course you will find Study Questions to help you test your knowledge, and comments that are vital to understanding a particular strategy or idea. Answers to the Study Questions with feedback on both correct and incorrect responses are provided in a special section beginning on page 9.1.

To assist you in your later reference and research, a detailed topical index has been included for this course beginning on page 10.1.

This course is divided into three Modules. Take your time and review all course Modules. When you feel confident that you thoroughly understand the material, turn to the CPE Quizzer. Complete one, or all, Module Quizzers for continuing professional education credit. Further information is provided in the CPE Quizzer instructions on page 11.1.

October 2009

COURSE OBJECTIVES

This course was prepared to provide the participant with an overview of specific tax issues that impact 2009 tax return preparation and tax planning in 2010. These are the issues that "everyone is talking about;" each impacts a significant number of taxpayers in significant ways.

Upon course completion, you will be able to:

- Determine who gets the Making Work Pay Credit and how it is paid out through employer withholding;
- List the requirements for expanded net operating loss (NOL) carrybacks;
- Prepare a written and electronic use or disclosure consent that satisfies the requirements of the tax code and Treasury regulations;
- Explain when and how a deduction may be claimed from passive activities;
- Apply the deferral of income to the reacquisition of business debt;
- List the kinds of innocent spouse relief and their specific requirements;
- Identify ways that transfers of property between same-sex married people or domestic partners may create additional tax liability or tax savings; and
- Compare and contrast different retirement planning vehicles and their tax advantages.

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TOP FEDERAL TAX ISSUES FOR 2010 CPE COURSE

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MODULE 2: DEALING WITH ECONOMIC DOWNTURN

MODULE 1: NEW LAWS/RULES — CHAPTER 1

Tax Relief and Incentives for Individuals

This chapter explores the many individual tax incentives in the *American Recovery and Reinvestment Act of 2009* (2009 Recovery Act). Congress passed, and President Obama signed, the massive 2009 Recovery Act in February 2009 to help jump start the U.S. economy out of recession. The 2009 Recovery Act provides tax breaks to working individuals, homeowners, new car and truck buyers, unemployed individuals, and other Americans.

LEARNING OBJECTIVES

Upon completion of this course, you will be able to:

- Identify recent tax acts passed by Congress;
- Describe the making work pay credit;
- Compare the 2008 and 2009 first-time homebuyer credits;
- Compute the temporary motor vehicle sales tax deduction;
- List the requirements of COBRA premium assistance;
- Describe enhancements to the health coverage tax credit;
- Identify energy tax incentives targeted to individuals;
- Explain the temporary suspension of required minimum distributions from retirement accounts; and
- Describe the CARS Act rules for trade-in autos and trucks and which types of vehicles qualify for new-vehicle vouchers.

INTRODUCTION

As the U.S. economy fell deeper into recession in early 2009, the new Obama Administration and Congress looked to the tax code to stimulate economic growth. The 2009 Recovery Act includes significant tax incentives to encourage consumer spending, especially in the areas of housing and transportation. Additionally, many wage earners have seen an increase in their take-home pay because of the making work pay credit (MWPC), one of the incentives in the 2009 Recovery Act. Like many recent tax laws, the incentives in the 2009 Recovery Act are temporary. Some, such as the MWPC, are new; others are extensions of previous tax breaks. Congress also imposed important income limitations on many of the incentives.

Three other recent acts offer relief to individuals. The *Worker, Retiree, and Employer Recovery Act of 2009* (WRERA) suspended required minimum distributions. Also, under "Michelle's Law," covered dependents who are full-time students and are at least 18 years old may maintain their parent's health insurance while the students take a medically necessary leave of absence from school. Finally, Congress also enacted a "cash-for-clunkers" law to encourage consumers to purchase new and more environmentally-friendly vehicles. As the economy starts to rebound, lawmakers must decide whether to extend these and other incentives.

AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009

Making Work Pay Credit

The MWPC is the centerpiece of the tax title in the 2009 Recovery Act. The credit, which is targeted to lower- and middle-income taxpayers, is technically claimed by taxpayers when they file their 2009 (and 2010) returns. However, Congress wanted to accelerate the credit, so it is being delivered in small increments through reduced payroll withholding in 2009 and 2010. Like many other tax breaks, the MWPC is temporary and will expire after 2010 unless Congress extends it.

The MWPC is equal to the lesser of:

- 6.2 percent of the taxpayer's earned income; or
- $400 ($800 for married couples filing joint returns).

EXAMPLE

Nicole earns $56,000 a year at her job. She claims one withholding allowance and is paid weekly. The making work pay credit will generate approximately $10 more in Nicole's paycheck (or $400 based on a 40-week payout in 2009).

PLANNING POINTER

The MWPC is reduced by the amount of any economic recovery payment or government retiree credit (discussed later).

COMMENT

The $800 cap for married couples filing jointly applies whether or not both spouses have earned income for the year.

Income limitations. Higher-income individuals are generally ineligible for the credit. The MWPC is reduced (but not below zero) by 2 percent of a single individual's modified adjusted gross income (AGI) that exceeds $75,000. For married couples filing jointly, the threshold amount is $150,000. The MWPC phases out completely at modified AGI of

$95,000 for single individuals and at modified AGI of $190,000 for married couples filing jointly.

Earned Income. The MWPC is limited to taxpayers who have earned income. Generally this means taxable compensation from employment, such as wages, salaries, and tips. Earned income does *not* include:

- Most nontaxable compensation;
- Amounts received as pension or annuity payments;
- Nonresident aliens' income that is not connected with U.S. businesses;
- Amounts earned for services provided by inmates at penal institutions; and
- Workfare payments that are subsidized under a state workfare program (such as Temporary Assistance for Needy Families (TANF)).

Net earnings from self-employment are considered earned income. However, earned income does not include net earnings from self-employment that are not taken into account in computing taxable income, such as an excludable parsonage allowance. Combat zone compensation, however, is counted.

The IRS issued revised withholding tables to reflect the MWPC in early 2009. The IRS instructed employers to start using the revised withholding tables no later than April 1, 2009.

COMMENT

The MWPC effectively eliminates the 6.2-percent employee share of Social Security tax on about the first $6,450 of a single worker's wages.

Eligible Individuals. All individuals with earned income are eligible for the credit, except:

- Nonresident aliens;
- Individuals who can be claimed as another taxpayer's dependent for a tax year beginning in the calendar year in which the individual's tax year begins;
- Estates and trusts; or
- Taxpayers without valid Social Security numbers (SSNs) (or, on a joint return, an SSN for at least one of the spouses).

CAUTION

An individual cannot substitute an IRS-issued taxpayer identification number (TIN) for a valid SSN.

Special concerns. The MWPC may be problematic for individuals who have more than one job, because both employers will reduce withholding. Married taxpayers whose combined income places them in a higher tax bracket may also be negatively affected. Taxpayers in these situations may want to file a new Form W-4, *Employee's Withholding Allowance Certificate,* to adjust their withholding. Failure to adjust withholding could result in smaller refunds or may cause taxpayers to owe tax when they file their 2009 returns in 2010.

PLANNING POINTER

Employers are not required to determine an employee's eligibility for the MWPC.

EXAMPLE

Joshua earns $51,000 a year at his first job, claims one withholding allowance, and is paid weekly. The MWPC will generate approximately $10 more per paycheck (or $400 based on a 40-week payout in 2009) for his first job. Joshua earns $20,000 a year at his second job, claims one withholding allowance, and is paid weekly. The MWPC as reflected in the revised wage withholding tables will generate approximately $9 more per week in take-home pay for his second job (or $360 based on a 40-week payout in 2009). His total withholding of $760 will exceed the $400 maximum credit. James may want to adjust withholding at one employer.

EXAMPLE

Adam and Anne are married. Adam earns $44,000 a year, claims four withholding allowances, and is paid weekly. The MWPC will generate approximately $15 more per pay period for Adam. Anne earns $48,000 a year, claims four withholding allowances and is paid weekly. The MWPC credit will generate approximately $16 more per pay period for Anne. If Adam and Anne's modified AGI allows them to be eligible for the credit when they file their 2009 return, their credit would exceed the $800 maximum for married couples filing jointly based on a 40-week payout in 2009. Adam and Anne may want to adjust their withholding through their respective employers.

Pensioners. Pension payments are not considered earned income for purposes of the MWPC. Consequently, a pensioner having no earned income is ineligible for the credit and may not have enough tax withheld from his or her pension payment under the revised 2009 withholding tables. In response, the IRS will allow plans to calculate optional additional withholding amounts for pension payments.

COMMENT

The income tax withholding method is optional. Pension plans do not have to use it; they may continue to use the revised withholding table.

Schedule M. The IRS has designed new Schedule M (Form 1040A or 1040), *Making Work Pay and Government Retiree Credits,* on its website. Schedule M will be filed with taxpayers' 2009 Form 1040A or 1040.

Schedule M asks taxpayers to identify whether they have 2009 wages of more than $6,451 ($12,903 if the taxpayer is married and filing a joint return). If the individual/married couple meets these thresholds, the taxpayer is directed to enter $400 ($800 if married filing jointly) on Schedule M. If not, the taxpayer should enter his or her earned income in accordance with the instructions. Draft Schedule M also applies the income phaseouts for the MWPC.

Economic recovery payments. In 2009, Social Security Administration, Department of Veterans Affairs, and Railroad Retirement Board distributed one-time economic recovery payments of $250 to qualified individuals. Although the payments are not considered taxable income, the MWPC must be reduced by the amount of any economic recovery payment individuals received.

Government retiree credit. Certain government retirees can claim a refundable $250 tax credit. The credit increases to $500 on a joint return if both spouses are eligible. The government retiree must receive some pension or annuity for service performed in the employ of the United States or any state, or any instrumentality thereof, that is not considered employment for purposes of the *Federal Insurance Contributions Act* (FICA) tax. Government retirees will claim the credit when they file their 2009 (and 2010) returns.

The government retiree credit is coordinated with the MWPC. Taxpayers who qualify for both must reduce the amount of their MWPC by the amount of their government retiree credit.

First-Time Homebuyer Credit

The first-time homebuyer credit was originally enacted in 2008. Congress extended and enhanced the credit in the 2009 Recovery Act. The enhanced credit reaches 10 percent of the purchase price, with a cap of $8,000 ($4,000 for married couples filing separate returns). The $8,000 credit is available for qualified home purchased after February 16, 2009, and before December

1, 2009. Eligibility for the first-time homebuyer credit is determined on the date of purchase.

CAUTION

The enhancements in the 2009 Recovery Act do not affect first-time homebuyers who purchased homes after April 8, 2008, and on or before December 31, 2008. For these taxpayers, the maximum credit remains $7,500 ($3,750 for married couples filing separately). Additionally, the credit for 2008 purchases generally must be repaid in equal installments over 15 years. For purchases in 2009 that take place before February 17, 2009, the credit is limited to $7,500 but the repayment rule does not apply.

Income limitations. Eligibility for the first-time homebuyer credit is restricted by income. The credit is subject to modified AGI phaseout ranging from $75,000 to $95,000 ($150,000 to $170,000 for joint filers) based on the tax-year return on which the credit is being claimed.

Claiming the credit. Shortly after Congress enhanced the credit, the IRS announced that individuals who qualify for the first-time homebuyer credit and purchase a home after December 31, 2008, and before December 1, 2009, may claim the credit on their 2008 or 2009 tax returns (IR-2009-14). The first-time homebuyer credit is claimed on Form 5405, *First-Time Homebuyer Credit.* Form 5405 is available on the IRS's website, **www.irs.gov.**

PLANNING POINTER

Taxpayers who filed a 2008 return and did not claim the credit for a 2009 purchase on the 2008 return should file Form 1040X with a completed and revised Form 5405. For taxpayers who have already filed Form 5405 for a 2009 purchase that claimed a $7,500 amount (either because the return was filed before the 2009 Recovery Act was enacted or because the taxpayer assumed that only a $7,500 credit could be claimed), an amended return Form 1040X for 2008 should be filed, along with another Form 5405, on which the taxpayer checks the box on Part I, line C to claim the additional $500 credit for homes purchased in 2009.

Qualified purchasers. A *first-time homebuyer* is any individual who has not held an ownership interest in any principal residence during the three-year period ending on the date of the purchase of the principal residence. Taxpayers who purchase a home from a close relative (spouse, parent, grandparent, child, or grandchild) cannot claim the credit. Nonresident aliens are also ineligible for the credit.

Qualified homes. To qualify for the first-time homebuyer credit, the home must be purchased and used as the taxpayer's primary residence. Vacation homes and rental property do not qualify for this credit.

New homes. The IRS has explained on its website that a new home constructed by the taxpayer is treated as purchased on the date the taxpayer first occupies the residence.

CAUTION

The first-time homebuyer credit is subject to the same offsets for debt (tax or other qualified debt) as any other refund.

Advance credit/monetization. The first-time homebuyer tax credit cannot be claimed in anticipation of a future purchase. The IRS has stated that taxpayers qualify for the credit when they finalize the purchase of their home, which for most purchasers occurs at the time of the closing. However, the U.S. Department of Housing and Urban Development (HUD) announced that it will allow taxpayers to monetize the first-time homebuyer credit. Under HUD's rules, taxpayers using FHA-approved lenders can apply the credit to their down payment in excess of the 3.5 percent of appraised value or their closing costs. FHA-lenders cannot monetize the credit to meet the required 3.5-percent minimum down payment. State housing agencies, on the other hand, can use the credit to advance 100 percent of the down payment.

COMMENT

The IRS has not commented on HUD's action other than to reiterate that the first-time homebuyer credit may not be claimed in advance. Taxpayers qualify for the credit when they finalize the purchase of their home. For a newly constructed home, the purchase date is the date the taxpayer first occupies the home. The credit does not preclude taxpayers from securing down payment assistance through legally available means, the IRS explained.

Allocation of the credit. Notice 2009-12 explained how to allocate the first-time homebuyer tax credit between two or more owners who are unmarried. Generally, the credit may be allocated according to the taxpayers' contributions to the purchase price, ownership interests in the residence, or "any other reasonable method."

STUDY QUESTIONS

1. Which of the following is considered earned income for purposes of qualifying to receive the MWPC?
   a. Income of nonresident aliens not arising from a connection with a U.S. business
   b. Net earnings from self-employment if they are taken into account in computing the individual's taxable income
   c. Annuity payments

2. Which of the following is a qualified purchaser eligible for the first-time homebuyer credit?
   a. A young adult who purchases her home from her grandparents
   b. An individual who has rented her only home since 2002
   c. A nonresident alien

New Vehicle Deduction

The 2009 Recovery Act created a temporary deduction to encourage taxpayers to purchase new cars, trucks, and motorcycles. State and local sales taxes on the purchase of a new motor vehicle may be deducted. The deduction is limited to the tax on up to $49,500 of the purchase price of an eligible motor vehicle. The new vehicle must be purchased after February 16, 2009, and before January 1, 2010, to qualify for the deduction. Both domestic and foreign-made vehicles qualify for the deduction.

PLANNING POINTER

The motor vehicle sales tax deduction's $49,500 purchase price limitation is imposed on a per vehicle basis. There is no limitation on the number of vehicles a taxpayer can purchase.

Qualified vehicles. The vehicle must be a passenger vehicle, light truck, or motorcycle. Motor homes also qualify for the deduction. Only new vehicles are eligible for the deduction.

Income phaseout. The deduction begins to phase out when an individual's modified AGI exceeds $125,000 ($250,000 for married couples filing joint returns). The deduction is reduced to zero when an individual's modified AGI reaches $135,000 ($260,000 for married couples filing joint returns).