

Impact of inflation adjustments on 2009 tax figures

Dear Reader:

In the next few months, individuals will start thinking about how much tax they'll owe or get back as a refund for 2008, and how their tax picture will change in 2009. Employees soon will be receiving brochures from the benefits departments of their companies calling on them to make different choices for 2009. Some of these choices have tax implications and are impacted by inflation-adjusted tax figures for 2009.

Taking into account the official inflation-indexed figures for 2009, which IRS recently released, this client letter puts together a list of typical questions that clients may have about next year's inflation adjustments to the tax brackets and other items, and provides answers to them. Practitioners can incorporate some or all of the questions and answers into a letter that can be sent to clients as a means of generating goodwill and to give them information that may be helpful in planning for 2009.

Question. *Do the tax rates go down in 2009?*

Answer. No. The tax rates for individuals stay at 10%, 15%, 25%, 28%, 33% and 35% in 2009. There is some tax relief, however, in 2009 in the form of inflation adjustments to the tax brackets and other items.

Question. *How do the inflation adjustments work?*

Answer. The point at which each of the top five tax brackets begins is increased for inflation. This means that, in 2009, more income will be taxed at the 10%, 15%, 25%, 28% and 33% rates than in 2008.

Question. *Are other income tax items adjusted for inflation?*

Answer. There are numerous other income tax items that are adjusted for inflation including, for example, the standard deduction and the personal exemption amount. In 2009, the exemption has increased to \$3,650 (from \$3,500 in 2008). Likewise, the basic standard deduction for a married couple filing jointly is \$11,000 in 2009 (from \$10,500 in 2008). Standard deductions for single taxpayers and other filers also generally will increase for 2009. Note that as a result of the inflation adjustments to the tax brackets, exemption amount, and standard deduction amounts, many taxpayers can receive a modest increase in income in 2009 without being pushed into a higher tax bracket.

Question. *Do all of the items that qualify for adjustments get at least some increase?*

Answer. No, that's because the way in which adjustments are made varies for different items. For example, different items have different rounding mechanisms. Many adjustments are rounded down, which could result in no increase for a particular year.

Question. *What kind of tax savings will be realized in 2009 from the adjustments?*

Answer. Let's look at a two-wage-earner couple with two children. For 2008, they have gross income of \$120,800, \$30,000 of itemized deductions, and taxable income of \$76,800, after taking into account their four \$3,500 (\$3,650 for 2009) personal exemptions. Their tax (before any allowable credits) for 2008 comes to \$11,888. If their

income stays at exactly the same level for 2009, their taxable income will go down to \$76,200, and their tax will go down to \$11,425, for a savings of \$463.

Question. *Do any taxpayers not benefit from inflation adjustments?*

Answer. The AMT can rob individuals of the benefit of inflation adjustments because the AMT is not adjusted for inflation.

Question. *What is the AMT?*

Answer. We actually have two income tax systems—the regular tax and the alternative minimum tax or AMT, which prevents taxpayers from paying too little tax by disallowing or reducing certain deductions and treating as income certain items that are exempt from regular tax. If an individual's AMT exceeds his regular tax, he pays the difference plus his regular tax. So let's say for 2008 an individual's regular tax was \$30,000 and his AMT also was \$30,000. He pays \$30,000 in regular tax. Now, for 2009, inflation adjustments push his regular tax down by \$300. His AMT is still \$30,000, because it's not adjusted for inflation, so he ends up still having to pay \$30,000. In other words, the AMT robs him of the \$300 benefit from the inflation adjustment. Note that the family of four with gross income of \$120,800 from the example above showing the benefit from the inflation adjustments could actually be subject to AMT, depending on the make-up of their itemized deductions and other factors.

Question. *Are the monthly amounts that an employee can exclude from income for transit passes and parking under a company program increased?*

Answer. The 2008 \$115 limit for transit passes will rise to \$120 in 2009. The parking limit will go from \$220 per month in 2008 to \$230 per month in 2009. Employees of companies who offer these benefits can save income tax. In addition, social security taxes can be saved by employees whose wages are not over the social security wage base (\$106,800 for 2009, up from \$102,000 for 2008) and by employers with respect to such employees.

Question. *What other key adjustments are there?*

Answer. There are some other important adjustments that affect individuals with incomes at higher levels. Many tax breaks are reduced or eliminated as income exceeds certain thresholds including, for example, itemized deductions, exemptions, and education tax breaks. These thresholds generally are increased for inflation. For example, itemized deductions will be reduced if 2009 adjusted gross income (AGI) is more than \$166,800 (\$83,400 for married individuals filing separately). For 2008, these figures were \$159,950 and \$79,975. If an individual's AGI is over the threshold amount (\$166,800; \$83,400 for married individuals filing separately), the amount of the itemized deductions otherwise allowed for the tax year is reduced by the lesser of (a) 3% of the excess of AGI over the applicable amount, or (b) 80% of the amount of itemized deductions otherwise allowable for the tax year.

In addition, for 2008 and 2009, the applicable overall limitation on itemized deductions is itself reduced by a third. Thus, the overall limitation amount equals two-thirds of the otherwise applicable limitation amount.

Question. *What can be done to avoid losing tax breaks when income starts approaching the thresholds at which tax breaks are reduced or eliminated?*

Answer. Individuals whose income is close to the threshold amount for a particular item may be able to take some steps to keep income below the threshold. A couple may know they are going to be over next year but may be able to keep below the threshold this year by taking certain steps. For example, it may be possible to reduce this year's income by pushing a bonus into next year, moving money from taxable interest bearing accounts to tax-exempt accounts, increasing 401(k) and IRA contributions, and selling stock at a loss. An individual who would be over the limit this year but who might not be next year, should consider the opposite type of planning moves, i.e., accelerating income into this year and deferring above-the-line deductions until next year.

Question. *What do the adjustments all mean for individuals?*

Answer. The inflation increases are low and thus the tax savings from the adjusted figures are low. Individuals can't figure on a whole lot of savings next year from the inflation adjustments. However, as a result of recent tax law changes, there are several steps that individuals can take to reduce their tax bill this year and next year, including the following:

Shift investments that produce ordinary income into stock or mutual funds because capital gains and qualified dividends are taxed at a maximum rate of 15%.

Place up to \$2,000 in a Coverdell education savings account (formerly education IRA) for a child or grandchild.

Make an up-to-\$5,000 annual contribution to an IRA (an additional \$1,000 can be contributed by qualifying individuals age 50 and over).

Make the maximum contribution that you can afford to a company 401(k) plan.

The limit is \$16,500 for 2009. Employers can allow those 50 or over to contribute an additional \$5,500.

Get tax-free reimbursements of over-the-counter drugs from your employer's health care flexible spending account.

Take advantage of the maximum lifetime learning credit, which is now \$2,000.

If you are a self-employed individual, you can deduct 100% of the amount you pay for medical care insurance for yourself, your spouse and your dependents.