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CLIENT ALERT

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008

Congress passed and the president signed the bill into law October 3, 2008. In addition to the major tax provisions that directly address current financial bailout measures, the new law includes an Alternative Minimum Tax (AMT) patch, an extensive package of tax extenders, energy incentives, disaster relief, etc. Although the new law's primary purpose is to solve the credit crunch in the financial markets, it also is one of the largest tax bills in recent years. The new law makes almost 300 changes to the Internal Revenue Code and provides taxpayer relief immediately in 2008 and 2009. Consequently, year-end tax planning takes on a special urgency this year to maximize your use of these new tax breaks both before 2008 ends and immediately at the start of 2009.

FINANCIAL MARKETS RESCUE PLAN

The financial markets rescue plan, Troubled Assets Relief Program (TARP), includes three major tax related provisions. TARP has two tracks; the direct purchase program and the auction program. The new law authorizes the government to make direct purchases of troubled assets. Alternatively, the government may acquire them through auction purchases.

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- **Executive Compensation**

In a direct purchase situation, compensation standards will be set by the Treasury Department. The rescue package also limits the deductibility of compensation under Code Sec. 162(m) to \$500,000 for CEOs, CFOs, and other executives of qualifying companies participating in TARP auctions, if the company has sold \$300 million or more in assets. Also, companies participating in TARP auctions must agree to limit golden parachutes payments; any amounts above that amount will be subject to an excise tax. In a direct-purchase situation, golden parachutes are prohibited. The government may also recover a bonus or other incentive paid to a senior executive of a company participating in the rescue package that had been paid based on statements of earnings, gains or other criteria that later are shown to be materially inaccurate.

- **Fannie and Freddie Stock Losses**

Community banks and other qualifying financial institutions that hold preferred stock in Fannie Mae and Freddie Mac may treat their Fannie Mae and Freddie Mac losses as ordinary losses. This treatment applies to preferred stock that was held on September 6, 2008 or sold or exchanged on or after January 1, 2008, and before September 7, 2008. This treatment is not available to individuals.

- **Extended Exclusion of Forgiveness of Debt Income for Homeowners**

Normally when a lender forecloses on property, sells the home for less than the borrower's outstanding mortgage and forgives all or part of the excess mortgage debt, the tax code treats the cancelled debt as taxable income to the homeowner. The Mortgage Forgiveness Debt Relief Act, enacted in late 2007, excludes from federal tax those discharges involving up to \$2 million of indebtedness (\$1 million for a married taxpayer filing a separate return) secured by a principal residence and incurred in the acquisition, construction or substantial improvement of the residence. The new law extends this treatment from the end of 2009 through 2012.

AMT PATCH

The Alternative Minimum Tax (AMT) has been "hitting" more and more taxpayer's since it was enacted in 1988. Over the last few years, Congress has been making temporary changes to exclude about 20 million taxpayer's from the law. Under the

new law's "AMT patch" for the 2008 tax year, the AMT exemption amounts are \$69,950 for married couples filing jointly and surviving spouses, \$46,200 for single taxpayers and heads of household, and \$34,975 for married couples filing separately for 2008. Suffice to say, this will help many of our clients. The law involves a complex calculation which we need to do when the return is prepared.

- **Nonrefundable Personal Credits**

The AMT patch allows nonrefundable personal credits to reduce the AMT liability and removes limits in the AMT on taking personal credits against regular tax liability. The personal credits include the dependent care credit and education tax credits. The adoption, child and saver's credit are already allowed in full against the AMT and regular tax.

- **Incentive Stock Options**

The new law provides relief to those high-tech workers and others who were left holding worthless stock options but paid a large tax bill based on AMT calculations when the tech industry collapsed. The new law will abate AMT liability stemming from the exercise of incentive stock options (ISOs) before 2008, effective for any unpaid tax liability on the law's date of enactment. Interest and penalties on the unpaid amounts would also be abated. The law allows all individuals, including those who paid their ISO AMT liabilities, to accelerate the refund of the minimum tax credit that has not been used. The law also increases the minimum tax credit by 50 percent of any interest and penalties paid before the date of enactment.

INDIVIDUAL INCENTIVES

Tax relief for individual taxpayers in the new law primarily comes in the form of a handful of popular "extenders."

- **State and Local Sales Tax Deduction**

The American Jobs Creation Act of 2004 and subsequent legislation allowed individuals to deduct state and local general sales taxes in lieu of state and local income taxes. This deduction expired at the end of 2007. The new law makes the deduction retroactive for 2008 and extends it for two years through December 31, 2009.

- **Higher Education Tuition Deduction**

The new law extends through December 31, 2009, the above-the-line higher education tuition deduction. The deduction allows eligible taxpayers to deduct the costs of qualified higher education expenses paid during the year for themselves, a spouse, or a dependent in lieu of claiming the Hope Credit or Lifetime Learning Credit. The deduction continues to be barred to taxpayers whose filing status is married filing separately, or if another person can claim an exemption for the taxpayer as a dependent on his or her tax return. The maximum deductible amount is \$4,000 for taxpayers with adjusted gross income not exceeding \$65,000 (\$130,000 for joint filers). Taxpayers whose income exceeds these limits but does not exceed \$80,000 (\$160,000 for joint filers) may deduct up to \$2,000 in qualified expenses.

- **Additional Standard Deduction Real Property Taxes**

The new law extends through 2009 the additional standard deduction for real property taxes for non-itemizers. Congress authorized a maximum \$500 additional standard deduction (\$1,000 for joint filers) in the Housing Assistance Tax Act of 2008, but made it available only for the 2008 tax year. The deduction is in addition to the standard deduction. For 2008, the \$10,900 standard deduction for joint filers will increase to a maximum of \$11,900 with the additional standard deduction. The \$5,450 standard deduction for single individuals will increase to a maximum \$5,950, and the head-of-household amount from \$8,000 to \$8,500.

- **Teachers' Classroom Expense Deduction**

For 2008 and 2009, teachers and other education professionals can deduct, above-the-line, up to \$250 of certain out-of-pocket classroom expenses, including the cost of books, supplies, equipment, and software used in the classroom. This deduction is available to qualified educators regardless of whether they itemized their deductions. Expenses that exceed \$250 and non-classroom supplies may be deducted as an employment-related miscellaneous itemized deduction subject to the two-percent floor for taxpayers who itemize.

- **Tax-Free Distributions from IRAs for Charitable Purposes**

The new law permits taxpayers to make tax-free distributions from IRAs for charitable purposes through December 31, 2009. This charitable contribution option expired January 1, 2008. The maximum contribution limit for 2008 and again for 2009 is \$100,000. This treatment applies to traditional and Roth IRAs. However, no charitable deduction is allowed for any portion of these withdrawals that would have been otherwise taxable. This provision can be very beneficial to “charity minded” individuals who have an IRA and are required to take minimum distributions.

- **Child Tax Credit**

The new law enhances the child tax credit. The credit is currently refundable to the extent of 15 percent of the taxpayer’s earned income in excess of approximately \$12,050 (reflecting inflation adjustments from the original floor of \$10,000). Under the new law, the floor falls to \$8,500.

BUSINESS TAX INCENTIVES

The new law includes incentives targeted to businesses, which revise as well as extend tax benefits.

- **Research Tax Credit**

The new law extends the research tax credit to amounts paid or incurred in 2008 and 2009. It also modifies the credit, increasing the alternative simplified credit while repealing the alternative incremental research credit. The alternative simplified credit was 12 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding tax years. The new law raises the percentage to 14 percent and makes some technical corrections.

- **Leasehold and Restaurant Improvements**

Under the new law, qualifying restaurant improvements and leasehold improvements will be eligible for 15-year cost recovery rather than a 39-year period for two more years, through December 31, 2009. Similarly, Congress authorized a 15-year recovery period for depreciation of certain improvements to retail space. This treatment is extended through December 31, 2009. The treatment applies to both

owner-occupied businesses and restaurants, as well as leased establishments.

- **Charitable Contributions**

The Tax Code gives businesses enhanced deductions for contributions of food to charitable organizations, as well as contributions of books and computer equipment to qualifying schools. The new law extends these tax breaks through December 31, 2009. Additionally, Congress extended the temporary suspension of limitations on charitable contributions in the case of a qualified farmer or rancher contributing food before January 1, 2009. S corp shareholders are also eligible for special tax treatment when making charitable contributions of qualifying property. The new law extends the special rule allowing S corp shareholders to take into account their pro-rata share of charitable deductions even if such deductions would exceed such shareholder's adjusted basis in the S corp through December 31, 2009.

- **New Markets Tax Credit**

The new law extends the New Markets Tax Credit through December 31, 2009. The New Markets Tax Credit is one of the few incentives in the Tax Code to encourage taxpayers to invest in or make loans to small businesses in economically distressed areas. In today's credit crunch, extension of the New Markets Tax Credit may help small businesses secure financing that otherwise would not be available.

- **Hurricane Katrina Relief**

Congress previously passed a package of tax incentives to help individuals and businesses recover from the hurricane. One provision enhanced the Work Opportunity Tax Credit for Hurricane Katrina-affected employers. The new law extends this provision through 2009. Another Katrina-related incentive, the increased rehabilitation credit for structures in the Gulf Opportunity Zone, is also extended through 2009.

ENERGY

The new law extends various energy tax incentives for consumers, producers, and manufacturers.

- **Energy Efficiency and Property**

The new law extends several energy-efficiency and energy property tax incentives. The Code Sec. 179D deduction for energy efficient commercial buildings is extended through December 31, 2013. The Code Sec. 25D residential energy efficient property credit is extended through December 31, 2016, along with adding incentives for residential small wind investment and geothermal heat pumps and authorizing taxpayers to use the credit to offset AMT. Congress also reinstated the Code Sec. 25C residential energy property credit for property placed in service in 2009. This energy incentive credit is for the purchase of residential energy property. A credit of up to \$500 is available for non-business energy property that meets the requirements for qualified energy efficiency improvements or qualified residential energy property expenditures. Eligible improvements include insulation materials, exterior windows, including skylights and exterior doors. Additionally, Congress modified the energy efficient appliance credit for manufacturers of qualifying dishwashers, clothes washers, and refrigerators.

- **Renewable Energy**

Included in the new law are several extended incentives to encourage the production of renewable energy. Congress extended the credit for producing electricity from qualified wind facilities through December 31, 2009, and the credits for producing electricity through biomass and other qualifying renewable sources through September 30, 2011. The credit for solar energy, fuel cell, and microturbine property is extended through December 31, 2016. The new law expands the definition of some of the renewable energy sources, such as biomass, enabling more producers to qualify for the tax incentives. To close a loophole, biodiesel fuel that is imported and immediately sold for export is ineligible for the tax incentive retroactive to May 15, 2008.

- **Bicycle Transportation Fringe Benefit**

Employees can exclude certain employer-provided transportation fringe benefits from income, such as transit passes and van pooling. The new law extends this treatment to employer-provided

transportation fringe benefits paid to employees who commute by bicycle. The exclusion amount is \$20 per month. This treatment is effective for tax years beginning after December 31, 2008.

- **Other Energy Incentives**

- Coal gasification investment credit
- Clean renewable energy bonds
- Steel industry fuel
- Alternative fuels credit
- Alternative refueling stations credit
- Percentage depletion for marginal wells
- Refinery expensing
- Excise tax on coal to fund Black Lung Disability Trust
- Plug-in electric drive vehicles
- Non-hydrogen alternative fuel refueling property

Congress also authorized a refund of coal excise taxes that the Internal Revenue Service collected from exporters, which the Supreme Court has deemed unconstitutional.

DISASTER RELIEF

The new law provides temporary, but significant, tax relief to victims of the severe storms, tornadoes, and flooding that swept through the Midwest in 2008 and – to a lesser extent – victims of Hurricane Ike in Texas. Additionally, Congress authorized national relief for locations declared disaster areas by the president in tax years beginning after December 31, 2007, with some exceptions. The Midwestern Disaster Area encompasses presidential declared disaster areas in Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin between May 20, 2008, and before August 1, 2008. The Hurricane Ike Disaster Area encompasses parts of Louisiana and Texas, which were declared disaster areas by the president on September 13, 2008.

- **Midwestern Disaster Area**

The tax incentives in the Midwestern Disaster Area mirror many of the ones enacted in 2005 after Hurricanes Katrina, Rita, and Wilma devastated the Gulf Coast. These include increased expensing for demolition, environmental remediation, and clean-up costs, enhanced depreciation for qualified disaster property, education, and housing tax benefits, and a higher standard mileage rate for charitable use of vehicles.

- **Hurricane Ike Disaster Area**

The incentives targeted to the Hurricane Ike Disaster Area are much more limited than the incentives for the Midwestern Disaster Area. Congress authorized temporary tax-exempt bond financing and low-income housing tax relief for certain areas damaged by Hurricane Ike.

- **National Disaster Relief**

Taxpayers affected by natural disasters (after December 31, 2007, and before January 10, 2010, with some exceptions) may be eligible for increased expensing for qualified disaster expenses, special depreciation for qualified disaster property, enhanced NOL carryback, and other targeted tax breaks.

RETURN PREPARER STANDARD

The Small Business and Work Opportunity Tax Act of 2007 (2007 Small Business Tax Act) replaced the “realistic possibility of success standard” in Code Sec. 6694(a) with the heightened “more likely than not standard” for undisclosed, nonabusive positions. The new law removes the “more likely than not” language under Code Sec. 6694(a) and replaces it with substantial authority. This change is retroactive to the effective date of the 2007 Small Business Tax Act. The Internal Revenue Service was expected to issue final regulations reflecting the “more likely than not standard” under Code Sec. 6694(a) before the end of 2008. However, the new law essentially makes these regulations unnecessary. The new law retains the “more likely than not standard” for tax shelters and reportable transactions.

TAX REVENUE RAISER

The new law includes more than \$43 billion in revenue raisers.

- **Broker Basis Reporting**

Reporting by brokers has been expanded. Brokers must report the adjusted basis of publically-traded securities when reporting sales transactions and indicate whether gain is long-term or short-term. Securities subject to the new reporting requirement include stock, bonds, debentures, commodities, derivatives, and other financial instruments designated by Treasury. Reporting will take effect for stock acquired in 2011, mutual funds acquired in 2012, and other securities acquired in 2013. The provision is estimated to raise \$6.7 billion over 10 years. Brokers will use the first-in, first-out (FIFO)

method or the average cost method to determine basis, unless the taxpayer provides specific identification of the securities being sold.

- **Foreign Deferred Compensation**

Nonqualified deferred compensation plans maintained by foreign corporations will generally become taxable, unless the compensation is deferred 12 months or less after the end of the year that the compensation vests. The tax can also apply to partnerships with foreign partners. Deferred compensation will be taxable when the amount is determinable. If the compensation is not determinable when it is deferred, the individual must pay a 20 percent surtax, plus interest, when the amount is determinable. The law applies to compensation for services performed after 2008 and is expected to raise \$25 billion. This provision is aimed at compensation schemes for executives who are paid by an entity that is located in a low-or-no-tax jurisdiction and is “indifferent” to the arrangement because it is not losing a deduction when it defers the income. The provision does not apply to an entity whose income is taxable in the U.S. or subject to “comprehensive foreign income tax.”

- **Code Sec. 199 Deduction**

Under the new law, the Code Sec. 199 domestic production activities deduction is capped at six percent for oil and gas production. The limit applies to “oil-related qualified production activities income (QPAI).” This includes income from the production, refining, processing, and transportation or distribution of oil or gas, or any primary product of oil and gas. The cap is expected to raise \$4.9 billion over 10 years. The deduction for all eligible taxpayers is currently six percent of QPAI. The deduction is scheduled to increase to nine percent in 2010 for all taxpayers except for taxpayers with oil-related QPAI.

- **Foreign Tax Credits**

The law tightens the rules for oil and gas companies to pay taxes on overseas income. It eliminates the distinction between foreign oil and gas extraction income (FOGEI) and foreign oil-related income from transportation and refining and applies the FOGEI foreign tax credit limitation (Code Sec. 907) to income from oil and gas production and sales. The provision takes effect in 2009 and is expected to raise \$2.2 billion over 10 years.

- **Oil Spill Tax**

The oil spill liability trust fund tax has been extended through 2017. The tax will increase from five cents per barrel to eight cents per barrel through 2016 and rises to nine cents in 2017. Congress eliminated the provision that suspends the tax when the trust's unobligated balance reaches \$2.7 billion. The change in treatment takes effect in the first quarter that is more than 60 days after enactment of the law and is expected to raise \$1.7 billion

- **Federal and Unemployment Tax (FUTA) Surtax**

The law extends the 0.2 percent surtax on FUTA (unemployment) taxes for one year, through 2009. FUTA tax is 6.2 percent of the first \$7,000 paid to each employee. The change is expected to raise \$1.5 billion.

October 9, 2008

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