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CLIENT UPDATE

Table of Contents

Obama's Tax Proposals Contain a Surprise	Page 1
Obama's Budget	Page 1-2
Buying a Car: Sales Deduction	Page 2
Real Estate: Home Buyer Credit	Page 2
Energy: Tax Breaks	Page 2

Obama's Tax Proposals Contain a Surprise

A tax reduction for some upper incomers. While attention has been focused on the tax increase resulting from his plan to bring back the top tax rates of 36% and 39.6%, there's a flip side to the plan, too: The current 28% tax bracket would be broadened. So for folks in upper brackets, a part of their income that's now taxed at 33% would be in the 28% bracket.

Take a look at which filers would benefit. New details of Obama's budget plan for 2011 show that the upper limit on the 28% bracket would shift from \$210,000 of taxable income to about \$230,000 for married filers and from \$170,000 to about \$190,000 for singles—the proposed starting points for the new 36% bracket. The actual top of the 28% bracket would be Obama's often mentioned trigger points: \$250,000 for couples and \$200,000 for singles minus the 2011 standard deduction and two personal exemptions for couples and one exemption for single taxpayers. The exact numbers will depend on the rate of inflation. Expanding the 28% bracket would save as much as \$1,000 of income tax for upper income taxpayers.

That's the one bright spot for upper incomers amid a bunch of tax hikes in Obama's budget that he says would pay for breaks for folks in the lower brackets. Among them:

- An increase in the top rate on capital gains and dividends to 20% for the same group hit by the hike in the top two marginal income tax rates.
- Cutbacks on itemized deductions and personal exemptions for these filers. Reductions in both these breaks were set to lapse after 2009, but Obama's proposal would reinstate the squeeze in 2011 for filers in the 36% and 39.6% tax brackets.
- And a cap at 28% on the rate at which itemized deductions cut tax liability. Obama isn't giving up on the idea, despite loud objections from many lawmakers.

For middle and low incomers, new tax breaks would be made

permanent:

- The payroll tax credit, equal to 6.2% of earned income and capped at \$400 for singles and \$800 for married filers, which is scheduled to expire after next year. This year's one time \$250 payment for retirement benefit recipients isn't revived.
- The juicier credit for college expenses that replaces the Hope tax credit through 2010. This credit tops out at \$2,500 a year per student, covering four years of college, not just the first two. Plus, the new tax credit covers the cost of books.
- And enhancements to the earned income tax credit and the child credit.

The Kiplinger Tax Letter, May 15, 2009.

Obama's Budget

Obama's plan for business includes curtailing some breaks. Among them: Write-offs for oil and gas firms, including the domestic production deduction, tax breaks for marginal wells and the election to expense intangible drilling costs.

With LIFO (Last In, First Out method where the most recently purchased items are recorded as sold first) inventory valuation, businesses would be required to change to FIFO (First In, First Out method where the oldest inventory items are recorded as sold first), but the increased tax bill from this switch could be spread evenly over eight years. Also, companies will be allowed to value inventory at the lower of cost or market.

Investment fund managers would get a tax hike for any share of profits taken as compensation—paying tax at ordinary rates instead of capital gains rates. The same for certain securities dealers, who would lose a special tax break that allows 60% of their trading profits to be taxed at long-term capital gains rates.

To help IRS find tax cheats, Obama proposes more information reporting: On payments to corporations, which are now exempt from reporting rules, businesses would have to issue corporations 1099s on

payments over \$600 a year.

Obama wants landlords to issue 1099s to service providers such as plumbers or painters. Folks renting their primary homes for short periods and owners who collect only small amounts of rental income would be exempted.

Filers with foreign accounts, along with a form they file annually, would have to start disclosing their accounts on their returns.

Independent contractors would be subject to tighter rules requiring firms to start withholding on payments if the contractor doesn't provide a valid ID number. Most of Obama's tax hikes stand a decent chance. They raise revenue that will be needed to offset the tax easings he is proposing.

Along with the tightenings, Obama offers two easings for small businesses: Exempting all gain on sales of small business stock held at least five years. Firms would need \$50 million or less in assets. The gain would be free of AMT, too. And making employee leasing firms solely liable for unpaid payroll taxes, letting the employer off the hook in certain situations where the leasing firm erred.

The Kiplinger Tax Letter, May 15, 2009.

Buying a Car

IRS takes a pro-taxpayer view on the sales deduction on new vehicles: **Buyers can deduct the sales tax paid on more than one vehicle** this year, IRS officials say. Although this break applies only to the tax on the first \$49,500 of the cost of the vehicle purchased after Feb. 16, 2009 and before Jan. 1, 2010, IRS will apply this cap to each individual car purchased. So if you buy two cars for \$30,000 apiece, the sales tax paid on both vehicles will qualify for the break.

Make sure you know the rules for this deduction to take full advantage: If you don't itemize, you add the sales tax on the vehicle to your standard deduction. If you itemize and deduct state income taxes, you get to deduct the sales tax paid on a qualifying vehicle in addition to your other itemizations. But if you itemize and elect to deduct sales taxes in lieu of income taxes, you don't get any extra break since you'd already be claiming the vehicle's sales tax. This break starts phasing out for married couples with AGIs over \$250,000 and singles with AGIs over \$125,000.

The Kiplinger Tax Letter, May 15, 2009.

Real Estate

If you're filing an amended '08 return for the first time home buyer credit, IRS will reduce the refund generated by the credit by any unpaid tax debt, just as with any other refund, the agency says in a private ruling. First time buyers can claim the tax credit—10% of the purchase

price, up to a maximum of \$8,000—on amended 2008 returns if they buy a primary home this year before Dec. 1, 2009. And remember, to qualify as a first time buyer, a purchaser must not have owned another principal residence in the United States within the previous three years.

And if you are a first time home buyer who is marrying a homeowner, purchase your marital home before the wedding. Eligibility for the credit is determined when settlement occurs, and the full credit can be allocated to you even if you buy the house in both names. If you wait until after the nuptials to buy, you'll lose the credit if your spouse had another main home in the past three years.

IRS may be allowing many erroneous claims for the home buyer credit, Treasury inspectors say after checking more than 500,000 home buyer credit forms. They found that in nearly 40,000 cases, filers who had deducted mortgage interest, points, property taxes and other homeownership tax breaks in the past three years claimed to be first time home buyers. The Service caught only a few of the scofflaws.

Renting real estate to a corporation you own won't get you a tax break. Any loss from the rental cannot offset your salary from the corporation, the Tax Court says. You cannot escape the passive loss rules by treating the rental and corporation's business as one economic unit. A similar rule applies if the rental is profitable. If you rent property to a closely held corporation in which you work more than 500 hours per year, the rental income cannot be used to offset your passive losses from other activities.

The Kiplinger Tax Letter, May 1, 2009.

Energy

Making energy saving improvements to your principal residence? IRS is giving you a temporary break. The economic stimulus law approved earlier this year not only increased several credits for energy savings but also toughened the standards for improvements needed to qualify for the credits. However, since the Revenue Service hasn't issued guidance on those new standards, taxpayers can rely on manufacturer's certifications under the outdated standards to determine if products such as insulated windows qualify for the tax credit. This year, the credit rate triples to 30% and the \$500 lifetime cap rises to \$1,500 for property put in use in 2009 and 2010. Also, the \$200 cap on windows is nixed.

The tax credit for alternative energy equipment is also much juicier. Solar water heaters, geothermal heat pumps, small wind turbines and the like. The credit is now 30% of the cost of such systems.

The Kiplinger Tax Letter, May 1, 2009.

