

A quarterly newsletter examining recent tax developments for the business professional.

INDIVIDUAL INCOME TAX CHANGES IN 2010

As a result of various new federal income tax laws, regulations, and other guidance issued in 2009 and over the last few years, many important federal individual income tax law changes go into effect during 2010. These changes impact a wide variety of matters, including the alternative minimum tax, the recapture of the first-time homebuyer credit, and the rules governing casualty loss deductions. Several of the key new individual income tax changes are discussed in detail below.

1. Alternative minimum tax expanded to cover numerous additional taxpayers. To the chagrin of many taxpayers, the alternative minimum tax (“AMT”) exemption for 2010 has been reduced from \$46,700 for single taxpayers (\$70,950 for married filing joint and \$35,475 for married filing separate) in 2009 to \$33,750 for single taxpayers (\$45,000 for married filing joint and \$22,500 for married filing separate) in 2010. Absent Congressional action, the reduction in the exemption amount means that many more individual taxpayers will be subject to the AMT in 2010 than in prior years.

2. AGI-based personal exemption phaseout and itemized deduction reduction eliminated. During the 2010 taxable year, individual taxpayers with higher levels of adjusted gross income (“AGI”) will no longer be subject to a phaseout of their personal exemption or a reduction in their itemized deductions. In 2009 and prior years, taxpayers with AGI in excess of certain threshold amounts were required to reduce the amount of their personal exemption and/or itemized deductions.

3. Recapture of first-time homebuyer credit commences. Taxpayers who claimed a first-time homebuyer credit under Internal Revenue Code (“IRC”) § 36 for homes purchased between April 8, 2008 and January 1, 2009 are required to begin repaying the credit during 2010. The first-time homebuyer credit generally must be repaid in equal installments over a 15-year period, but is accelerated if a taxpayer disposes of the residence or ceases to use the residence as his or her principal residence prior to the expiration of the 15-year recapture period.

4. Relaxed casualty loss rules enacted. In general, individual taxpayers are entitled to claim a personal casualty or theft loss deduction only if the

amount of the casualty or theft exceeds a certain dollar limitation. Likewise, net casualty and theft losses generally may be claimed as itemized deductions only to the extent they exceed 10% of the individual taxpayer’s AGI. However, for 2010, the dollar limitation per casualty or theft has been reduced from \$500 to \$100 and, as previously discussed, individual taxpayers with higher AGI levels will not be subject to a reduction in their itemized deductions in 2010.

5. Carryover basis regime to replace federal estate tax. Due to Congress’ failure to take steps with respect to the repeal of the federal estate tax, the income tax basis rules for property acquired from a decedent are now similar to the gift tax carryover basis rules. For the present time, individuals acquiring property from a decedent generally will acquire the decedent’s basis in the property, rather than the step-up in basis permitted under the prior federal estate tax regime. However, each estate will receive an “extra” \$1.3 million of basis to be added to the carryover basis of the assets held at death and an “extra” \$3 million to be allocated to assets passing to surviving spouses.

6. Required minimum distributions return. Under IRC § 401(a)(9) required minimum distributions must again be made for the 2010 calendar year from IRAs and other employer-provided retirement plans. Required minimum distributions were waived during 2009.

7. End of exclusion for unemployment compensation. During 2009, up to \$2,400 of unemployment compensation benefits were excludable from gross income under IRC § 85(c). However, there is no similar exclusion for unemployment compensation benefits received in 2010.

RECENT HIGHLIGHTS & HOT TOPICS

Recent Highlights & Hot Topics provides a brief summary of the latest breaking tax developments and happenings on a taxpayer-by-taxpayer basis.

INDIVIDUAL INCOME TAX: Currently, taxpayers are entitled to deduct interest expense on two categories of debt secured by their homes: acquisition indebtedness and home equity indebtedness. The amount treated as acquisition indebtedness cannot exceed \$1 million and the amount treated as home equity indebtedness cannot exceed \$100,000. However, in Chief Counsel Advice 200940030, the IRS recently concluded that acquisition indebtedness can also qualify as home equity indebtedness under IRC § 163(h)(3)(C), to the extent that it exceeds \$1 million dollars. As a result, taxpayers can now deduct up to \$1.1 million of the debt securing the purchase of their principal residence.

CORPORATE TAX: Subchapter S corporations may be subject to increased scrutiny by the IRS due to the issuance of a new Government Accountability Office (the “GAO”) report addressing S corporation noncompliance with the federal tax laws. The major issues identified were the misreporting of income and/or expenses, mistakes in calculating shareholder basis, and the failure to pay employees adequate wage compensation. The GAO estimated that 71% of S corporations that used a paid preparer for their returns were noncompliant.

PARTNERSHIP TAX: In Hegarty v. Commissioner, T.C. Summary Opinion 2009-153, the Tax Court once again rejected the IRS’s position that, under the passive activity loss rules, a taxpayer who holds an interest in a limited liability company is a “limited partner” for purposes of the material participation tests. That standard, as interpreted by the IRS, treats losses from a limited partner’s interest in a limited partnership as presumptively passive, unless the limited partner can satisfy one of three of the more stringent material participation tests. The taxpayers in Hegarty were able to establish material participation under a more lenient

test, which only required participation in the business for more than 100 hours per year, and, as a result, were entitled to claim a large loss from their fishing boat charter activity. In a similar case, Thompson v. United States, 104 AFTR 2d 2009-5381 (2009), decided before Hegarty, the IRS acquiesced in result only.

EMPLOYMENT TAX: The U.S. Immigration and Customs Enforcement (“ICE”) Office recently issued Notices of Inspection (“NOI”) to 1,000 employers nationwide. The NOIs alerted employers that ICE will be auditing their hiring records to check compliance with all applicable employment eligibility verification laws. Although the names of the businesses were not released, ICE stated that they were selected as result of investigative leads, intelligence, and the businesses’ connection to public safety and national security.

REAL ESTATE TAX: In Private Letter Ruling 200953005, the IRS ruled that a limited liability company’s indebtedness, collateralized by its ownership interest in a disregarded entity owning real property, was qualified real property business indebtedness (“QRPBI”), eligible for cancellation of indebtedness income exclusion under IRC § 108(a)(1)(D). IRC § 108(a)(1)(D) allows a solvent taxpayer (other than a C corporation) to elect to reduce its basis in its real property instead of recognizing cancellation of indebtedness income on the discharge of indebtedness secured by the real property. QRPBI generally must be incurred or assumed by the taxpayer in connection with real property used in a trade or business and be secured by the real property. PLR 200953005 is significant because the IRS agreed to treat an ownership interest in a disregarded entity that owned the real property as synonymous with the ownership of the real property for purposes of applying the QRPBI exception to the recognition of cancellation of indebtedness income.

Please be advised that this newsletter only provides brief descriptions of tax information of general interest and that any tax information contained herein was not intended and cannot be used for the purpose of: (1) avoiding penalties that may be imposed by the Internal Revenue Service; or (2) supporting, promoting, or marketing any transaction(s) or matter(s) addressed herein.

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