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TO: All Professional Tax Personnel **NTA-705**
FROM: Robin Tuttle Christian, CPA **DATE:** June 23, 2009

RE: Update on the New Sales Tax Write-off for New Vehicles

Background

In an effort to stimulate automobile sales, the American Recovery and Reinvestment Act of 2009 (the Stimulus Act) established a temporary deduction for state and local sales and excise taxes paid on the purchase of new (not used) (1) passenger autos and light trucks with gross vehicle weight ratings of 8,500 pounds or less, (2) motorcycles, and (3) motor homes. To qualify, the vehicle must be purchased after 2/16/09 and before 1/1/10. Also, the deduction is limited to taxes allocable to the first $49,500 of the purchase price. [See IRC Secs. 63(c)(1)(E) and 164(b)(6).]

Itemizers claim this deduction as an additional itemized deduction, while nonitemizers add the deduction to their standard deduction amount. [See IRC Secs. 63(c)(1)(E) and 164(a)(6).] In either case, this deduction is allowed for both regular tax and AMT purposes. [See IRC Sec. 56(b)(1)(E).]

The new deduction is subject to phase-out provisions. The phase-out range for unmarried individuals and married individuals who file separately is between MAGI of $125,000 and $135,000. The phase-out range for married joint-filing couples is between MAGI of $250,000 and $260,000. For this purpose, MAGI is defined as "regular AGI" increased by any income exempt from taxation under IRC Secs. 911, 931, and 933 (all of which have to do with income from outside the U.S.).

Recent IRS Guidance

Number of Vehicles That Qualify. As mentioned earlier, the new deduction is limited to taxes allocable to the first $49,500 of the purchase price. What was not clear, however, was if the deduction was limited to taxes on only one vehicle or if it could be claimed for taxes paid on two or more qualifying vehicles.

In an informal letter to RIA, the IRS has recently indicated that the limitation is imposed on a per vehicle basis. Accordingly, a taxpayer may deduct the taxes paid on the purchase of more than one vehicle, even if the total of the purchase price exceeds $49,500. There is no limitation on the number of vehicles an individual can purchase. Thanks, IRS—we like that answer. This is good news for a taxpayer who needs to purchase two or more cars this year—they can deduct the sales taxes on the first $49,500 of the purchase price of each qualifying vehicle, assuming they don't run up against the deduction phase-out AGI limits.

States without Sales Taxes. According to IRC Sec. 164(b)(6)(A), qualified motor vehicle taxes deductible under this new provision are state or local sales or excise taxes imposed on the purchase of a qualified motor vehicle. So, it appeared that taxpayers who purchased qualifying vehicles in states without a sales tax were out of luck. Not so, says the IRS in News Release 2009-60.

Taxpayers who purchase qualifying motor vehicles in states without a sales tax, such as Alaska, Delaware, Hawaii, Montana, New Hampshire, and Oregon can qualify for the deduction. In this case, the taxpayers are entitled to deduct other fees or taxes imposed by the state or local government. The fees or taxes that qualify must be assessed on the purchase of the vehicle and must be based on the vehicle's sales price or as a per unit fee. More good news—this is getting to be a habit for the IRS.

Optional Sales Tax Deduction versus the New Vehicle Sales Tax Deduction

For 2009, itemizers who elect to deduct state and local sales taxes in lieu of deducting state and local income taxes cannot claim the new vehicle sales tax deduction. But, these taxpayers can deduct state and local sales taxes on qualified motor vehicle purchases anyway—without regard to the $49,500 purchase price limitation, the AGI phase-out, or whether the vehicle was new or used. However, the new qualified motor vehicle sales tax deduction is allowed for AMT, whereas the amount deducted in lieu of state and local income taxes is not. So, taxpayers in AMT will need to carefully weigh their options on their 2009 Form 1040.

> **Example 1:** Ted and Dee Smith file a joint return and live in a state that has no state or local income tax. They itemize their deductions and are in a 28% tax bracket for regular income tax purposes and a 26% tax bracket for AMT purposes. In 2009, they pay state sales taxes of $5,000 including taxes of $2,500 on the purchase of a qualified motor vehicle. Before taking into account any deduction for the payment of those taxes, their tentative AMT is $26,000 (26% of taxable excess of $100,000) and their regular income tax is $25,500. Accordingly, they owe an AMT of $500 ($26,000 less $25,500). The total tax payable will be $26,000 (i.e., regular income tax of $25,500 plus AMT of $500).
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> If they elect to deduct their sales taxes (as the in lieu of state and local income tax deduction), their taxable income will be reduced by $5,000 and their regular income tax will be reduced by $1,400 (28% of $5,000) to $24,100. However, their taxable excess will remain at $100,000 since sales taxes deducted in lieu of state income taxes are not deductible in computing AMT. Accordingly, the tentative AMT will remain at $26,000, and the AMT will increase to $1,900 ($26,000 less $24,100). The total taxes payable will remain at $26,000 (regular income tax of $24,100 plus AMT of $1,900).
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> On the other hand, if the Smiths don't make the election to deduct sales taxes in lieu of state and local income taxes, they will be able to deduct the $2,500 of sales taxes they paid for a qualified motor vehicle. This deduction is allowed against both regular income tax and the tentative AMT. Thus, their regular income tax will be reduced by $700 (28% of $2,500) to $24,800, and their tentative AMT will be reduced by $650 (26% of $2,500) to $25,350. While their AMT will increase by $50 to $550, the total taxes payable will be reduced by $650 from $26,000 to $25,350 (regular income tax of $24,800 plus AMT of $550).

Observation: In states where there is an income tax, the election to deduct sales taxes in lieu of state income taxes was typically made only when the taxpayer purchased some major item, such as an auto. Now that the new qualified motor vehicle sales tax deduction applies, the election will be less likely to be beneficial since the sales taxes on the first $49,500 of the sales price is deductible even if income taxes are deducted, as long as the AGI phase-out doesn't apply.

> **Example 2:** During 2009, Joe, a single taxpayer, has AGI of $115,000. He pays state and local sales taxes of $5,000, including $2,500 on the purchase new car and state income taxes of $4,000. Under pre-Stimulus Act law, Joe would have elected to deduct sales taxes in lieu of income taxes so as to get a $1,000 additional deduction ($5,000 instead of $4,000). However, because of the Stimulus Act changes, Joe can get a total deduction of $6,500 ($4,000 of income taxes and $2,500 for taxes on the qualified motor vehicle) if he doesn't make the election to deduct sales taxes in lieu of state income taxes.

Practice Tip: Hopefully, tax preparation software will optimize the deduction in these situations. If not, you'll have to run the numbers.

References:

IRC Secs. 56(b)(1)(E), 63 and 164.
IRS News Release 2009-60.