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Tax Effects of the Financial Rescue Package

Issue

On Oct. 3, 2008, President George W. Bush signed into law the *Emergency Economic Stabilization Act of 2008* (EESA), the *Energy Improvement and Extension Act of 2008* (EIEA), and the *Tax Extenders and Alternative Minimum Tax Relief Act of 2008* (TEAMTRA).

The EESA allows the U.S. secretary of the Treasury to purchase certain troubled assets from financial institutions and raises the amount of federal insurance for bank deposits from \$100,000 to \$250,000 through Jan. 1, 2010. The EIEA and TEAMTRA extend various tax provisions that have expired or were set to expire in the near future. All three acts are part of Public Law 110-343.

Taxpayers Potentially Affected

The EESA, EIEA, and TEAMTRA affect both corporate and individual taxpayers. The EESA will have the greatest impact on financial institutions and certain homeowners, while the EIEA and TEAMTRA will affect most corporate and individual taxpayers.

Tax Provisions of the *Emergency Economic Stabilization Act of 2008*

- **Tax deduction limitations for participating financial institutions.** The EESA allows the secretary of the Treasury to purchase certain troubled assets from financial institutions. Financial institutions participating in this program are subject to various restrictions, including deduction limits on compensation for executive officers taking unnecessary risks, recovery of any bonus or incentive compensation paid to a senior officer based on materially inaccurate statements of earnings, a prohibition on golden parachute payments or new golden parachute contracts during participation in the program, and the limiting of deductible compensation to \$500,000 for any "covered executives" under Sec. 162(m) of the Internal Revenue Code. Which of the compensation limitations applies depends on whether the Treasury secretary buys troubled assets directly or via auction, how much is purchased, and whether the secretary acquires a meaningful debt or equity position in the financial institution.
- **Gain or loss from sale of Federal National Mortgage Association (Fannie Mae) or Federal Home Loan Mortgage Corp. (Freddie Mac) preferred stock.** The EESA allows financial institutions which held preferred stock in either Fannie Mae or Freddie Mac on Sept. 6, 2008, or which sold such stock after Dec. 31, 2007, and before Sept. 7, 2008, to treat gain or loss from the sale as ordinary. The legislation gives the Treasury secretary the authority, but not the obligation, to extend ordinary treatment of these stocks to certain other situations, such as if the financial institution were a holder of auction-rate securities for which these preferred stocks were the underlying asset.

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- **Home mortgage debt forgiveness.** Under the *Mortgage Forgiveness Debt Relief Act of 2007* (MFDRA), taxpayers may exclude up to \$2 million of mortgage debt forgiveness on their principal residence from gross income. (Home equity loans do not qualify for this relief.) The indebtedness must be discharged on or after Jan. 1, 2007, and before Jan. 1, 2010. The EESA extends this provision for three years. As a result, indebtedness discharged after Dec. 31, 2006, and before Jan. 1, 2013, may be excluded from the taxpayer's gross income.

Tax Provisions of the *Energy Improvement and Extension Act of 2008*

- **Renewable energy tax credits.** The EIEA extends the availability of a tax credit for electricity generated by certain renewable power sources. The tax credit for energy generated by a wind or refined-coal facility is extended to facilities that are placed in service by Jan. 1, 2010. The tax credit for energy generated by an open-loop or closed-loop biomass facility, a geothermal or solar energy facility, a small irrigation power facility, a landfill gas facility, a trash combustion facility, or a qualified hydropower facility is extended to facilities placed in service by Jan. 1, 2011. The act also modifies the definitions of refined coal, qualified hydropower, and biomass facilities. In addition, the EIEA includes a new tax credit for the production of marine and hydrokinetic renewable energy and for the production of steel industry fuel.
- **Energy tax credits.** The EIEA extends the availability of an energy investment tax credit for any qualified solar-energy, fuel-cell, or microturbine property to be placed in service by Dec. 31, 2016 (Jan. 1, 2017, for solar-energy property). The limitation on the tax credit for fuel-cell property is also increased. A tax credit is added for combined heat and power system property placed in service by Jan. 1, 2017. The EIEA also permits the energy investment tax credits to be used against alternative minimum tax.

In addition, the EIEA creates two new tax credits for certain small wind-energy property and geothermal heat pumps. The act also extends through Dec. 31, 2016, a tax credit available to individuals for residential energy-efficient property (including solar electric property, qualified residential wind property, and geothermal heat pumps).

- **Bonus depreciation.** The EIEA expands the first-year bonus depreciation deduction to include qualified cellulosic biofuel plant property. Originally, taxpayers could claim only the first-year bonus depreciation deduction on qualified cellulosic biomass ethanol plant property. Cellulosic biofuel includes any liquid fuel that is produced from lignocellulosic or hemicellulosic matter.
- **Alternative fuels tax credit.** A credit enacted by Congress in 2005 of 50 cents per gallon for alternative fuels sold or consumed for business purposes was set to expire on Sept. 30, 2009. The EIEA increases this tax credit to \$1 per gallon and extends it through Dec. 31, 2009. The act also increases from 50 cents to \$1 the tax credit available for biodiesel and renewable diesel fuels produced for sale or use by the taxpayer and extends the credit's availability through Dec. 31, 2009.
- **Alcohol fuels tax credit.** The EIEA limits the alcohol fuels tax credit to alcohol fuels produced within the United States for use as fuel within the United States.
- **Tax credit for qualified plug-in electric drive motor vehicles.** The EIEA creates a dollar-for-dollar tax credit for taxpayers purchasing a qualified plug-in electric drive motor vehicle placed into service after Dec. 31, 2008. The credit is equal to \$2,500 plus \$417 for each kilowatt-hour of traction battery capacity in excess of four kilowatt-hours. The credit, based on the weight of the vehicle, is limited. The credit will begin to phase out once 250,000 qualified plug-in electric drive motor vehicles are sold for use in the United States.
- **Alternative fuel vehicle refueling property tax credit.** Taxpayers are allowed an income tax credit equal to 30 percent of the cost of any qualified alternative fuel vehicle refueling property placed in service during the taxable year. The credit is

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generally the smaller of 30 percent of the property's cost or \$30,000 for property subject to depreciation. All other property is limited to an income tax credit of \$1,000. The credit is available for property placed in service on or after Jan. 1, 2006, and before Dec. 31, 2009. The EIEA extends this credit for one year for property placed in service by Dec. 31, 2010. The act also includes electricity under the definition of clean-burning fuels.

- **Fringe benefits for bicycle commuters.** Beginning Jan. 1, 2009, employers will be able to provide employees who commute via bicycle a fringe benefit not required to be included in their gross income. The amount of the fringe benefit is limited to \$20 per month per employee of bicycle commuting – that is, any month during which an employee regularly uses a bicycle for a substantial portion of the travel between his or her principal residence and place of employment.
- **Commercial buildings deduction.** Businesses are eligible for an immediate deduction of expenses attributable to qualified energy-saving improvements to commercial buildings. The maximum deduction is limited to \$1.80 per square foot of the building on a lifetime basis, but a partial deduction might be allowed if a separate building system meets the requirements but the overall building does not. The EIEA extends the deduction for four years. To qualify for the credit, the energy-saving improvements must be installed after Dec. 31, 2005, and before Jan. 1, 2014.
- **New home construction credit.** Contractors are eligible for a credit for each energy-efficient home they construct. The amount of the credit is determined by which energy-saving requirement is met. If the new construction reduces the annual heating and cooling energy consumption by 50 percent (and 20 percent of this reduction is attributable to improvements in the building envelope), the contractor is eligible for a \$2,000 credit per qualified home, to be used against the contractor's tax liability. If the new construction reduces heating and cooling consumption by 30 percent or meets other requirements established by the U.S. Environmental Protection Agency, the contractor is eligible for a \$1,000 credit per qualified home constructed. The credit, set to expire on Dec. 31, 2008, is extended for one year for homes constructed through Dec. 31, 2009.
- **Credit for carbon dioxide sequestration.** The EIEA creates a new tax credit for capturing and sequestering carbon dioxide emissions. The tax credit is equal to \$20 per metric ton of carbon dioxide captured and disposed of by the taxpayer. A reduced credit of \$10 per metric ton is available to taxpayers that capture carbon dioxide and use the carbon dioxide as a tertiary injectant in a qualified enhanced oil or natural gas recovery project. To qualify for the credit, the taxpayer must capture at least 500,000 metric tons of carbon dioxide.
- **Accelerated depreciation for qualified reuse and recycling property.** The EIEA permits an additional 50 percent of depreciation for qualified reuse and recycling of property for which original use begins with the taxpayer, that has a useful life of at least five years, and that is placed into service after Aug. 31, 2008. Such property includes any machinery and equipment (not including buildings or real estate) used exclusively to collect, distribute, or recycle qualified reuse and recyclable materials. This provision does not expire.
- **Domestic production activities deduction.** Taxpayers with qualifying manufacturing activities are permitted a deduction of up to 9 percent of taxable income for domestic production. For any taxable year beginning on or after Jan. 1, 2009, the EIEA reduces this deduction for taxpayers with income from oil-related qualified production activities.
- **Broker reporting.** Stockbrokers are generally required to provide certain information to the Internal Revenue Service (IRS) relating to sales of stock held in brokerage accounts. The EIEA requires brokers to include the customer's adjusted basis and compute whether any gain or loss is short-term or long-term for covered securities acquired on or after Jan. 1, 2011, for corporate stock; Jan. 1, 2012, for stock for which an average basis method is permissible; or Jan. 1, 2013, for any other securities. Transfers of stock to a broker will require furnishing a statement to that broker as prescribed by regulations to be established by the Department of the Treasury.
- **Federal Unemployment Tax Act (FUTA) taxes.** The EIEA extends a 2 percent surtax on FUTA taxes through 2009. Therefore, for wages paid during 2009, the FUTA tax rate is 6.2 percent on the first \$7,000 of an employee's taxable income.

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Provisions of the *Tax Extenders and Alternative Minimum Tax Relief Act of 2008*

- **Research credit.** The TEAMTRA extends the research and experimentation credit – which had expired Dec. 31, 2007 – retroactively for research expenditures incurred through Dec. 31, 2009. The act also increases the credit rate under the alternative simplified credit from 12 percent to 14 percent for taxable years ending on or after Jan. 1, 2009. Finally, the TEAMTRA terminates the alternative incremental credit for taxable years beginning after Dec. 31, 2008.
- **Alternative minimum tax (AMT).** Over the past few years, Congress has passed several laws to provide limited AMT relief to individual taxpayers by increasing their AMT exemption amounts. All of this relief expired, however, with the close of the 2007 calendar year; therefore, Congress has been attempting to pass legislation to limit the impact of the AMT in tax years after 2007. The TEAMTRA provides some limited AMT relief.

First, the TEAMTRA extends the ability to use nonrefundable personal credits to offset AMT through the 2008 tax year. Second, for years beginning in 2008 and through 2012, the amount of refundable long-term unused AMT credits is increased to the greater of either 50 percent of the long-term unused AMT credit or the amount of the AMT refundable credit for the current taxable year. The TEAMTRA eliminates a phaseout of the use of long-term unused AMT credit – that is, credit generated more than three years before the current tax year – which was in place for high-income taxpayers. Third, the TEAMTRA abates any underpayment interest and penalties for amounts outstanding as of Oct. 3, 2008, for a tax year ending before Jan. 1, 2008, in which the exercise of incentive stock options caused an AMT tax liability. If that taxpayer has already paid interest and penalties for tax years ending before Jan. 1, 2008, 50 percent of the amount of interest and penalties will increase their AMT credit carryforward. Fourth, the TEAMTRA provides a limited one-year increase in the AMT exemption amount, as indicated here:

Taxpayer	AMT Exemption Amount (2008)
Married Filing Joint	\$69,950
Individual/Head of Household	\$46,200
Married Filing Separately	\$34,975

- **State and local sales tax deduction.** The *American Jobs Creation Act of 2004* provided taxpayers with an itemized deduction for state and local sales taxes. The TEAMTRA extends this deduction – which had expired on Dec. 31, 2007 – retroactively through 2010.

Taxpayers may calculate their deduction by accumulating actual receipts throughout the year or by using optional sales tax tables provided by the IRS, in IRS Publication 600.

- **Education deductions.** The above-the-line higher education tuition deduction, which expired at the end of 2007, is extended retroactively through Dec. 31, 2009. Single taxpayers with an adjusted gross income (AGI) of \$65,000 or less (\$130,000 for joint filers) are eligible for a maximum deduction of \$4,000 in connection with qualified tuition and related expenses. The maximum deduction is reduced to \$2,000 for single taxpayers with an AGI of \$80,000 or less (\$160,000 for joint filers).

In addition, teachers and other educators will be able to continue deducting \$250 of out-of-pocket expenses per year through Dec. 31, 2009.

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- **Standard deduction for property taxes.** The *Housing Assistance Tax Act of 2008* created a standard deduction for state and local real property taxes paid by individuals who do not itemize deductions on their Form 1040, "U.S. Individual Income Tax Return." This deduction is limited to \$500 (\$1,000 for married couples filing jointly). The TEAMTRA extends this standard deduction, which was set to expire in 2008, through Dec. 31, 2009.
- **Charitable donations.** The *Pension Protection Act of 2006* allowed qualified taxpayers to donate \$100,000 of taxable individual retirement account distributions per year to qualified charities tax-free through Dec. 31, 2007. The TEAMTRA extends this provision retroactively through Dec. 31, 2009.
- **New markets tax credit (NMTC).** Since inception, including the pending 2008 allocations, the NMTC program has awarded tax credits to be taken on up to \$28.5 billion of investment in qualifying businesses located in low-income communities. The TEAMTRA extends the program for one year to allow community development entities to apply for 2009 credit allocations on an additional \$3.5 billion in investment.
- **Qualified leasehold and restaurant improvements.** Prior law had established a 15-year recovery period for certain leasehold and restaurant improvements. The recovery period was due to revert back to 39 years at the end of 2008. The TEAMTRA extends the 15-year recovery period for improvements placed in service before Jan. 1, 2010. In addition, the act extends the 15-year recovery period to certain improvements made to retail space.

To qualify as leasehold improvement property, the improvements must be made by the lessor or lessee to an interior portion of nonresidential real property. Generally, structural improvements will not qualify for the 15-year recovery period. For restaurant improvements to qualify, the improvements must be made in a building where greater than 50 percent of the space is used to prepare meals or consume the prepared meals. For retail improvements to qualify, the improvements must be made in a building that is open to the general public and used in the retail trade or business of selling tangible personal property to the general public.

Finally, the qualified improvements must be placed into service more than three years after the building was first placed in service. The property is not eligible for first-year bonus depreciation. Taxpayers making improvements to leased real estate should determine if the property qualifies for the accelerated recovery period.
- **Other credits.** The TEAMTRA extends several additional credits. The mine rescue training team credit, the Indian employment credit, the railroad track maintenance credit, the work opportunity tax credit for employees of certain businesses affected by Hurricane Katrina, the possessions tax credit for American Samoa (for existing claimants), and the increased rehabilitation credit for structures in the Gulf Opportunity Zone are all extended through 2009. The railroad tax maintenance credit is also permitted as a credit against AMT. The refundable amount of the child tax credit is also increased under the TEAMTRA.
- **Other incentives.** The TEAMTRA extends several additional existing tax incentives. The election to expense advanced mine safety equipment is extended through Dec. 31, 2009. Environmental remediation costs may continue to be expensed through Dec. 31, 2009. The election to expense qualified film or production costs is extended through Dec. 31, 2009. The provision to use a seven-year cost recovery period for sports racing-track facilities is retroactively extended for property purchased and placed in service through Dec. 31, 2009. A five-year depreciation period is permitted for certain farming machinery and equipment placed in service on or after Jan. 1, 2008, and before Jan. 1, 2010. The enhanced deduction for qualified computer contributions, the enhanced deduction for charitable contributions of book inventory, and the enhanced deduction for charitable contributions of food inventory are also extended through Dec. 31, 2009. The domestic production deduction is available for manufacturing activities in Puerto Rico through Dec. 31, 2009.
- **Preparer standards.** The *Small Business and Work Opportunity Tax Act of 2007* revised the penalties applicable to

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preparers in several ways. Significantly, the act changed the standard by which preparers could avoid preparer penalties for undisclosed positions claimed on a tax return to being “more likely than not” (that is, having at least a 50 percent chance of succeeding on audit). In order for taxpayers to avoid penalties, undisclosed positions need to have only “substantial authority” (that is, have a 40 percent chance of succeeding on audit). TEAMTRA reduced the standard to avoid tax preparer penalties to substantial authority so that it would match the standard for taxpayers.

- **Disaster relief.** In light of the Midwestern flooding, Hurricane Ike, and Hurricane Gustav in 2008, Congress has provided several provisions for tax relief. The provisions for the Midwestern disaster area reflect many of the provisions enacted following Hurricane Katrina, including expensing for environmental remediation and demolition costs, enhanced depreciation for qualified disaster area property, education and housing tax benefits, a \$500 exemption for persons providing shelter for victims during 2008 and 2009, and an increased charitable mileage rate. The TEAMTRA also established a worker retention credit for the Midwestern flooding victims of 40 percent of up to the first \$6,000 paid to employees in an affected area through Jan. 1, 2009. The provisions for Hurricane Ike and Hurricane Gustav are more limited, generally authorizing temporary tax-exempt bond financing and adding some low-income housing relief.

In addition, the TEAMTRA created several new incentives for qualified disaster losses, which are generally losses incurred in a location declared a disaster area by the president. These provisions include, among other items:

- A five-year net operating loss carryback for qualified disaster losses incurred on or after Jan. 1, 2008, and before Jan. 1, 2011;
- Fifty percent bonus depreciation and increased small-business expensing (applicable expensing amount is increased by \$100,000 and phaseout is increased by \$600,000) for qualified disaster assistance property purchased on or after Jan. 1, 2008, and before Jan. 1, 2010;
- Demolition and other costs related to qualified disaster losses are fully deductible for qualified disaster expense; and
- Personal casualty losses occurring in a federally declared disaster zone during 2008 or 2009 are fully deductible (that is, can also be claimed by individuals not itemizing deductions).

For further information on the disaster relief provisions included in the new legislation and to identify locations included in the qualified disaster areas, please refer to the IRS Web site at www.irs.gov/newsroom/article/0,,id=108362,00.html.

- **Foreign provisions.** The TEAMTRA extended the Subpart F exceptions for active banking, financing, and insurance income through Dec. 31, 2009. The look-through rules for payments between related controlled foreign corporations under the foreign personal holding company rules were also extended through 2009. The withholding tax exemption for certain regulated investment companies paying interest-related dividends and short-term capital gains to foreign individuals and corporations was extended through 2008 and 2009.

A foreign corporation is generally indifferent about when a deduction is received for deferred compensation of U.S. employees. To ensure employees cannot abuse this indifference by improperly deferring the receipt of compensation, the TEAMTRA requires compensation deferred under a nonqualified deferred compensation plan to be included in gross income when there is no substantial risk of forfeiture.

As you review the changes made to federal tax law as a result of this new legislation, please be aware that tax incentives reducing your federal taxable income might not be allowable when computing your state taxable income. Many states have tax laws that do not automatically incorporate changes to federal legislation and could result in differences between your state and federal taxable income.

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Contact Information

If you have any questions, comments, or concerns about the *Emergency Economic Stabilization Act of 2008*, the *Energy Improvement and Extension Act of 2008*, or the *Tax Extenders and Alternative Minimum Tax Relief Act of 2008*, contact David Holets in Crowe's National Tax office at 317.706.2683 or david.holets@crowehorwath.com.

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