2008
Federal
Update

This update is provided as a courtesy to our ClientWhys CPE students and includes recent tax law changes that effect 2008 tax preparation and 2009 and beyond tax planning. The current economic climate has prompted Congress to extend and enact many new tax laws for 2008 and future years. More changes are expected from the new Congress and the new Administration.

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TABLE OF CONTENTS

Personal Exemptions	3
Standard Deduction	3
Itemized Deductions	3
Marriage Penalty Relief Penalty – Basic Standard Deduction	3
Social Security Inflation Adjustments	4
Updated California SDI Rates	4
Section 179 Expensing	4
Domestic Production Deduction	4
Extra IRA Contributions – Victimized Employees	5
Musicians Tax Break	7
Amortization of Expenses for Creating or Acquiring Music	7
Foreign-Earned Income Exclusion	7
Unreasonable Position	8
Willful or Reckless Conduct	8
Definition of a Tax Preparer	9
Transitional Relief – Preparer Penalties	9
Home Mortgage Debt Forgiveness Relief	10
Home Sale Exclusion Liberalized for Surviving Spouse	10
First Time Home Buyer Credit	10
Public Safety Officers Exclusion for Health & Long Term Care Insurance	12
Mortgage Insurance Premium Deduction Extended	13
Exclusion for Members of Qual. Volunteer Emer. Response Organizations	14
Teacher's Classroom Expenses	14
Deduction for Higher Education Expenses	15
401(k) Contribution Limits	15
IRA Contribution Limits	15
Traditional IRA Phase Out for Active Participants	15
Low-Income Saver's Credit	15
Plan Now for 2010 Roth Conversions	16
Contributions – Recordkeeping Requirements	17
Tax-Free Direct IRA Distributions for Charity	18
Standard Deduction for Property Taxes	19
Sales Tax Deduction	19
AMT Patch Applied for Another Year	19
Kiddie Tax	20
EIC and Combat Pay	21
Vehicle Mileage Rates	21
Advanced Lean Burn Technology Credit	21
Hybrid Vehicle Tax Incentives	21
Home Energy Credits	23
Residential Energy-Efficient Property (REEP) Credit	24
Refundable AMT Tax Credit Provisions	24
Research and Development (R&D) Credit	27
Environmental Remediation Costs	27
Leasehold Improvements and Restaurant Property	28
Farm Machinery & Equipment	28
Race Horses	28
Required Minimum Distributions (RMD) for 2009	28
Casualty Floor Increased to $500 for 2009	28
10%-Of-AGI Limitation in Disaster Areas	28
NOL Carryback in Disaster Areas	29
Expensing Debris Removal & Demolition Expenses in Disaster Areas	29
Disaster Loss Standard Deduction	30
Hurricane-Related Insurance Reimbursement	30
Differential Wage Credit	30
Tax Treatment of Differential Pay	31
Home Gain Exclusion & Nonqualified Home Use	32
SE Optional Methods – Increased Thresholds	33

PERSONAL EXEMPTIONS

Inflation Adjustments for personal exemptions and phase-out thresholds

	2008	2009
Exemption	3,500	3,650
Phase-Out AGI		
Single	159,950	166,800
Head of Household	199,950	208,500
Joint	239,950	250,200
Married Separate	119,975	125,100

STANDARD DEDUCTION

The basic standard deduction for married persons filing jointly remains at double the amount for singles through 2008; it was scheduled to decline to merely a percentage of the standard deduction for singles in 2005. The basic standard deduction for joint returns will be twice the standard deduction for single returns for taxable years 2005 through 2010. Absent any further law change, it will revert to 167% in 2011. The standard deductions for 2008 and 2009 are:

	2008	2009
Single	5,450	5,700
Joint	10,900	11,400
Married Separate	5,450	5,700
Head of Household	8,000	8,350
Blind & 65+ Jt	1,050	1,100
Blind & 65+ Others	1,350	1,400

ITEMIZED DEDUCTIONS

Phase-Out Thresholds

	2008	2009
Married Separate	79,975	83,400
Others	159,950	166,800

MARRIAGE PENALTY RELIEF PENALTY - BASIC STANDARD DEDUCTION

Instead of being twice the amount of the single rate, the standard deduction for joint filers has historically been 167% of the single amount and was part of the so-called marriage penalty. Congress, in the 2001 Act, scheduled an increase in the standard deduction for joint filers to begin in 2005 and reaching twice the amount of the single deduction in 2009. Then, as part of Bush's tax reduction, the 2003 Act accelerated the implementation of the 200% factor – if only temporarily, for tax years 2003 and 2004, which was scheduled to revert to 174% in 2005.

This Tax Act sets the percentage to 200% for years 2005 through 2008, which means that combined with prior law that percentage remains at 200% through 2010. Absent of any further law change, it will revert to 167% in 2011.

SOCIAL SECURITY

Year	2008	2009
Taxable Earnings	102,000	106,800
Max FICA	6,324.00	6,621.60
Max SE	12,648.00	13,243.20
Earnings Limits	13,560	14,160
Minimum Earnings	1,050	1,090
Nanny Tax Threshold	1,600	1,700

UPDATED CALIFORNIA SDI RATES

Year	2007	2008	2009
Tax %	0.6	0.8	1.1
Max Wages	83,389	86,698	90,669
Max Tax	500.33	693.58	997.36

SECTION 179 EXPENSING

As a stimulant for business growth, Congress has temporarily increased the Sec. 179 expense deduction amount limit from what would have normally been $25,000. The higher, inflation-adjusted amount was extended through 2010 by the Small Business and Work Opportunity Act of 2007.

For 2009, the inflation-adjusted deduction is $133,000 and provides small businesses the ability to take a big deduction for all or part of their office equipment, furniture, computers, machinery, and other "personal property" items purchased during the tax year. This is in lieu of depreciating (spreading the cost) of the property over several years.

This deduction does not apply to land or buildings or for improvements to buildings. In addition, the deduction amount is reduced if more than $510,000 in equipment is purchased in 2008. Keep in mind that this tax break cannot be used to generate a loss on an individual return.

Year	2006	2007	2008*	2009	2010
Jt, HH, S	108,000	125,000	250,000	133,000	25,000
MS	54,000	62,500	125,000	66,500	12,500
E-Zone	145,000	160,000	285,000	168,000	60,000

**Rates were increased for 2008 as an economic stimulus.*

DOMESTIC PRODUCTION DEDUCTION

The purpose of the domestic production deduction is to encourage domestic (i.e., within the U.S.) manufacturing and other production activities. The tax incentive is in the form of a tax deduction equal to 3% of the net income from eligible activities. The deduction percentage increases to 6% for 2007 through 2009 and then jumps to 9% after 2009. As with all tax incentives, it comes with a number of complicated limitations and qualifications. In an effort to simplify this deduction, the IRS issued final regulations and procedures for the deduction.

What is a qualified production activity? The following are some common eligible activities: (1) the sale or rental of tangible personal property, including computer software, manufactured, produced or grown in the U.S., (2) the construction of real property in the U.S., and (3) the performance of engineering or architectural services in the U.S. in connection with real property construction projects in the U.S. Qualified production activities do not include purely sales activities or purely service activities except for construction, engineering and architectural services.

Deduction limitations – The deduction cannot exceed 50% of the "W-2" wages paid to employees during the year, and it cannot exceed the taxpayer's taxable income for the year. An individual's deduction is limited to modified adjusted gross income rather than taxable income. In a recently-passed tax law change, the "W-2" wages for purposes of this limitation are limited to wages properly allocated to the qualified production activity.

Who receives this deduction? Generally, the deduction is allowed to all taxpayers including individuals, corporations, farm cooperatives, estates and trusts. The deduction is passed through to owners of partnerships, S-corporations and cooperatives, allowing them to deduct it on their own returns. Prior law included a special limitation for a partnership or S-corporation owner that was removed by a recent new tax law.

Example of how the deduction is determined – ABC, Inc. produces widgets in the U.S. that it wholesales to other retailers. The company's revenue from the sale of the widgets is $2 million with a manufacturing cost of $750,000. ABC, Inc. also has $1 million of income from widget repair services. The total "W-2" wages for the year were $400,000 of which $150,000 is properly allocated to the widget manufacturing costs and the balance used to provide the repair services. The deduction would be determined as follows:

Qualified Production Activity Income (widget sales)	$2,000,000		
Cost of Manufacturing the Widgets Sold	<$ 750,000>		
Net Income	$1,250,000		
3% of the Net Income		$ 37,500	
Wages attributable to the Widget Production	$ 150,000		
50% of Wage Limitation		$ 75,000	
Domestic Production Deduction (lesser of the two)			$ 37,500

Of course, the deduction on ABC Inc.'s tax return will be limited to the company's taxable income. This example is rather a simplistic illustration of how the deduction is determined. In actual practice, inventory, cost of goods, determination of qualified production wages, etc., all have rules, procedures and complications of their own. However, the deduction can be very beneficial and well worth the added accounting. In fact, most taxpayers who qualify for the deduction are required to claim it, even if the administrative costs of applying the law and regulations outweigh the benefit of claiming the deduction.

EXTRA IRA CONTRIBUTIONS – VICTIMIZED EMPLOYEES

For the 2007, 2008 and 2009 tax years, a class of taxpayers termed "applicable individuals" can elect to make **additional** IRA contributions of up to **$3,000 per year**. A taxpayer is in the applicable individual class if:

- The individual was a **participant in a Code Sec. 401(k)** plan under which the **employer matched at least 50%** of employee contributions to the plan with employer stock.

- In a tax year **preceding the tax year of an additional contribution,** the individual's employer:

  (1) (or any controlling corporation of the employer) **was a debtor in a bankruptcy case;** and

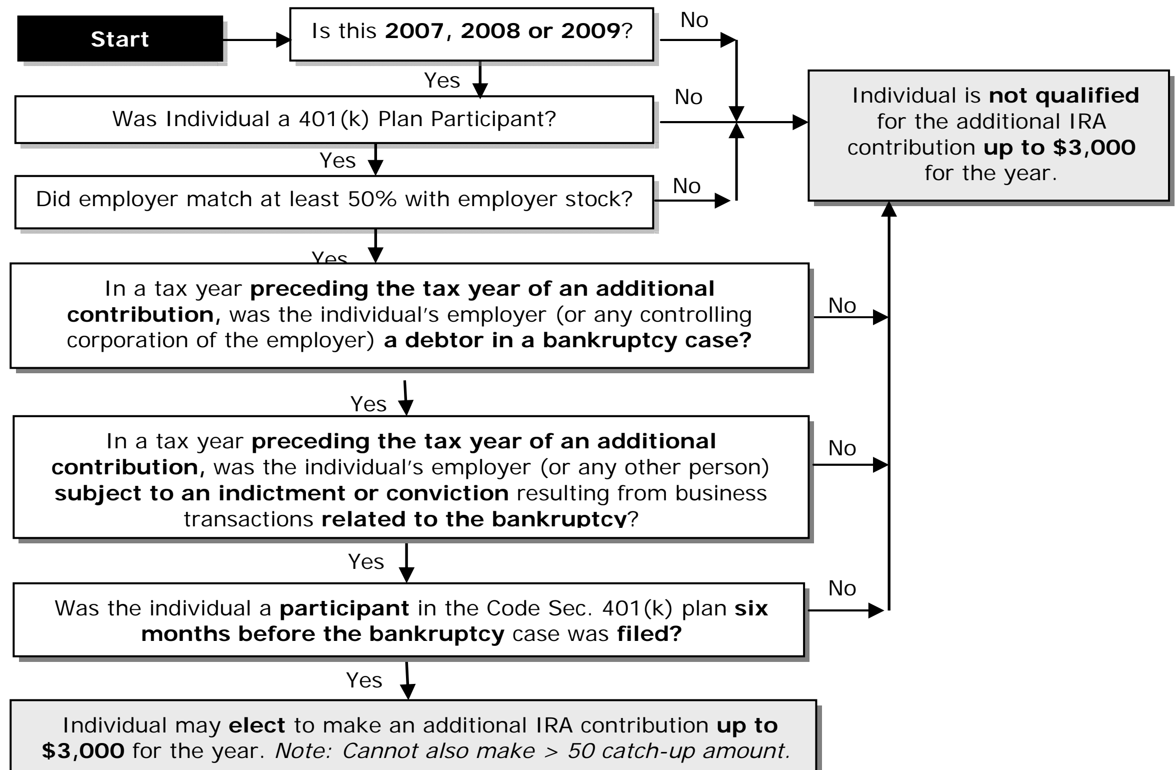
  (2) (or any other person) was **subject to an indictment or conviction** resulting from business transactions related to the bankruptcy.

- The individual was a **participant** in the Code Sec. 401(k) plan on the date that is **six months before the bankruptcy** case was **filed.**

An applicable individual who elects to make additional IRA contributions of up to $3,000 a year **can't make IRA catch-up contributions** that apply to individuals **age 50 and older**.

AGI Phase-Out – Although the new law is silent on the deductibility AGI phase-out, based on its placement into Sec. 219, it is likely that this extra contribution would receive the same treatment as the catch-up allowance for individuals age 50+ (i.e., the phase-out for deductibility would apply and contributions could be designated as nondeductible.)

This provision is designed to help taxpayers whose employers were involved in Enron-type scandals.



MUSICIANS TAX BREAK

Prior to the 2006 Tax Act, copyrights, literary, musical, or artistic compositions, letters or memoranda, or similar property held by a taxpayer whose personal efforts created the property received no special tax treatment.

Under this new legislation, and at the election of the taxpayer, the sale or exchange of musical compositions or copyrights of musical works created through the taxpayer's personal efforts is treated as the sale of a capital asset. Thus, if otherwise qualifying, the sale would be taxed at the more favorable capital gains tax rates. For calendar-year taxpayers, this provision applies for sales or exchanges in tax years 2007 through 2010.

AMORTIZATION OF EXPENSES FOR CREATING OR ACQUIRING MUSIC

The Act provides that for any tax year beginning after Dec. 31, 2005 and before Jan. 1, 2011, a taxpayer may elect to amortize (deduct) over a five-year period trade or business expenses: (a) paid or incurred to create or acquire a musical composition (including words), or a copyright to such property; and (b) that are otherwise properly capitalized. The five-year period begins with the month in which the composition or copyright is placed in service.

The five-year amortization election doesn't apply to expenses:

- That are qualified creative expenses which aren't required to be capitalized under the uniform capitalization rules;
- To which a simplified procedure applies;
- That are amortizable Section 197 intangibles; or
- That, without regard to this provision, would not be allowable as a deduction.

The election is to be made in a time and manner specified by the IRS, and it applies to all musical property placed in service for the tax year.

FOREIGN-EARNED INCOME EXCLUSION

The Tax Increase Prevention and Reconciliation Act of 2005 include four significant changes to the Sec. 911 foreign-earned income and housing exclusions:

- **Exclusion is now Inflation-Adjusted** – The exclusion of $80,000[1] is inflation-adjusted beginning in 2006.
- **Housing Allowance Base Amount** – Taxpayers are allowed to deduct as a housing allowance the excess of their actual housing costs over a base amount. The base amount is 16% of the annual exclusion limitation amount.
- **Housing Exclusion Limit** – The housing exclusion is limited to 30% of the taxpayer's earned income exclusion for the year less the base amount.
- **Marginal Tax Rates** – Prior to 2006, an individual's tax rates on other income was based on his or her taxable income after the allowable exclusions. However, beginning in 2006, the excluded income will be included for purposes of determining the marginal tax rates applicable to the other income.

Tax Year	2006	2007	2008	2009
Max Exclusion	82,400	85,700	87,600	91,400
Housing Daily Base Amt	36.12	37.57	38.30[1]	40.07
Housing Annual Base	13,184	13,712	14,016	14,624
Housing 30% Cap	24,720	25,710	26,280	27,420
Max Housing Exclusion	11,536	11,998	12,264	12,796

* Inflation adjusted beginning in 2006
** The housing exclusion is now capped at 30% of the earned income exclusion, except in what is deemed to be high-cost areas (see IRS tables), in which case the Cap is increased for the specific area..
[1] Leap Year (366 days)

UNREASONABLE POSITION

A tax return preparer who prepares a return or refund claim for which any part of a tax liability understatement is due to an "unreasonable position" (defined below) must pay a penalty for each return or claim equal to the **greater** of:

- **$1,000** or
- **50% of the income derived** (or to be derived) by the tax return preparer for preparing the return or claim (Code Sec. 6694(a)(1), as amended by Act § 8246(b)).

A position is "unreasonable" if:

- The tax return preparer knew (or reasonably should have known) of the position,
- There was not a reasonable belief that the position would more likely than not be sustained on its merits, and
- The position was not disclosed as provided in Code Sec. 6662(d)(2)(B)(ii), or if the position was disclosed, there was no reasonable basis for the position. (Code Sec. 6694(a)(2), as amended by the 2007 Small Business and Work Opportunity Act § 8246(b))

This change is effective for returns prepared after May 25, 2007 with some transitional relief for returns, amendments and refund claims due on or before 12/31/07; to 2007 estimated tax due on or before 1/15/08 and to 2007 employment and excise tax returns due on or before 1/31/08. *(IRS Notice 2007-54)*

WILLFUL OR RECKLESS CONDUCT

A tax return preparer who prepares a return or refund claim for which any part of a tax liability understatement is due to an "unreasonable position" (defined below) must pay a penalty for each return or claim equal to the **greater** of:

- **$5,000** or
- **50% of the income derived** (or to be derived) by the tax return preparer for preparing the return or claim (Code Sec. 6694(a)(1), as amended by Act § 8246(b)).
- If the unreasonable position penalty was also imposed, the willful or reckless conduct penalty is reduced by the unreasonable position penalty.

"Willful or reckless conduct" is conduct by the tax return preparer which is a:

- Willful attempt to understate the tax liability on the return or claim, or
- Reckless or intentional disregard of rules or regulations. (Code Sec. 6694(b)(2), as amended by Act § 8246(b))

Effective for returns prepared after May 25, 2007; no transitional relief is available for the willful/reckless conduct penalty.

DEFINITION OF A TAX RETURN PREPARER

The definition of a tax preparer has been broadened to include preparers of income, estate, gift, employment, excise tax and exempt organization returns. (Code Sec. 7701(a)(36), as amended by Act § 8246(a)(1)). The term "income tax return preparer" has been replaced with "tax return preparer."

HOME MORTGAGE DEBT FORGIVENESS RELIEF

Under the prior law, **which can still apply**, the discharge of indebtedness was included in a taxpayer's income in the year the debt was discharged. There also are certain exceptions to this rule. Two exceptions which apply to a taxpayer's home are:

- Title 11 bankruptcy cases (Code Sec. 108(h)(3)) and
- Insolvent debtors (Code Sec. 108(a)(1)(B)).

In both exceptions, the taxpayer must reduce their tax attributes, including basis in property, by the amount of excluded discharged debt. Tax attributes generally include loss carryovers.

New Law – Under a retroactive provision of the Mortgage Relief Act of 2007 and subsequently extended, taxpayers are generally allowed to exclude up to $2 million ($1 million for MS) of qualified principal residence acquisition debt on the taxpayer's qualified principal residence discharged on or after January 1, 2007 and before January 1, 2013. The basis of the taxpayer's home is reduced by the excluded amount, but not below zero. In some circumstances, this could result in a higher gain on the home sale, which may or may not be fully excludable under the home sale exclusion rules.

Caution – The exclusion does not apply to a taxpayer's designated 2nd (vacation) residence. Use the same rules that apply to home sale rules to determine if the home is the taxpayer's principal residence or a second home.

Caution – The exclusion only applies to the discharge of qualified principal residence acquisition debt. Thus, equity debt is not included as part of the exclusion. Acquisition indebtedness of a principal residence is indebtedness incurred in the acquisition, construction, or substantial improvement of an individual's principal residence that is secured by the residence. It includes the refinancing of debt to the extent the amount of the refinancing doesn't exceed the amount of the refinanced indebtedness. (Joint Committee on Taxation, JCX-86-07)

Ordering rule - The principal residence exclusion takes precedence over insolvency exclusion **unless elected otherwise** (Code Sec 108(a)(2)(C)). If only a part of a loan is qualified principal residence indebtedness, the exclusion from income for canceled qualified principal residence indebtedness applies only to the extent the amount canceled exceeds the amount of

the loan (immediately before the cancellation) that is **not** qualified principal residence indebtedness. The remaining part of the loan may qualify for another Sec 108 exclusion.

Basis Adjustment - If the taxpayer excludes canceled qualified principal residence indebtedness from income **and continues to own the residence after the cancellation**, the taxpayer must reduce the basis of the residence (but not below zero) by the amount of the canceled qualified principal residence indebtedness excluded from income. Enter the amount of the basis reduction on line 10b of Form 982.

Electing Out of Mortgage Relief Exclusion – An insolvent taxpayer (other than one in a Title 11 bankruptcy) can elect to have the mortgage forgiveness exclusion not apply and can instead rely on the Code Sec. 108(a)(1)(B) exclusion for insolvent taxpayers. (Code Sec. 108(a)(2), as amended by Act § 2(c)) Thus, where a taxpayer has significantly tapped the equity in the home, and has a significant amount of debt discharge that does not qualify for the exclusion, it may be to their advantage to forgo the mortgage relief exclusion and instead use the insolvent taxpayer exclusion.

HOME SALE EXCLUSION LIBERALIZED FOR SURVIVING SPOUSE

Under the pre-Mortgage Relief Act law, the up-to-$500,000 exclusion is available only if a husband and wife file a joint return for the year of sale. Thus, if the home is sold in a year after the year of a spouse's death—when a joint return would no longer be allowed to be filed—the surviving spouse can only get a maximum home sale exclusion of $250,000.

New law - The Mortgage Relief Act, effective for sales and exchanges after Dec. 31, 2007, allows surviving single spouses to qualify for the up-to-$500,000 exclusion if the sale occurs no later than 2 years after their spouse's death, and the requirements for the $500,000 exclusion under Code Sec. 121(b)(2)(A) were met immediately before the spouse's death. (Code Sec. 121(b)(4), as amended by Act § 7(a)).

Note: Keep in mind that the surviving spouse, depending upon the state of residence and the manner in which title is held, will have a 50% or 100% step up (or step down) in basis of the home as a result of the spouse's death.

FIRST-TIME HOMEBUYER CREDIT

The Housing Act of 2008 gives eligible first-time homebuyers a refundable tax credit (Code Sec. 36, as added by Act § 3011) that must be paid back annually over a 15-year period. The credit is in effect a tax-free loan from the government.

Amount of the Credit: The credit is equal to the lesser of:

- 10% of the purchase price or
- $7,500 ($3,750 for married individuals filing separately. Caution: if either spouse fails the first-time homebuyer definition then neither gets the credit even if filing separately).

Effective: The new homebuyer credit applies for qualifying **home purchases after Apr. 8, 2008 and before July 1, 2009.** (The Committee Report says this applies whether or not there was a binding contract to purchase the home before Apr. 9, 2008.)

Phase-Out - Modified AGI (regular AGI adjusted for foreign exclusions of sections 911, 931, and 933)**:**

- Individual Taxpayers: Between $75,000 and $95,000
- Joint Filers: Between $150,000 and $170,000

Definition of a First-Time Homebuyer - A taxpayer is considered a first-time homebuyer if he (or spouse, if married) had no present ownership interest in a principal residence in the U.S. during the 3-year period before the purchase of the home to which the credit applies. If the individual is married, neither the individual nor his spouse may have had a present ownership interest in a principal residence during that three-year period, even if they file as MS. (Code Sec. 36(c)(1)) Ownership of a home outside the U.S. during the three-year period will not disqualify the taxpayer (Com Rept, ¶5026)

No credit is allowed if the:

- D.C. homebuyer credit is allowable for the tax year the residence is bought or a prior tax year;
- Taxpayer's financing is from the proceeds of tax-exempt mortgage revenue bonds;
- Taxpayer is a nonresident alien;
- Taxpayer disposes of the home (or it ceases to be a principal residence) before the close of a tax year for which a credit otherwise would be allowable.

Qualifying Home – For the purpose of this credit, "principal residence" has the same meaning as when used in Section 121 (home sale gain exclusion), so coops and condos would qualify. However, the home purchase qualifies only if:

(1) The property isn't acquired from a person related to the buyer (Note: for this purpose persons are related if their relationship would result in the disallowance of losses under Section 267. Thus, siblings would not be related for this purpose), and

(2) The basis of the property in the hands of the buyer is not determined by reference to the adjusted basis of the property in the hands of the person from whom it was acquired, or property acquired from a decedent. Thus, property acquired by gift or inheritance does not qualify for the credit.

Election to Accelerate Credit - Eligible first-time homebuyers who purchase a principal residence after Dec. 31, 2008, and before July 1, 2009, may elect to treat the purchase as made on Dec. 31, 2008 and thereby obtain the credit on their 2008 return rather than waiting until they file their 2009 return in 2010. (Code Sec. 36(g)) If a taxpayer has already filed their 2008 return, they can amend to claim the credit. Credit phase-out will be based upon 2008 modified AGI; therefore, care should be taken when considering this election.

CREDIT RECAPTURE & OTHER RULES

- **Regular recapture rule** – The credit for new homebuyers is recaptured ratably over fifteen years, with no interest charge, beginning with the second tax year after the tax year in which the home is purchased. For each tax year of the 15-year recapture period, the credit is recaptured as an additional income tax amount equal to 6-2/3% of the amount of the credit. (Code Sec. 36(f)(1) , Code Sec. 36(f)(7))

  Example: *Frank and Mary Smith, eligible taxpayers with modified AGI below the phase-out limits, buy a $200,000 principal residence in August of 2008. They may claim a first-time homebuyer credit of $7,500 on their 2008 income tax return (lesser of $20,000 (10% of the $200,000 cost of the home) or $7,500). On their income tax return for 2010, the Smiths will pay an additional income tax amount equal to $500 (6 2/3% of $7,500). They also will pay an additional income tax of $500 on their income tax returns for tax years 2011 through 2024 (assuming they own the home and use it as a principal residence for that period).*

  Recapture Periods:

  - Credit Claimed on **2008 return:** 6-2/3% per year **2010** through **2024**

- Credit Claimed on **2009 return:** 6-2/3% per year **2011** through **2025**

- **Accelerated recapture rule** – If a taxpayer who claims the credit for a new homebuyer sells the home (or the taxpayer or his spouse no longer use it as a principal residence) before the complete repayment of the credit, any remaining credit repayment amount is paid with the tax return for the year in which the home is sold (or ceases to be used as the principal residence). However, the credit repayment amount can't exceed the gain from the sale of the residence to an unrelated person. For this purpose, gain is determined by reducing the home's basis by the amount of the credit to the extent not previously recaptured. (Code Sec. 36(f)(2), Code Sec. 36(f)(3))
- **Taxpayer's Death** – Neither the regular nor the accelerated recapture rules apply to any tax year ending after the taxpayer's death.
- **Involuntary Conversion** – If the home is involuntarily converted (e.g., it is destroyed in a storm), and the taxpayer buys a new principal residence within a two-year period beginning on the date of the disposition or the date the home ceases to be the principal residence, (1) the accelerated recapture rule does not apply, but (2) the regular recapture rule applies to the replacement principal residence during the recapture period in the same way as if the replacement principal residence were the converted residence. (Code Sec. 36(f)(4))
- **Divorce** – In the case of a transfer of the residence to a spouse or to a former spouse incident to a divorce, the accelerated recapture rule won't apply to the transfer, but both the regular and accelerated recapture rules will apply to the transferee spouse (and not the transferor spouse) who will be responsible for any future recapture.
- **Vacation Home** – Because only prior ownership in a principal residence is considered, it is possible for a taxpayer who already owns a vacation home to claim the new credit, if he otherwise qualifies.
- **Home Under Construction** – A home constructed by a taxpayer is treated as purchased on the date the taxpayer first occupies it. One would assume occupancy prior to the issuance of a local authority "occupancy permit" would not count.
- **Purchase Price** – The term means the principal residence's basis on the date it is acquired. The basis includes legal fees, escrow and recording fees. Real estate taxes owed by the seller and paid by the buyer are also included as part of the purchase price. Caution: This does not include real estate taxes owed by the purchaser.
- **Unmarried Purchasers** - If two or more individuals who are not married purchase a principal residence, the total credit allowed to all of the individuals is limited to $7,500. That amount is allocated among the individuals in the manner prescribed by the IRS. (Code Sec. 36(b)(1)(C))
- **Joint Returns** – If the credit was allowed on a joint return, half of the credit is treated as having been allowed to each individual filing the return for recapture purposes. (Code Sec. 36(f)(5))

PUBLIC SAFETY OFFICERS EXCLUSION FOR HEALTH & LONG-TERM CARE INSURANCE

Eligible retired public safety officers (policemen, firefighters) may elect to exclude governmental retirement plan distributions made in tax years beginning after 2006 that don't exceed their health or long-term care premiums, if the distributions are paid directly to insurers. The exclusion is limited to $3,000 per year. Any amount excluded is not deductible

as a medical expense for itemized deductions and is not includible as health insurance for the self-employed health insurance deduction. (PPA § 845)

IRS Notice 2007-7 explains the new exclusion for qualifying payouts to public safety officers:

- A public safety officer is an individual serving a public agency in an official capacity, with or without compensation, as a law enforcement officer, a firefighter, a chaplain, or as a member of a rescue squad or ambulance crew.
- The exclusion is available only to public safety officers who separate from service:
    (1) After attaining normal retirement age or
    (2) Due to disability. It is not available to surviving spouses or dependents after the public safety officer dies.
- The exclusion applies only if an eligible retired public safety officer elects to have an amount subtracted from his distributions from an eligible government plan (one described in Code Sec. 414(d) that is either a Code Sec. 403(a) or Code Sec. 403(b) plan, or an eligible governmental plan under Code Sec. 457(b)) and uses that amount to pay qualified health insurance premiums. The employer sponsoring the eligible government plan is not required to offer such an election.
- The distribution must be paid directly to an accident or health insurance plan, one providing insurance issued by an insurance company regulated by a State (including a managed care organization that is treated as issuing insurance).
- Benefits attributable to service other than as a public safety officer are eligible for favorable tax treatment under Code Sec. 402(l), as long as the individual separates from service as a public safety officer, because of disability or after attaining normal retirement age, with the employer maintaining the eligible government plan.

MORTGAGE INSURANCE PREMIUM DEDUCTION EXTENDED

The Mortgage Relief Act extends the rules treating qualified mortgage insurance premiums as deductible qualified residence interest for three years. Previous legislation had established this deduction for 2007 only. Thus, they apply if the amounts: (1) are paid or accrued before Jan. 1, 2011; (2) aren't properly allocable to any period after Dec. 31, 2010; and (3) are paid or accrued with respect to a mortgage insurance contract issued after Dec. 31, 2006. (Code Sec. 163(h)(3)(E)(iv), as amended by Act § 3)

To be deductible, the premiums must have been paid in connection with acquisition debt for a mortgage insurance contract issued after Dec. 31, 2006. It must be for a qualified residence (first and second homes) and the premiums must have been paid or accrued after Dec. 31, 2006 and before Jan. 1, 2011.

The deductible amount of the premiums phases out ratably by 10% for each $1,000 (or fraction thereof) by which the taxpayer's AGI exceeds $100,000 (10% for each $500 (or fraction thereof) by which a married separate taxpayer's AGI exceeds $50,000).

Qualified mortgage insurance means mortgage insurance provided by the Veterans Administration (VA), Federal Housing Administration (FHA), or Rural Housing Administration (RHA), and private mortgage insurance, as defined by Sec. 2 of the Homeowners Protection Act of '98 (12 U.S.C. 4901), as in effect on Dec. 20, 2006. Prepaid premiums for mortgage

insurance other than that provided by the VA or RHA are not fully deductible in 2007 but must be amortized over the period to which they apply. The unamortized balance is not deductible if the mortgage is paid off before the end of its term.

EXCLUSION FOR MEMBERS OF QUALIFIED VOLUNTEER EMERGENCY RESPONSE ORGANIZATIONS

The Mortgage Relief Act provides, effective for tax years beginning after Dec. 31, 2007 and before Jan. 1, 2011, an exclusion from gross income to members of qualified volunteer emergency response organizations for any:

(1) Qualified state or local tax benefit; and

(2) Qualified payment (Code Sec. 139B(a), as added by Act § 5(a))

A Qualified State or Local Tax Benefit - is any reduction or rebate of state or local income, real property, or personal property taxes on account of services performed by individuals as members of a qualified volunteer emergency response organization. (Code Sec. 139B(c)(1)) Unlike qualified payments, there is no cap on the amount excludable. However, the amount of state or local taxes taken into account by a taxpayer in determining his Schedule A deduction for taxes is reduced by the amount of any qualified state or local tax benefit. (Code Sec. 139B(b)(1))

A Qualified Payment - is a payment (whether reimbursement or otherwise) provided by a state or political subdivision on account of the performance of services as a member of a qualified volunteer emergency response organization. The amount of these payments considered "qualified," and therefore excludable, is limited to $30 multiplied by the number of months during the year that the taxpayer performs such services. (Code Sec. 139B(c)(2)) The expenses paid or incurred by the taxpayer in connection with the performance of services that he may deduct as a Schedule A charitable contribution are allowed only to the extent they exceed the amount of excluded qualified payments. (Code Sec. 139B(b)(2))

Limited Qualified Payment Exclusion - The maximum exclusion for qualified payments in a year is $360 ($30 × 12 months). However, this exclusion apparently isn't a simple $30 a month allowance. Rather, the payments are determined on a yearly basis ($30 × number of months of service). Thus, a taxpayer who serves for 12 months could exclude $360 received during the year even if it was received all in one month (for example, in the first or last month of the year).

A Qualified Volunteer Emergency Response Organization - is any volunteer organization which is: (1) organized and operated to provide firefighting or emergency medical services for persons in the state or its political subdivision; and (2) required (by written agreement) by the state or political subdivision to furnish firefighting or emergency medical services in the state or political subdivision. (Code Sec. 139B(c)(3))

TEACHER'S CLASSROOM EXPENSES

The $250 tax deduction for out-of-pocket costs incurred to purchase books, supplies and other classroom equipment by elementary and secondary school teachers and certain other school professionals is retroactively restored for 2008 and extended through 2009.

DEDUCTION FOR HIGHER EDUCATION EXPENSES

The Extenders Act of 2008 retroactively restored this deduction for 2008 and extended it through 2009. Thus, individual taxpayers will be allowed to deduct up to $4,000 of higher education expenses instead of claiming the Hope or Lifetime Learning tax credits for 2008 and 2009.

401(k) CONTRIBUTION LIMITS

Year	2008	2009
Taxpayer < 50	15,500	16,500
Taxpayer 50+	20,500	22,000

IRA CONTRIBUTION LIMITS

2001 legislation increases the annual IRA contribution limit slowly through 2008 and indexes the limit for inflation in $50 increments for years after 2008. For individuals who have attained the age of 50 before the close of the taxable year, the deductible amount is increased by a specific amount. (See table below.)

Year	Contribution Limits	
	Under Age 50	Age 50 and Over
2006 through 2007	4,000	5,000
2008	5,000	6,000
2009 and after	Inflation Adjusted	

TRADITIONAL IRA PHASE OUT FOR ACTIVE PARTICIPANTS

Active participants in qualified plans must limit their IRA deductions when their AGI reaches certain "threshold levels." If the AGI is below the "threshold," even an active participant may deduct an IRA contribution within the IRA limits described above. The phase-out threshold levels for active participants are:

Filing Status	2006	2007	2008	2009
S, HH	50,000	52,000	53,000	55,000
Jt, SS	75,000	83,000	85,000	89,000
MS	0	0	0	0
Delta– Single	10,000	10,000	10,000	10,000
Delta – Married	10,000	20,000	20,000	20,000

LOW-INCOME SAVER'S CREDIT

Current tax law includes a provision where a low-income taxpayer's contributions to an IRA or other qualified plan are supplemented by the "Saver's" credit. This credit is available to any taxpayer age 18 and older that is not a full-time student or a dependent of another taxpayer. The credit is 50, 20 or 10 percent of the first $2,000 of retirement plan contributions and is phased out after (per the tables shown below).

2008 Phase Outs

Modified Adjusted Gross Income						Applicable percentage
Joint return		Head of household		Others		
Over	Not over	Over	Not over	Over	Not over	
$ 0	$ 32,000	$ 0	$ 24,000	$ 0	$ 16,000	50
32,000	34,500	24,000	25,875	16,000	17,250	20
34,500	53,000	25,875	39,750	17,250	26,500	10
53,000		39,750		26,500		0

2009 Phase-Outs

Modified Adjusted Gross Income						Applicable percentage
Joint return		Head of household		Others		
Over	Not over	Over	Not over	Over	Not over	
$ 0	$ 33,000	$ 0	$ 24,750	$ 0	$ 16,500	50
33,000	36,000	24,750	27,000	16,500	18,000	20
36,000	55,500	27,000	41,625	18,000	27,750	10
55,500		41,625		27,750		0

Modified AGI - Adjusted gross income will be determined without regard to Code Sec. 911 (foreign earned income exclusion and foreign housing exclusion or deduction), Code Sec. 931 (exclusion of income from American Samoa, Guam, or the Northern Mariana Islands), and Code Sec. 933 (exclusion of income from Puerto Rico). *(Code Sec. 25B(e))*

PLAN NOW FOR 2010 ROTH CONVERSIONS

Beginning in 2010, under the previously-enacted legislation, the income and marital status restrictions that limit the ability of a taxpayer to convert a traditional IRA to a Roth IRA have been removed, leading to some interesting and very advantageous tax and estate planning strategies.

Under prior law, an individual was allowed to convert a traditional IRA into a Roth IRA if the taxpayer's adjusted gross income (AGI) for the year (without the income from the converted IRA) was $100,000 or less. The $100,000 limit is figured without regard to required minimum distributions from an IRA. Although the income is taxable, the 10% early withdrawal penalty does not apply.

Beginning in 2010, the new legislation:

(1) Eliminates the $100,000 modified AGI limit on conversions of traditional IRAs to Roth IRAs, and

(2) Permits married taxpayers filing a separate return to convert amounts in a traditional IRA into a Roth IRA. Under prior law, married taxpayers who filed separate returns were restricted from making conversions.

Special 2010 Income Inclusion Rule: *For conversions made in 2010, the taxpayer can choose to elect to:*

- *Include the income in the 2010 return, or*
- *Include one-half of the conversion income in 2011 and one-half in 2012.*

Note: 2010 is the last year for the current "low" tax rates unless Congress extends them in future legislation.

Income from conversions made in a year after 2010 will be taxable in the year of the conversion. There are also a number of special rules regarding early distributions with respect to conversions.

Looking Ahead - There are some interesting strategies a taxpayer can employ to convert nondeductible traditional IRA contributions to a Roth IRA, thereby funding the more favorable Roth IRA.

- **Strategy** - Taxpayers who have employer plans and are restricted from making deductible traditional IRA contributions because of income level can make nondeductible traditional IRA contributions in the four tax years leading up to 2010, and then convert those nondeductible traditional IRAs to Roth IRAs with virtually no tax since they were nondeductible. Only the earnings would be taxable. Taxpayers who are prohibited from making Roth IRA contributions because their income exceeds the limit may also benefit from this strategy.
- **Strategy** - Using the same strategy above, even a taxpayer who can make a deductible contribution can elect to make it nondeductible, providing the same result as above.
- **Strategy** – Generally, rollovers are thought of as transfers from a qualified plan to an IRA or from one IRA to another IRA. However, beginning in 2002, the law has allowed the taxable part of an IRA to be rolled (or transferred) to other qualified plans, including 401(k) plans, 403(a) and 403(b) annuities and 457 governmental retirement plans (assuming the plan will accept the IRA funds). For taxpayers who have mixed IRAs (including both deductible and nondeductible contributions), this provides a means to segregating the taxable and nontaxable amounts and then later converting the nontaxable portion without paying any conversion tax (except on any interim earnings). Thus, the taxable portion can be rolled into a qualified plan, leaving the nontaxable portion in the IRA where it can be converted to the Roth IRA.
- **Strategy** - More aggressive taxpayers with the financial resources to pay the rollover tax might also consider rolling (or transferring) the funds from a qualified plan into a traditional IRA and then converting the traditional IRA to a Roth IRA.

Keep in mind that to minimize the conversion tax requires careful planning and strict adherence to the conversion rules.

RECORDKEEPING FOR CASH DONATIONS

Prior to this law change, for cash contributions less than $250, taxpayers were only required to have a contemporaneous record of the contributions. Under the new tax law taking effect in 2007, and effective for tax years after 2006, for contributions of money, regardless of the amount, applicable recordkeeping requirements are satisfied only if the donor maintains as a record of the contribution a:

- Bank record or
- Written communication from the donee showing:
  - The name of the donee organization,
  - The date of the contribution, and
  - The amount of the contribution.

CAUTION!

The recordkeeping requirements may not be satisfied by maintaining other written records. This means that unless the charitable organization provides written communication, cash donations put into a "Christmas kettle," church collection plate, and pass-the-hat collections at youth sporting events will not be deductible. Donations made by a debit or credit card can be substantiated by a bank record.

TAX-FREE DIRECT IRA DISTRIBUTIONS FOR CHARITY

The 2008 Extenders Act reinstates for 2008 and 2009 the Pension Protection Act of 2006 (§1201(a)) provision that provides for an exclusion from gross income, not to exceed $100,000 per taxpayer (husband and wife can each contribute $100,000, Notice 2007-7, Q&A 34), for otherwise taxable IRA distributions from a traditional or Roth IRA that are qualified charitable distributions. Thus, this provision is applicable for years 2006 through 2009.

This provision allows taxpayers age 70½ or over to make IRA distributions directly to a qualified charity. Any amount not exceeding $100,000 can be directly distributed to the charity. The key to benefiting from this provision lies in the fact that the distribution: (1) is not included in the taxpayer's income for the year, (2) counts toward the taxpayer's minimum required distribution for the year, and (3) does not count as a charitable contribution for the year. Here is how taxpayers can benefit from this new provision:

- By making a contribution directly from the IRA, taxpayers are able to exclude the amount they contributed from their income for the year, which is essentially the same as deducting the contribution without itemizing their deductions.
- This technique also lowers a taxpayer's adjusted gross income (AGI) for other tax breaks pegged at various AGI levels, such as medical expenses, passive losses, etc., allowing them greater benefits from the AGI limited deductions.
- For taxpayers receiving Social Security (SS), the taxability of the SS is also based on income. Thus, excluding the portion of the IRA distribution directly distributed to the charity can reduce the taxable portion of the SS.
- Taxpayers who wish to make very large contributions (up to the 100,000 limit) can do so with IRA funds that would have otherwise been taxable to them.

Example: *Retired couple (both over 70 ½) file a joint return. Their income consists primarily of RMD from their IRA accounts totaling $35,500, both of their SS incomes totaling $28,000, and $2,000 of investment income. They are very active with their church and make a $14,000 contribution each year. They have no other income or deductions. Compare the results below (example uses 2006 rates) with and without a qualified charitable distribution:*

IRA (RMD) Distributions	*$35,500*	*<14,000>*	*$21,500*
Taxable SS Incomes ($28,000 Total)	*12,375*	↑	*2,750*
Investment Income	*2,000*	Qualified charitable distribution	*2,000*
AGI	*49,875*		*26,250*
Church Contribution/Std Deduction	*<14,000>*		*<12,300>*
Personal Exemptions	*<6,600>*		*<6,600>*
Taxable Income	*$29,275*		*$7,350*
Tax	*$3,636*		*$ 735*

In this example, instead of making a charitable contribution, the taxpayer made a qualified charitable distribution of $14,000, lowering their AGI, reducing their taxable SS and then using the standard deduction. Result: Tax savings of $2,901.

We want to stress that a qualified charitable IRA contribution must be directly distributed to the qualified charity. Otherwise, the distribution is taxable as income, and the charitable deduction would be taken on the taxpayer's itemized deductions subject to all the normal limitations. Please call this office before attempting to execute this strategy.

STANDARD DEDUCTION FOR REAL PROPERTY TAXES

Section 63(c)(1), as added by the Housing Assistance Tax Act of 2008, provided for an additional standard deduction for property taxes. This provision was originally slated to be for 2008 only but has been extended to include 2009.

SALES TAX DEDUCTION

The tax break allowing individual taxpayers to choose between deducting state income tax or sales tax, whichever provides them the best benefit, is retroactively restored for 2008 and extended through 2009.

AMT PATCH APPLIED FOR ANOTHER YEAR

Congress has been promising alternative minimum tax (AMT) relief or reform for some time. However, the two houses of Congress have been unable to reach a consensus on what to do with the AMT. Unable to resolve the issue of AMT reform, Congress, for the third year in a row, has applied a one-year patch to address the problem (which includes 2008).

The one-year AMT patch increases the AMT exemption amounts, thereby avoiding a huge tax increase for an estimated 23 million taxpayers. The legislation also allows certain personal tax credits to be deducted for one more year.

2008 AMT Exemption Amounts (before phase out)

Unmarried Taxpayers	$46,200 (up from $44,350 for 2007)
Married Filing Jointly & Surviving Spouse	$69,950 (up from $66,250 for 2007)
Married Filing Separately	$34,975 (up from $33,125 for 2007)

Under this one-year patch, the sum of the following credits may offset both the regular tax and AMT for 2008:

- Code Sec. 21 **dependent care** credit;
- Code Sec. 22 credit for the **elderly a**nd permanently and totally disabled;
- Code Sec. 23 **adoption** credit;
- Code Sec. 24 **child tax** credit;
- Code Sec. 25 **mortgage** credit;
- Code Sec. 25A **Hope** and **Lifetime** Learning credits;
- Code Sec. 25B lower-income **saver's** credit;
- Code Sec. 25D **residential energy efficient property** credit for solar electric, solar hot water, and fuel cell property added to a residence; and
- Code Sec. 1400C first-time **D.C. homebuyer** credit (which was extended through 2009).

Caution: These changes represent a one-year patch to the AMT and, without further legislation, will create a significant tax increase for many taxpayers in 2009.

KIDDIE TAX

Beginning in 2008, the Small Business Act expands the Kiddie Tax rules to apply to children through age 18, and children over age 18 but under age 24 who are full-time students—if their earned income doesn't exceed one-half of the amount of their support. (Code Sec. 1(g)(2)(A), as amended by Small Business Act § 8241(a))

To avoid the negative affects of the Kiddie Tax, it has been a popular higher-education funding tax strategy for parents to transfer appreciated capital assets, such as stock, to a child to be sold after the child was out from under the Kiddie Tax rules – initially age 14, then age 18 after the 2006 rules change. This strategy looked to be especially attractive for years 2008 through 2010 when the tax rate for long-term capital gains (and qualified dividends) drops to zero for taxpayers in the 15% or lower marginal rate. Parents of unmarried children age 18 to 23 who are full-time students expected that the children would also be able to enjoy the lower capital gains rates.

However, Congress has essentially closed this loophole by subjecting children through age 18 and full-time students age 19 to 23 to the Kiddie Tax rules beginning in 2008. Another change to the rules may prevent some of these older children from falling into the Kiddie Tax trap; if the child's earned income exceeds one-half of the child's support, the Kiddie Tax rules won't apply.

Because of these impending changes, a parent may want to reconsider any planned transfers of income-generating stocks, bonds, and other investments to children age 18, or those age 19-23 who are full-time students. However, placing or moving a child's funds into investments, such as the following that produce little or no current taxable income, can help avoid the Kiddie Tax, at least in the years until the investments need to be sold or redeemed to pay for the education expenses:

- **U.S savings bonds** – Interest can be deferred until the bonds are cashed.
- **Tax-deferred annuities** - Interest can be deferred until the annuity is surrendered.
- **Municipal bonds** – Generally produce tax-free interest income (may be taxable to the state).
- **Growth stocks** - Stocks that focus more on capital appreciation than current income.
- **Unimproved real estate** – That provides appreciation without current income.

- **Family employment** - If the family has a business, that family business could employ the child. The child's earned income is not subject to Kiddie Tax and will generate a deduction for the family business (assuming the wages are reasonable for work actually performed). The child's earned income can offset the standard deduction for a dependent and the excess income will be taxed at the child's rate (not the parent's). In addition, the child would also qualify for an IRA, which provides additional income shelter.

EIC AND COMBAT PAY

The election to have excluded combat pay counted as income for purposes of calculating the earned income tax credit (EIC) has been made permanent by the Heroes Act of 2008.

Thus, military personnel can elect starting in 2004 to include combat pay as earned income for purposes of the earned income credit. Whether it will be advantageous to make this election depends on the level of the taxpayer's earned income. In some cases, adding combat pay to other earned income will increase the amount of the credit. But for taxpayers whose earned income is in the phase-out range, increasing earned income by the combat pay amount will reduce (or could totally eliminate) the credit.

VEHICLE MILEAGE RATES

The table below reflects Inflation Adjustments for years 2007 through 2009.

	BUSINESS		**PERSONAL**		
	Business	**Deprec**			
Year	**Rate**	**Element**	**Moving**	**Medical**	**Charity**
2007	48.5	19.0	20.0	20.0	14.0
2008 (Jan-Jun)	50.5	21.0	19.0	19.0	14.0
2008 (Jul-Dec)	58.5	21.0	27.0	27.0	14.0
2009	55.0	21.0	24.0	24.0	14.0

ADVANCED LEAN BURN TECHNOLOGY CREDIT

For the first time, the IRS has listed vehicles that qualify for a credit under the advanced lean burn technology. Those shown below are as of August 20, 2008. For a more current list, consult the IRS website. CAUTION: These vehicles are also subject to the overall 60,000 unit limitation and the credit may be reduced or eliminated by the AMT.

- Volkswagen 2009 Jetta—2.0L TDI Sedan manual and automatic $1,300
- Volkswagen 2009 Sportwagen—2.0L TDI manual and automatic $1,300
- Mercedes-Benz GL320 BLUE TEC $1,800
- Mercedes-Benz R320 BLUE TEC $1,550
- Mercedes-Benz ML320 BLUE TEC $ 900

HYBRID VEHICLE TAX INCENTIVES

The hybrid vehicle tax credit (available through 2009) is made up of two separate credits:

- The increased fuel economy credit, ranging from $400 to $2,400, and
- The lifetime fuel savings credit, ranging from $250 to $1,000.

Thus, the maximum credit available is $3,400 — the more fuel-efficient the vehicle, the higher

the credit. Since these are tax credits, they directly offset regular income tax and generally provide a larger overall tax benefit. However, they cannot be used to offset the Alternative Minimum Tax (AMT). In addition, the full credit only applies to the first 60,000 vehicles produced by each manufacturer. Thus, before a taxpayer purchases a hybrid vehicle, they need to:

(1) Make sure that they are not in the AMT and can benefit from the credit,

(2) Verify the amount of credit available for the vehicle being purchased, and

(3) Make sure the credit is not limited because the manufacturer has exceeded the 60,000 car limit.

The following is a list of vehicles qualifying for the credit. Note that Toyota reached the 60,000 vehicle limit in the third quarter of 2006. Thus, beginning in the fourth quarter of 2006, the credit will be reduced by 50% for vehicles purchased from 10/1/06 to 3/31/07. From then onwards, the credit will only be 25% of the otherwise allowable amount between 4/1/07 through 9/30/07. No credit will be given for Toyota vehicles purchased 10/1/07 and later.

HYBRID & ALTERNATIVE FUEL CREDITS – (Updated through 12/31/07)

		MODEL YEAR CREDIT (100%)			
MFG	MODEL	2005	2006	2007	2008
Ford	Escape Hybrid 2 WD	2,600	2,600	2,600	3,000
	Escape Hybrid 4 WD	1,950	1,950	1,950	2,200
	Mercury Mariner Hybrid 4 WD	---	1,950	1,950	2,200
	Mercury Mariner Hybrid 2 WD				3,000
GM	Chevrolet Silverado (2WD) Hybrid Pickup	---	250	250	
	Chevrolet Silverado (4WD) Hybrid Pickup	---	650	650	
	Chevrolet Tahoe Hybrid (2WD & 4WD)	---	---	---	2,200
	GMC Sierra (2WD) Hybrid Pickup	---	250	250	
	GMC Sierra (4WD) Hybrid Pickup	---	650	650	
	GMC Yukon Hybrid (2WD & 4WD)	---	---	---	2,200
	Saturn Vue Green Line	---	---	650	1,550
	Saturn Aura Hybrid	---	---	1,300	1,300
	Malibu Hybrid	---	---	---	1,300
Honda	Accord Hybrid AT & Nav1 AT	650	1,300	1,300	
	Accord Hybrid AT [1]	---	650	---	
	Civic GX [2]	4,000	4,000	4,000	
	Civic Hybrid (SULEV) MT	1,700	---	---	
	Civic Hybrid (SULEV) CVT	1,700	2,100	2,100	2,100
	Insight CVT	1,450	1,450		
	Honda FCX (Hydrogen Powered)	12,000	12,000		
Toyota	Lexus RX400h 2WD or 4WD	---	2,200	2,200	
	Lexus GS 450h	---	---	1,550	
	Toyota Camry Hybrid	---	---	2,600	
	Toyota Highlander 2WD or 4WD	---	2,600	2,600	
	Toyota Prius	3,150	3,150	3,150	
Nissan	Altima	---	---	2,350	2,350
Mazda	Tribute 2WD Hybrid				3,000
	Tribute 4 WD Hybrid				2,200

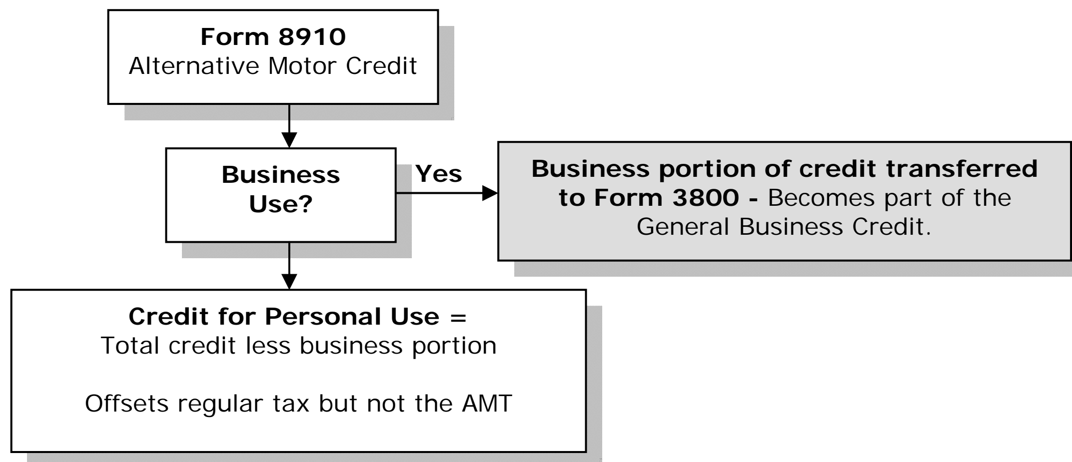
(1) Without updated control calibration (2) Alternate Fuel Credit – Natural Gas

Manufacturers That Have Reached the 60,000 Vehicle Limit – The following two manufacturers have reached the 60,000 vehicle limit; as a result, the credit for those two manufacturers must be phased out as noted:

- **Toyota Motor Corporation** - reached the 60,000 vehicle phase-out threshold in 2006. Therefore, taxpayers who purchased Toyota and Lexus hybrids during 2007 must **reduce** the otherwise allowable credits as follows; purchased before April 1, 2007 – 50% Reduction, purchased after March 31, 2007 but before October 1, 2007 – 75% Reduction and purchased after September 30, 2007 – No credit allowed!

- **American Honda Motor Company** - reached the 60,000 vehicle phase-out threshold in the third quarter of 2007. Honda hybrid vehicles purchased before Jan. 1, 2008 qualify for the full credit. For Honda hybrid vehicles bought on or after Jan. 1, 2008, and on or before June 30, 2007, the credit is 50 percent of the otherwise allowable credit amount. Taxpayers buying vehicles on or after July 1, 2008, and on or before Dec. 31, 2008, can only get 25 percent of the credit.

Note: The credit is allocated between the personal and business portions of the credit. The business portion of the credit is treated as part of the General Business Credit.



HOME ENERGY CREDIT

The Section 25C credit for certain energy-efficient property installed on the taxpayer's principal residence that originally expired in 2007 has been reinstated for 2009 only. This provision allows a nonrefundable $500 credit for the installation of qualified windows, skylights, air circulation systems, hot water boilers and other energy-efficient equipment.

The 2008 Energy Act adds biomass fuel stoves to the list of energy-efficient building property that qualifies for the non-business energy credit. Thus, energy-efficient building property includes a stove that burns "biomass fuel," to heat a dwelling unit located in the U.S. that the taxpayer uses as a residence, or to heat water for use in the residence, and that has a thermal efficiency rating of at least 75%. The Act also removes geothermal heat pumps from the Sec. 25C credits and adds them to the more generous Sec. 25D category. The type of water heater that qualifies has been broadened to include natural gas, propane or oil heaters with a thermal efficiency of at least 90%. The Act also added asphalt roofs, which include the appropriate cooling granuals.

Credit Limits: A lifetime credit with a cap of $500 subject to specific improvement limitations.

Credit Amount: Subject to the above limits, the credit is made up of two parts:

(a) 10% of the cost of qualified energy-efficient improvements, and

(b) 100% of the cost of residential energy property expenses, limited to the dollar amounts noted on the next page.

RESIDENTIAL ENERGY-EFFICIENT PROPERTY (REEP) CREDIT

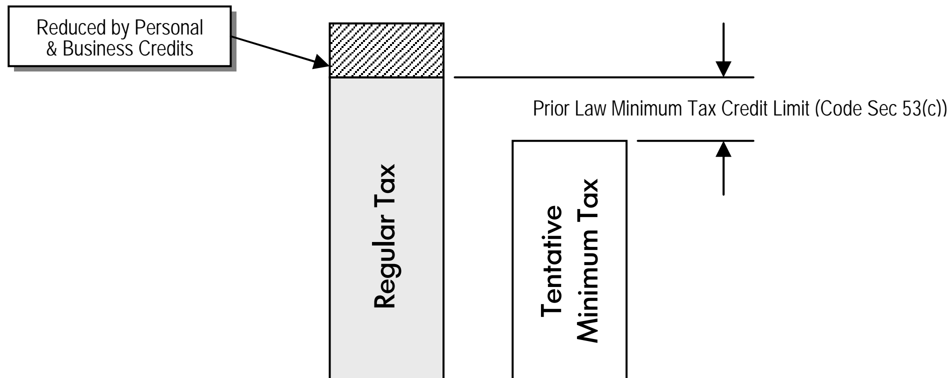
The Sec. 25D credits that were set to expire after 2008 have been extended through 2016. This includes the credit for the installation of solar water heating systems (excluding swimming pools) and qualified fuel cell property. The Act also increased the maximum 30% credit from $2,000 to $4,000 and allows a REEP credit for residential wind property and geothermal heat pumps. The Act also allows the REEP credit to be claimed against the AMT. The following are the credit limits:

- Qualified Solar Electric Property
  - 2006 through 2008: $2,000
  - 2009 though 2016: No Limit
- Qualified Solar Water Heating Systems
  - 2006 through 2016: $2,000
- Qualified Fuel Cell Property
  - $500 for **each 0.5 kilowatt** of capacity of a qualified **fuel cell** (no annual maximum)
- Qualified Small Wind Energy Property (2009 through 2106 Only)
  - $500 for **each 0.5 kilowatt** of capacity
  - $4,000 maximum
- Qualified Geothermal Heat Pumps (2009 through 2106 Only)
  - 2009 through 2016: $2,000

REFUNDABLE AMT TAX CREDIT PROVISIONS

This provision, effective beginning in 2007, allows individuals to take advantage of a refundable credit with respect to certain long-term unused AMT credits existing prior to January 1, 2013. This provision was substantially modified for years beginning 2007; thus, there are two sets of rules, one for 2007 and another for years after 2007.

Under Pre-Act Law – To the extent an individual's AMT liability is caused by deferral adjustments (such as incentive stock options), a credit may be carried forward to a later year where the tentative minimum tax is less than the individual's regular tax. The minimum tax credit for a tax year was limited to the excess of: (a) the individual's regular tax liability for the tax year to which the credit was being carried, reduced by the sum of his nonrefundable personal credits and business-related income tax credits for the year, over (b) his tentative minimum tax (i.e., AMT before deducting regular tax) for the year. The credit was nonrefundable—i.e., any minimum tax credit in excess of the above-described limitation could not be refunded. However, the "excess" could be carried forward (but not back) indefinitely.



For Tax Years After 2006 - For tax years beginning after December 20, 2006, if an individual has a **"long-term unused minimum tax credit"** for any tax year beginning before Jan. 1, 2013, the amount determined under the Code Sec. 53(c) limit on the minimum tax credit for the tax year can't be less than the **"AMT refundable credit"** amount for that tax year. (Code Sec. 53(e)(1), as amended by Act Sec. 202(a)) This credit is subject to a phase-out (Code Sec. 53(e)(2)), and is refundable (Code Sec. 53(e)(4)). Thus, we have two new terms we need to become accustomed with:

AMT Refundable Credit Amount - The "AMT Refundable Credit Amount" (Code Sec. 53(e)(2)(A)), as amended by the Technical Corrections Act of 2007 and the 2008 Extenders Act, is the greatest of:

(1) $5,000 (pre-2008);

(2) 50% (20% for 2007) of the long-term unused minimum tax credit; or

(3) The AMT refundable credit amount (if any) for the prior year – before any reduction by reason of AGI.

WORKSHEET

1. Long-term unused Minimum Tax Credit... __________
2. Statutory Amount ($5,000 for 2007 otherwise $0)..__________
3. Enter 50% (20% for 2007) of Line 1..................... __________
4. Prior Year's AMT Refundable Credit Amount.............. __________
5. Largest of line 2, 3 or 4 .... __________
6. **AMT Refundable Credit Amount** (Smaller of line 1 or 5)......... __________

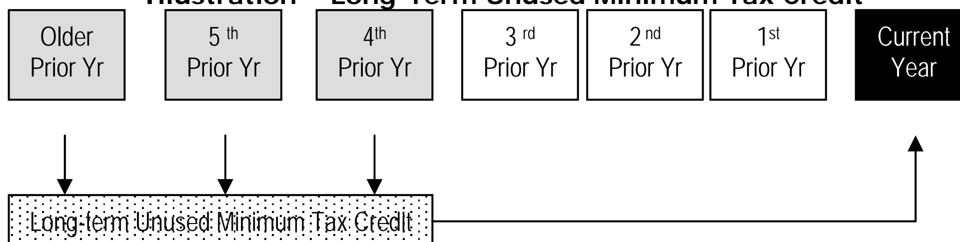
Long-Term Unused Minimum Tax Credit - The "long-term unused minimum tax credit" (Code Sec. 53(e)(3)(A)) for any tax year is the portion of the minimum tax credit **for tax years before the third tax year immediately preceding** the tax year. For this purpose, credits are treated as allowed under Code Sec. 53(a) on a first-in, first-out (FIFO) basis. (Code Sec. 53(e)(3)(B))

Special Adjustment for 2008 and 2009

The 2008 Extenders Act provides that the AMT refundable credit amount and the AMT credit for each of the first two tax years beginning after Dec. 31, 2007, are increased by one-half of the amount of any interest and penalty paid before the date of enactment on account of the application of the minimum tax adjustment for ISOs. (Code Sec. 53(f)(2), as amended by Act Sec. 103(b))

Example: Taxpayer filed late for 2007 and was subject to interest and penalties because he did not pay the AMT attributable to the ISO income on time. However he pays them before October 3rd and incurs a 5% failure to pay penalty plus interest of $400. The $400 is added to his long-term refundable credit carryover to 2008. Thus because of the new 50% rule he would recover $200 of those penalties in each of 2008 and 2009.

Illustration – Long-Term Unused Minimum Tax Credit



Example: *Taxpayer has a long-term unused minimum tax credit of $100,000 from a year 5 years prior to the current tax year (2008). For the current tax year, the taxpayer's regular tax is $80,000 and his tentative AMT is $65,000. For years prior to 2007, the taxpayer would have only been able to reduce his regular tax down to the tentative AMT and, as a result, would have been only able to use $15,000 of the credit.*

For 2008, we compute his AMT refundable credit as follows:

1. *Long-Term Unused Minimum Tax Credit.. $100,000*
2. *Statutory Amount ($5000 for 2007 otherwise $0)...... $ 0*
3. *Enter 50% (20% for 2007) of Line 1........................ $ 50,000*
4. *Prior Year's AMT Refundable Credit Amount........... $ 0*
5. *Largest of Line 2, 3 or 4... $ 50,000*
6. ***AMT Refundable Credit Amount** (Smaller of Line 1 or 5)......... $ 50,000*

For 2008, we compute his AMT refundable credit as follows:

1. *Long-Term Unused Minimum Tax Credit ($100,000 - $50,000).............. $ 50,000*
2. *Statutory Amount .... $ 5,000*
3. *Enter 50% (20% for 2007) of Line 1............... $ 25,000*
4. *Prior Year's AMT Refundable Credit Amount.... $ 50,000*
5. *Largest of Line 2, 3 or 4 ....$ 50,000*
6. ***AMT Refundable Credit Amount** (Smaller of Line 1 or 5).........$ 50,000*

Phase Out – For 2007, only the AMT refundable credit amount is reduced (phased out) by the same percentage that applies to the personal exemption amounts. Thus, the AMT refundable credit must be reduced by 2% for each $2,500, or part of $2,500 ($1,250 for married filing separately), that the taxpayer's AGI exceeds the limit for the taxpayer's filing status.

2007 Phase-Out Amounts

Single	Head of Household	Joint (SS)	Married Separate
$156,400	$195,500	$234,600	$117,300

If the AGI exceeds the amount shown by more than $122,500 ($61,250 if married filing separately), the amount allowed for the refundable AMT credit is reduced to zero.

For this purpose, the taxpayer's AGI is determined without regard to the exclusions for foreign earned income (Sec. 911), Residents of American Samoa (Sec 931) or Residents of Puerto Rico (Sec. 53(e)(2)(B)).

Although the *post-2006* rules do not apply specifically to the AMT treatment of incentive stock options (ISO), the legislative history of this new rule indicates that it was the primary reason for the change.

DEFERRAL items of preference that can create an AMT Credit include:

- Qualified small business stock,
- Incentive stock option preference,
- Large partnerships adjustments,
- Adjusted gain or loss,
- Post-1986 depreciation adjustments,
- Passive activities ,
- Loss limitations,
- Circulation expenses differences,
- Long-term contract preferences,
- Mining cost differences,
- Research and experimental costs,
- Installment sales (pre-1987),
- Intangible drilling costs preferences and
- Depreciation (pre-1987).

RESEARCH AND DEVELOPMENT (R&D) CREDIT

The research and development (R&D) credit is restored for 2008 and extended for 2009. In addition, for tax years ending after 2006, the new law enhances the credit by (1) increasing the rates of the alternative incremental credit and (2) creating a new alternative simplified credit that does not use gross receipts as a factor (so that newer businesses can access the credit).

ENVIRONMENTAL REMEDIATION COSTS

The election to expense (currently deduct) environmental remediation costs associated with cleaning up certain hazardous sites is extended through 2009.

LEASEHOLD IMPROVEMENTS AND RESTAURANT PROPERTY

The accelerated write-off for certain leasehold improvements and restaurant property (depreciation over 15 years instead of 39 years) began as part of the Jobs Act in 2004 and has been extended through 2009 by the 2008 Extenders Act. The 2008 Act also provides that qualified restaurant property means any property that is: (1) a building, if that building is placed in service after Dec. 31, 2008, and before January 1, 2010, or (2) an improvement to a building, if more than 50 percent of the building's square footage is devoted to preparation of, and seating for on-premises consumption of, prepared meals.

Retail Space Improvements - The 2008 Extenders Act provides that any qualified retail improvement property placed in service after Dec. 31, 2008, and before Jan. 1, 2010, must be depreciated straight-line over 15 years under MACRS.

FARMING MACHINERY & EQUIPMENT

The 2008 Extenders Act provides that machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which is used in a farming business (as defined in section 263A (e)(4)), the original use of which commences with the taxpayer after December 31, 2008, and which is placed in service before January 1, 2010, is treated as 5-year property.

RACEHORSES

For animals placed in service after 2008 and before 2014, all racehorses are assigned a three-year recovery period under MACRS, regardless of their age. However, for property placed in service after 2013, only those racehorses that are more than two years old when placed in service by the purchaser are in the three-year recovery period. (Code Sec. 168(e)(3)(A), as amended by the Farm Act of 2008 §15344)

REQUIRED MINIMUM DISTRIBUTIONS SUSPENDED FOR 2009

A new law passed late in 2008 allows taxpayers age 70-½ and over and those who have inherited IRAs (beneficiaries) to forgo their required minimum distribution (RMD) for 2009. Thus, these individuals can take a distribution less than is required, even none, and avoid the 50% RMD penalty. Keep in mind that this is for tax year 2009 only. So if the taxpayer turned 70-½ in 2008 and delayed the first distribution to 2009, as permitted in the first RMD year, they will still be required to make that delayed distribution in 2009 and no later than April 1, 2009.

CASUALTY FLOOR INCREASED TO $500 FOR 2009

The 2008 Extenders Act increases the per-casualty floor for casualty and theft losses of personal-use property from $100 to $500 for 2009. The per-casualty floor will revert to $100 beginning in 2010.

10%-OF-AGI LIMITATION – DISASTER AREAS

The 2008 Extenders Act waives the 10%-of-AGI limitation for losses attributable to a federally declared disaster in **2008 and 2009**. If a taxpayer has casualty losses both within and outside of a federally-declared area, then the 10% of AGI limitation is applied to the losses outside of the disaster area and not applied to losses within the disaster area.

(1) The amount of the personal casualty gains for the tax year, plus

(2) The net disaster loss, plus

(3) So much of the excess of personal casualty losses over personal casualty gains, *reduced by the net disaster loss,* as exceeds 10% of the individual's AGI. (Code Sec. 165(h)(3)(A) as amended by 2008 Extenders Act §706(a)(1))

> ***Example -*** *An individual with $100,000 of AGI has the following personal casualty items during the tax year: a $5,000 personal casualty gain; a $30,000 allowable personal casualty loss attributable to a federally declared disaster; and a $7,000 allowable personal casualty loss.*

Disaster Casualty Loss	*<$30,000>*	
Personal Casualty Gain	*$5,000*	
Net Disaster Loss		*<$25,000>*
Non-Disaster Casualty Loss	*<$7,000>*	
10% of AGI	*$10,000*	
Net Non-Disaster Loss		*$0*
Net Casualty Loss		*<$25,000>*

5-YEAR NOL CARRYBACK FOR DISASTERS

Small businesses and farmers have a three-year carryback period (instead of the usual two years) for net operating losses (NOLs) attributable to a disaster. The 2008 Extenders Act provides a special five-year carryback period for NOLs to the extent of qualified disaster losses occurring in 2008 and 2009. Taxpayers may apply those NOL carrybacks to offset up to 100% of AMTI (90% rule will not apply).

- **Qualified disaster loss -** A "qualified disaster loss" is the lesser of:

  (1) Sum of:

  (a) The losses allowable for the tax year attributable to a federally-declared disaster, occurring before Jan. 1, 2010 and occurring in a disaster area, and

  (b) The deduction for the tax year for qualified disaster expenses that is allowable or that would be allowable if not otherwise treated as an expense, or

  (2) The taxpayer's NOL for the tax year.

  Any remaining portion of the NOL is subject to the general two-year carryback period.

- **Limitations** - A qualified disaster loss does not include losses from:

  (1) Property used in connection with a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, or store whose principal business is the sale of alcoholic beverages for off-premises consumption;

  (2) Gambling or animal racing property; and

  (3) Farming losses (treated separately under farm loss rules).

EXPENSING DEBRIS REMOVAL & DEMOLITION EXPENSES

Generally, deductions are not allowed for the costs of demolishing structures, and the costs are, instead, charged to the capital account of the underlying land. The treatment of the cost of debris removal depends on the nature of the costs incurred. Sometimes the cost of debris removal is an ordinary and necessary business expense which is deductible in the year paid or incurred. However, if the debris removal costs are in the nature of replacement of part of the property that was damaged, the costs are capitalized and added to the taxpayer's basis in the property.

For years **after 2007**, a taxpayer may elect to treat any qualified disaster expenses which are paid or incurred by the taxpayer in connection with a trade or business or with business-related property as an expense deductible in that tax year. (Code Sec. 198A(a) as added by 2008 Extenders Act §707(a) Div C)

LOSSES TREATED AS ADDITIONAL STANDARD DEDUCTION

The 2008 Extenders Act adds an individual's disaster loss deduction as a component of the standard deduction for **2008 and 2009**. (Code Sec. 63(c)(1)(D) as amended by 2008 Extenders Act §706(b)(1)) Thus, an individual's standard deduction is the sum of the:

(1) Basic standard deduction;

(2) Additional standard deduction for individuals who are age 65 or over and/or blind;

(3) Real property tax deduction (new for 2008 and extended through 2009 by the 2008 Extenders Act); and

(4) The disaster loss deduction.

This provision is beneficial to taxpayers with net disaster losses whose other itemized deductions are less than their standard deduction.

Deduction allowed under AMT - The disaster loss deduction component of the standard deduction is deductible for AMT purposes in computing AMTI.

ELECTION TO INCLUDE REIMBURSEMENT FOR HURRICANE-RELATED CASUALTY IN LOSS YEAR

The Housing Act allows a taxpayer who claimed a casualty loss to a principal residence (within the meaning of the Code Sec. 121 home sale exclusion rules) from Hurricanes Katrina, Rita, or Wilma, and in a later year receives a grant under Public Laws 109-148, 109-234, or 110-116 as reimbursement of that loss, to elect to file an amended return for the tax year to which the deduction was allowed. This differs from the normal rule that reimbursement for a casualty loss is taken into income in the year it is received rather than recomputing the loss for the year the deduction was taken.

On the amended return, the casualty loss deduction must be reduced, but not below zero, by the amount of the reimbursement. The amended return must be filed by the later of three years after the original due date for filing the tax return or four months after July 29, 2008. Any tax underpayment is subject to one year of interest, but no penalty or additional interest applies if payment is made no later than one year after the filing of the amended return. (Act § 3082(a))

NEW CREDIT FOR SMALL BUSINESS EMPLOYERS - ACTIVE DUTY DIFFERENTIAL WAGES

The recently enacted Heroes Act creates a new tax credit for eligible small business employers that pay differential wages to qualifying employees who are performing service in the uniformed services while on active duty for a period of more than 30 days. The credit is equal to 20% of up to $20,000 of differential pay to each qualifying employee during the tax year, but only for payments after June 17, 2008 and before 2010.

A qualified employee is one who has been an employee for the 91-day period immediately preceding the period for which any differential wage payment is made. (Code Sec. 45P, as added by Act Sec. 111(a))

An eligible small business employer is one that:

(1) Employed on average less than 50 employees on business days during the tax year; and

(2) Under a written plan, provides eligible differential wage payments to each of its qualified employees.

"Differential wage payment" is defined below at "Revised Tax Treatment of Differential Pay."

Other Rules:

- Taxpayers under common control are aggregated when determining if a taxpayer is an eligible small business employer.
- The credit cannot be claimed by a taxpayer that has failed to comply with the employment and reemployment rights of members of the uniformed services (as provided under Chapter 43 of Title 38 of the United States Code). (Code Sec. 45P(d), as added by Act § 111(a))
- No deduction may be taken for that part of compensation which is equal to the credit, and the amount of any other credit otherwise allowable under Chapter 1 (Normal Taxes and Surtaxes) of Subtitle A (Income Taxes) of the Code for compensation paid to an employee must be reduced by the differential wage payment credit allowed with respect to such employee. (Code Sec. 280C(a), as amended by Act § 111(c))
- The differential wage payment credit is part of the general business credit and thus is subject to the rules for business credits.
- The credit is not allowable against a taxpayer's alternative minimum tax liability. (Code Sec. 38(b)(33), as amended by Act § 111(b))

REVISED TAX TREATMENT OF DIFFERENTIAL PAY

Differential pay is compensation that some employers pay to service members during their active duty to make up the difference between the employee's regular salary and his or her military pay. Unfortunately, the Heroes Act made a number of changes that may discourage some employers from providing differential pay. Under the Heroes Act of 2008, differential pay will be:

- Subject to income tax withholding (was not prior to the law change and continues not to be subject to FICA withholding);
- Treated as compensation for retirement plan purposes (after 2008); and
- Qualifies as compensation for purposes of an IRA contribution (after 2008).

The Heroes Act also included a definition of differential pay:

(1) Made by an employer to individuals with respect to any period during which they are performing service in the uniformed services while on active duty for a period of more than 30 days; and
(2) Represents all or part of the wages that they would have received from the employer if they were performing services for the employer. (Code Sec. 3401(h)(2), as amended by Act § 105(a)(1)) Generally, an employer's plan providing differential pay must be amended (may be retroactively amended) to reflect the above changes no later than the last day of the first plan year beginning after 2009. This applies only if in the interim the plan or contract is operated as if the differential pay-related amendments were in effect. (Act § 105(c))

GAIN ATTRIBUTABLE TO NON-QUALIFIED PERIODS NOT EXCLUDABLE

Under the Housing Assistance Act of 2008, gain from the sale or exchange of a principal residence allocated to periods of non-qualified use is not excluded from gross income, effective for sales after December 31, 2008. The amount of gain allocated to periods of non-qualified use is the amount of gain multiplied by a fraction the numerator of which is the aggregate periods of non-qualified use during the period the property was owned by the taxpayer and the denominator of which is the period the taxpayer owned the property.

Non-Qualified Use - A period of non-qualified use means any period during which the property is not used by the taxpayer or the taxpayer's spouse or former spouse as a principal residence except as noted below. For this purpose, periods of non-qualified use **do not include** any period:

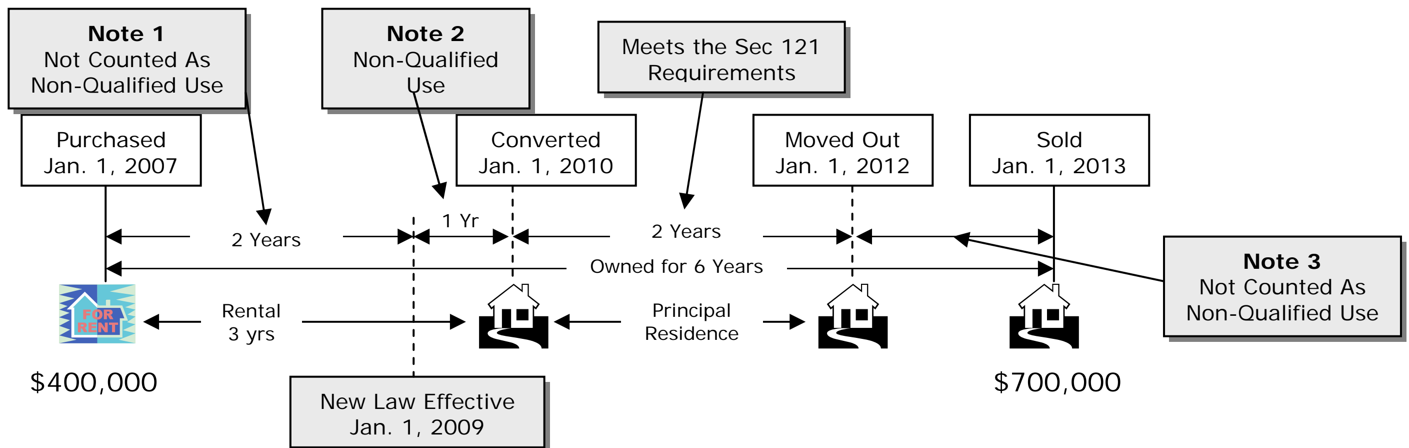
- Before January 1, 2009;
- After the last date the property is used as the principal residence of the taxpayer or spouse (regardless of use during that period); and
- Not to exceed two years that the taxpayer is temporarily absent by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances.

The present-law election for the uniformed services, Foreign Service and employees of the intelligence community is unchanged.

If any gain is attributable to post-May 6, 1997 depreciation, the exclusion does not apply to that amount of gain, as under present law, and that gain is not taken into account in determining the amount of gain allocated to non-qualified use.

These new provisions are illustrated by the following example:

Example *–Assume that an individual buys a property on January 1, 2007, for $400,000, and uses it as rental property for three years claiming $30,000 of depreciation deductions. On January 1, 2010, the taxpayer converts the property to his principal residence. On January 1, 2012, the taxpayer moves out, and the taxpayer sells the property for $700,000 on January 1, 2013.*



Note 1 *– Under the new law, non-qualified use before Jan. 1, 2009 is not counted as non-qualified.*

Note 2 *– In this example, there was one year of non-qualified use after Jan. 1, 2009, effective date of the new law.*

Note 3 *– Under the new law, non-qualified use after the last date the property is used as the principal residence of the taxpayer or spouse is not counted as non-qualified.*

Without considering purchase or sales costs and assuming there were no improvements or other basis adjustments, the sale would result in a gain of $330,000 ($700,000 – (400,000 – 30,000)). The $30,000 gain attributable to the depreciation deductions is included in income. Of the remaining $300,000 gain, 16.67% of the gain (1 year of non-qualified use divided by the 6 years of total ownership), or $50,010, is allocated to non-qualified use and is not eligible for the exclusion. Since the remaining gain of $249,990 is less than the maximum gain of $250,000 that may be excluded, the remaining gain of $249,990 is excluded from gross income.

INCREASED THRESHOLDS FOR SE OPTIONAL METHODS

For tax years beginning after Dec. 31, 2007, the Farm Act modifies the farm optional method so that electing taxpayers may be eligible to secure four credits of Social Security benefit coverage each tax year by increasing and indexing the thresholds. Similar modifications are made to the nonfarm optional method. This is a substantial change.

Farm and nonfarm optional methods - Use of these methods allows a taxpayer to continue SE tax coverage even in years when profits are small (or even when there is a loss). A taxpayer who uses one of the optional methods for figuring SE tax also uses the resulting imputed income when calculating the credit for child and dependent care expenses and the earned income credit. Beginning in 2008, the base amounts used in calculating the imputed net farm and nonfarm earnings were increased and named the "lower limit" and the "upper limit." The table below indicates the values for these amounts:

	Prior to 2008	2008	2009*
Lower Limit	$1,600	$4,200	
Upper Limit	$2,400	$6,300	

Note: *Beginning in 2008, the lower limit is determined by multiplying the minimum earnings for a quarter's Social Security coverage by four. Thus, for 2008, the lower limit is $4,200 ($1,050 x 4). The upper limit is determined by multiplying the lower limit by 1.5, resulting in an upper limit for 2008 of $6,300 ($4,200 x 1.5).*

** Values not available at press time*

The following flowcharts detail the qualifications for each method and the computations for both. The two methods can be applied in unison.