Taxpayers May Request Waiver of Underpayment of Estimated Tax Penalty from MWPC

The IRS recently announced that taxpayers may request waiver of the penalty for underpayment of estimated tax resulting from the Making Work Pay Credit (MWPC). In certain cases, the MWPC will result in under-withholding and taxpayers would be liable for a penalty for failing to pay estimated tax. In early 2009, the IRS revised the withholding tables to reflect the Making Work Pay credit and instructed employers to start using the new tables as of April 1, 2009. Employees do not have to file a new Form W-4 to claim the Making Work Pay credit. However, individuals with more than one job may need to file a new Form W-4 if they do not want the Making Work Pay credit to reduce their withholding more than their credit.

For tax years beginning in 2009 and 2010, most individuals with earned income can claim a refundable Making Work Pay Credit (MWPC) (Code Sec. 36A). The credit can be claimed against both regular tax liability and alternative minimum tax (AMT) liability (Code Sec. 36A(a)).

Eligible individuals. All individual taxpayers are eligible for the credit, except for:

- a nonresident alien,

- an individual who can be claimed as another taxpayer's dependent for a tax year beginning in the calendar year in which the individual's tax year begins,

- an estate or trust, or

- a taxpayer whose return does not include his or her social security number (SSN) or, on a joint return, an SSN for at least one of the spouses. A taxpayer identification number (TIN) issued by the IRS does not qualify as an SSN for this purpose (Code Sec. 36A(d)(1).

On the one hand, the requirement of a valid SSN limits the MWPC to taxpayers who are legally permitted to work in the U.S. On the other hand the MWPC is generally delivered to taxpayers via reduced tax withholding from their paychecks, rather than in a lump sum from the IRS. This may lessen the impact of the SSN requirement, since employers and withholding agents are generally less rigorous than the IRS in validating SSNs. Finally, the requirement of only one valid SSN on a joint return extends the MWPC to taxpayers who are married to noncitizens, including many diplomats and members of the military who are stationed abroad.

The amount of the MWPC is equal to the lesser of:
(1) 6.2 percent of the taxpayer's earned income (as defined below), or

(2) $400 ($800 for married couples filing joint returns) (Code Sec. 36A(a)).

The MWPC is unavailable for higher-income taxpayers (phase out begins at $75,000 for single taxpayers and $150,000 for joint filers). The credit must be reduced by the amount of the taxpayer’s economic recovery payment or government retiree credit. The MWPC is limited to taxpayers with earned income, while the economic recovery payments and government retiree credits are available to individuals who are eligible for certain governmental benefits and pensions. A failure to reduce the claimed MWPC by the amount of the taxpayer's economic recovery payment or government retiree credit is a mathematical or clerical error on the return, which allows the IRS to assess any resulting additional tax without using deficiency procedures.

The MWPC effectively eliminates the 6.2-percent employee share of social security tax on about the first $6,450 of a single worker's wages.

Phaseout. The amount of the MWPC (before any reduction for economic recovery payments or government retiree credit) is reduced (but not below zero) by two percent of the taxpayer's modified adjusted gross income (AGI) that exceeds $75,000 (or $150,000 on a joint return)(Code Sec. 36A(b)(1).

For this purpose, modified AGI is the taxpayer's AGI for the tax year, plus any amounts excluded from gross income under Code Sec. 911 (relating to foreign earned income and housing; Code Sec. 931 (relating to income from sources within Guam, American Samoa, or the Northern Mariana Islands); Code Sec. 933 (relating to income from sources within Puerto Rico). Thus, the $400 MWPC is phased out completely at modified AGI of $95,000, and the $800 MWPC on a joint return is phased out at modified AGI of $190,000.

For purposes of the MWPC, earned income is generally defined as it is for purposes of the Code Sec. 32 earned income credit (EIC). Thus, earned income includes taxable compensation from employment, such as wages, salaries and tips. Earned income does not include most nontaxable compensation, amounts received as pensions or annuities, nonresident aliens' income that is not connected with U.S. businesses, amounts earned for services provided by inmates at penal institutions, and workfare payments that are subsidized under a state workfare program (such as Temporary Assistance for Needy Families (TANF)). Net earnings from self-employment are included, but earned income is reduced by any net loss from self-employment (Code Sec. 32(c)(2) and Reg. §1.32-2(c)(2)).

For purposes of the MWPC, however, the definition of "earned income" is modified in two respects:

- Earned income includes amounts excluded from gross income under Code Sec. 112 (relating to compensation received by members of the Armed Forces for active service, or while hospitalized for injuries incurred while serving, in a combat zone) regardless of whether the taxpayer elects to include combat pay in earned income for purposes of the EIC.

- Earned income does not include net earnings from self-employment that are not taken into account in computing taxable income, such as an excludable parsonage allowance (Code Sec. 36A(d)(2)).

Procedure. The MWPC is generally delivered to taxpayers via reductions in the amount of income tax withheld from their paychecks, rather than as a lump-sum credit against their tax liability. As mentioned, the IRS provided withholding tables that incorporate the MWPC, and asked employers to start using them by April 1, 2009. The tables, along with other instructions related to the MWPC, are also incorporated in IRS Publication 15-T (IRS News Release IR-2009-13, Feb. 23, 2009). Although withholding reductions are automatic for most workers, eligible taxpayers still must claim the credit on their tax returns.

For purposes of calculating a deficiency, the MWPC is taken into account as a negative tax (Code Sec. 6211(b)(4)(A).

As discussed above, two MWPC-related mistakes or omissions on a return are treated as mathematical or clerical errors that allow the IRS to assess any resulting deficiencies without using deficiency procedures: failure to reduce the amount of the MWPC by the amount of the taxpayer's economic recovery payment or government retiree credit; and failure to provide a correct social security number for the taxpayer, or for at least one of the spouses on a joint return (Code Sec. 6213(g)(2)(N).

Coordination with government benefits. For purposes of determining any individual's eligibility for benefits or assistance, or the amount or extent of benefits or assistance, under any federal program or under any state or local program financed in whole or in part with federal funds, MWP credits and refunds allowed or paid (including credits and refunds under the U.S. possession rules discussed below) are not taken into account as income, or taken into account as resources for the month of receipt and the following two months (P.L. 111-5). Thus, MWP credits and refunds do not count toward or negatively impact an individual's eligibility for income-based government benefits, such as social security benefits, food stamps and other programs.

Termination. The MWPC does not apply in tax years beginning after December 31, 2010.

The MWPC shares several similarities with the Code Sec. 6428 recovery rebate credit, which most taxpayers received in the form of rebates of during 2008. The definition of earned income is the same; the definition of eligible individuals is the same except for the income and tax thresholds that applied to the recovery credit; the effect on eligibility for other government programs is the same; and the provisions governing U.S. possessions are the same.

Waiver of Penalty due to underpayment. . In order for the IRS to consider waiving the penalty for underpayment of tax, the underpayment of tax must have been caused by adjustments to the withholding tables that took effect in spring 2009. To request a waiver, taxpayers should check box A or box B in Part II of Form 2210, Underpayment of Estimated Tax by Individuals, Estates and Trusts. Taxpayers must still make up any shortfall in the actual withholding amounts (2009 Instructions for Form 2210.

2009 Worker, Homeownership and Business Assistance Act

Two popular but temporary tax incentives have been given a new lease on life as part of legislation extending unemployment compensation benefits. The Worker, Homeownership, and Business Assistance Act of 2009, signed into law by President Obama on November 6, 2009, extends those incentives and more.

The first-time homebuyer credit and expanded five-year net operating loss (NOL) carryback, both originally scheduled to expire in 2009, have been extended and enhanced into 2010. Many homebuyers who are not first-timers will now be eligible for a tax credit up to $6,500, with first-time homebuyers qualifying for a maximum $8,000 credit through at least April 30, 2010. Similarly, nearly all businesses will be able to take advantage of expanded NOL carryback treatment for either 2008 or 2009 NOLs. The new law also excludes from income qualified military base closure payments.

The availability of quick refunds from 2008 and 2009 NOL five-year carrybacks will mean a huge boost to businesses trying to survive the short term. The housing industry also hopes that the homebuyer credit will continue home sale traffic and bridge the gap between slow winter sales and what is hoped will be a more robust spring market.

To pay for all this, the new law requires electronic filing of individual returns by all but the smallest return preparers, delays implementation of worldwide interest allocation, increases the penalties for failing to file partnership and S corporation returns, and accelerates estimated tax payments for certain large corporations.

The new law also extends unemployment benefits by up to 14 weeks (with six additional weeks for individuals in states with high unemployment). However, it does not extend the existing temporary exclusion from gross income of the first $2,400 of unemployment benefits received in 2009. The extended unemployment benefits are paid for by keeping the FUTA surtax.

First-Time Homebuyer Credit

When originally enacted, the first-time homebuyer credit reached 10 percent of the purchase price of a qualified residence (for a maximum credit of $7,500) and was repayable in equal installments over 15 years. Congress subsequently raised the credit to a maximum to $8,000, set a November 30, 2009 cutoff date, and generally eliminated the repayment requirement.

The new law not only extends the credit, it also extends the credit to higher income taxpayers and allows a reduced credit to some non-first-time homebuyers. The new law also expressly excludes high-end homes from the credit. The availability of the credit for higher-income taxpayers and some existing homeowners will not be applied retroactively. These tax breaks are effective only for purchases made after November 6, 2009.

The first-time homebuyer credit was scheduled to expire after November 30, 2009. The new law provides a new expiration date of April 30, 2010. If a taxpayer enters into a binding contract before May 1, 2010, to close on the purchase of a principal residence before July 1, 2010, the credit will be treated as not expiring until July 1, 2010.

The first-time homebuyer credit may be allocated between two or more unmarried taxpayers using any reasonable method, the IRS explained in Notice 2009-12. For example, the credit may be allocated between unmarried taxpayers based on their respective contributions toward the purchase price of the residence or their respective ownership interests.

Qualified buyers cannot claim both the District of Columbia first-time homebuyer credit and the general first-time homebuyer credit.

To accelerate claims for the credit, the new law allows taxpayers to elect to treat the purchase of a principal residence in 2009 or before the new deadline in 2010 as made on December 31 of the calendar year preceding the purchase. The first-time homebuyer credit is claimed on Form 5405.

In May, the U.S. Department of Housing and Urban Development (HUD) announced that taxpayers could monetize the first-time homebuyer credit. Taxpayers financing through a state housing agency or other HUD-approved advance programs can monetize 100 percent of the down payment. Taxpayers using Federal Housing Administration (FHA) lenders can apply the credit to closing costs or make a larger down payment above the FHA-required 3.5 percent minimum. HUD's authorization for monetizing the credit has no sunset date.

Non-First-Time Buyers

Effective for purchases after November 6, 2009, the credit is no longer restricted to first-time homebuyers. Individuals who the new law refers to as "long-time residents of the same principal residence" may be eligible for a modified credit even though they are not technically first-time homebuyers. The new law treats as a first-time homebuyer an individual who has owned and used the same residence as his or her principal residence for any five-consecutive year period during the previous eight-year period ending with the date on which the new residence is purchased. This provision is aimed not only at individuals who are stepping-up from their first home to a larger and more expensive residence, but also at retirees who are moving to more manageable quarters.

Non-first-time homebuyers will benefit from the credit but at a reduced amount. Their maximum credit will be $6,500 rather than $8,000 ($3,250 for married taxpayers filing separately rather than $4,000).

Income thresholds. Previously, the first-time homebuyer credit phased out for single individuals with modified adjusted gross income (MAGI) between $75,000 and $95,000 and for married couples filing joint returns with MAGI between $150,000 and $170,000. The new law raises the start of the phase-out for single individuals to $125,000 and the start of the phase-out for married couples filing joint returns to $225,000.

Repayment. For principal residences purchased in 2009 and 2010, there is generally no requirement to repay the first-time homebuyer credit. However, a taxpayer may have to repay the credit if the residence ceases to be his or her principal residence within 36 months from the date of purchase. The full amount of the credit the taxpayer received becomes due on the return for the year in which the residence ceases to be the taxpayer's principal residence. Exceptions, such as death, continue to apply.

Purchase price. For the first time, Congress set a ceiling on eligibility for the credit based on the purchase price of the principal residence. No credit is allowed if the purchase price of the principal residence exceeds $800,000.

Service members. The new law waives the credit recapture rules for members of the U.S. uniformed services, Foreign Service, and intelligence community who are called to duty before 36 months after the date of purchase of a principal residence. Additionally, the new law extends the first-time homebuyer credit for individuals on qualified official extended duty outside the U.S. to purchases made before May 1, 2011 (or July 1, 2011, for taxpayers with binding contracts).

Oversight. To curb abuses of the first-time homebuyer credit, the new law gives the IRS math error authority to disallow the credit during processing. The new law also expressly excludes dependents and related parties from claiming the credit. Additionally, the taxpayer (or his or her spouse) must be at least 18 as of the date of the purchase to be eligible. All taxpayers must attach a copy of their settlement agreement to their return.

NOL Carryback

The American Recovery and Reinvestment Act of 2009 (2009 Recovery Act) allowed eligible small businesses (with average gross receipts of $15 million or less) to elect to carryback net operating losses

(NOLs) from 2008 for three, four or five years rather than the standard two years. The new law provides a similar election to all U.S. businesses of every size to carry back NOLs up to five years but with a 50-percent income limit on NOL offsets in the fifth year. The new, expanded election is available for NOLs incurred in either 2008 or 2009, but not for both years. However, an eligible small business that elected under the 2009 Recovery Act to carryback 2008 NOLs may make the election for an additional year, enabling the qualified small business to carryback NOLs from both 2008 and 2009 for up to five years.

This is a major expansion of the NOL rules. The Joint Committee on Taxation (JCT) estimates that the new carryback provisions would cost the federal government and benefit businesses by nearly $34 billion in 2010 (but balancing out to $10.4 billion over 10 years).

50-percent limitation. Under the new law, an NOL carried back to the fifth year before the loss year is limited to 50-percent of the available taxable income for that year. Any remaining NOL can fully offset taxable income in the remaining four carryback years. The 50-percent limitation does not apply to an eligible small business that elected to carry back its 2008 NOL under the 2009 Recovery Act. However, it does apply to its 2009 NOLs.

Election. The election to take advantage of the new law's NOL provision must be made by the due date (including extensions) for the tax return filed for the taxpayer's last taxable year beginning in 2009. Once made, the election is irrevocable. If the taxpayer had previously elected not to carry back an NOL from a tax year ending before the date of enactment of the new law, the taxpayer may revoke that election before the due date (including extensions) for filing the taxpayer's 2009 return. The election is available for a tax year ending after December 31, 2007, and beginning before January 1, 2010. Thus, a fiscal year taxpayer can make the election for tax years beginning or ending in either 2008 or 2009.

Insurance companies. Under normal circumstances, insurance companies generally can carry back operating losses up to three years. The new law would give insurance companies a similar election to carry back NOLs from 2008 or 2009 for either four years or five years. The same 50-percent limit would apply to carrybacks to an insurance company's fifth year preceding the loss year.

AMT. The new law also suspends the 90-percent income limitation on the use of NOLs for determining the alternative minimum tax (AMT) for an extended carryback year.

TARP restrictions. The election to carry back NOLs up to five years is not available to companies receiving assistance under the Trouble Asset Relief Program (TARP) if the federal government acquired stock (or a right to acquire stock) in the company before the date of enactment of the new law, or if the federal government provides funds to the company (in exchange for a stock interest) after the date of enactment of the new law.

Military Exclusion

More than 40 years ago, Congress created the Housing Assistance Program (HAP) to compensate qualified military and civilian employee homeowners when base closures negatively impact the real estate market. In some cases, HAP makes payments to offset the decline in real estate values. These payments are excluded from the recipient's gross income. The 2009 Recovery Act expanded HAP to cover, among other things, recent base realignment and closure actions as well as members of the U.S. armed forces who are relocated during the current real estate slowdown. The new law expands the exclusion from income to cover HAP payments under the 2009 Recovery Act.

Electronic Filing

The new law significantly expands the universe of e-filing by requiring individual returns prepared by paid return preparers to be filed electronically with limited exceptions. The e-file requirement applies to any return of tax imposed by subtitle A on individuals, estates or trusts filed after December 31, 2010. The new law excludes preparers who prepare or reasonably expect to prepare 10 or fewer individual income tax returns from mandatory e-filing. The law maintains the current rule that requires corporations and taxexempt organizations with assets of $10 million or more and that file at least 250 returns during a calendar year, including income tax, information, excise tax, and employment tax returns, to e-file their Form 1120 and 1120S income tax returns and Form 990 information returns.

Penalties

Effective for returns for tax years beginning after December 31, 2009, the new law increases the penalties for failure to file a partnership or S corporation return. The penalty for failure to file a partnership return increases from $89 to $195. Similarly, the penalty for failure to file an S corporation return increases from $89 to $195. The combined increases are expected to raise approximately $1.2 billion over 10 years.

Corporate Estimated Tax

Congress passed the Corporate Estimated Tax Shift Act of 2009 (Shift Act) in July, which revoked provisions of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) with regard to corporate estimated tax payments. The Shift Act increased estimated tax payments for corporations in the $1 billion-plus class to 100.25 percent for estimated payments due in July, August, and September of 2014. The new law increases the required corporate estimated tax payments factor for large corporations for payments due in July, August and September 2014 by 33 percentage points. The Shift Act allows large corporations to reduce their subsequent estimated tax payments in 2014 by the increase.

FUTA Surtax

The 0.20 percent FUTA (unemployment) surtax, first enacted in 1976, was most recently extended in the Emergency Economic Stabilization Act of 2008 through year-end 2009. The new law extends the FUTA surtax through June 30, 2011. The total FUTA tax on employers, therefore, continues to be 6.2 percent.

Worldwide Interest

Under the American Jobs Creation Act of 2004, a worldwide affiliated group may make a one-time election to determine the foreign source taxable income of the group by allocating and apportioning the domestic members' interest expense on a worldwide basis, as if all members of the group were a single corporation. However, subsequent legislation delayed the effective date of this provision until tax years beginning after December 31, 2010. The new law delays the provision even further: until tax years beginning after December 31, 2017. This measure is expected to raise approximately $20 billion over 10 years.