

TAX NEWSLETTER

LATE 2007 TAX ACTS

JANUARY 17, 2008

Dear Clients and Other Friends,

True to recent form, Congress passed a December tax bill. Most of the changes first apply in 2008 but some apply retroactively to the beginning of 2007 and aren't even reflected on tax forms that the IRS has already sent out. The most important change prevents many middle-income taxpayers from being snared by the alternative minimum tax (AMT) for 2007. But there were other changes as well.

It is always fun to have new laws enacted two weeks before the start of "tax season". With the start of tax season I have sent those of you who were clients last year your engagement letters and organizers for the 2007 returns. If you have not received them, be sure to contact me. I still have room for some clients so please remember to refer me to your friends and business associates so they can enjoy the same high quality work to which you have become accustomed!

Now to recap the new laws-

AMT Relief: In general terms, to find out if you owe alternative minimum tax (AMT), you start with regular taxable income, modify it with various adjustments and preferences (such as add backs for property and sales tax deductions and dependency exemptions), and then subtract an exemption amount (which phases out at higher levels of income). This sounds like a recipe for a poison potion.... The result is multiplied by an AMT tax rate of 26% or 28% to arrive at the tentative minimum tax. You then pay the higher of the AMT or your regular tax. Capital gains and qualified dividends are taxed at the regular capital gains rates for both regular tax and AMT.

For 2007 only, a new law provides some relief. It increases the maximum AMT exemption amount over its 2006 level by \$3,700 to \$66,250 for married taxpayers filing joint returns, and by \$1,850 to \$44,350 for unmarried individuals and to \$33,125 for married persons filing separately. However, after 2007, the maximum AMT exemption amount will drop precipitously to where it was in the year 2000 unless Congress provides another fix.

Another provision in the new law provides AMT relief for those individuals claiming certain "nonrefundable" personal tax credits (such as the credit for dependent care and the Scholarship and Lifetime Learning credits). For 2007, these credits may offset an individual's regular tax and AMT. After 2007, unless Congress acts, these credits will be allowed only to the extent that an individual has regular income tax liability in excess of the tentative minimum tax, which has the effect of disallowing these credits against AMT.

Another new law also liberalized the AMT refundable credit amount that was first enacted in 2006 to help taxpayers who were stung by the AMT as a result of exercising incentive stock options. The change is highly technical but the essence of it is that eligible individuals may now claim this credit more rapidly (i.e., over fewer years) than would have been the case without the change.

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Forgiven mortgage debt tax relief: Addressing the subprime lending crisis, another late 2007 law provides tax relief for homeowners whose mortgage debt is forgiven. Prior to the enactment of this law, a homeowner could be taxed on the amount of forgiven mortgage debt. For example, before this law, an individual with a \$200,000 mortgage whose lender foreclosed on the home and sold it for \$180,000 would have had to report \$20,000 of income from the forgiven debt. The result would have been the same if the lender restructured the loan and reduced the principal amount to \$180,000. Under the new law, a taxpayer does not have to pay federal income tax on up to \$2 million of debt forgiven for a qualifying loan secured by a qualified principal residence (e.g., one to buy or renovate a residence). The change applies to debts discharged from Jan. 1, 2007 to Dec. 31, 2009.

Mortgage insurance deduction extended for 3 years: Mortgage insurance premiums will continue to be deductible after 2007, thanks to another relief provision for homeowners. Originally, this deduction was available only for 2007. It now applies through 2010. Basically, it allows taxpayers to treat amounts paid during the year for qualified mortgage insurance as home mortgage interest—and thus deductible in most instances. The special rule for home mortgage interest is phased out at higher levels of adjusted gross income (AGI). The insurance must be in connection with home acquisition debt, the insurance contract must have been issued after 2006, and the taxpayer must pay the premiums for coverage in effect during the year. No, this is not for home insurance – it is for home mortgage insurance – nice try.....

Home sale exclusion liberalized for surviving spouse: A qualifying taxpayer may exclude up to \$250,000 (\$500,000 for joint return filers) of gain from the sale or exchange of property that the taxpayer has owned and used as his or her principal residence. Married taxpayers filing jointly for the year of sale may exclude up to \$500,000 of home-sale gain if (1) either spouse owned the home for at least 2 of the 5 years before the sale; (2) both spouses used the home as a principal residence for at least 2 of the 5 years before the sale; and (3) neither spouse is ineligible for the full exclusion because of the once-every-2-year limit on the exclusion.

Before the late 2007 law changes, the up-to-\$500,000 exclusion was available only if a husband and wife filed a joint return for the year of sale. Thus, if the home was sold in a year after the year of a spouse's death—when a joint return would no longer be filed—the surviving spouse could only get a maximum home sale exclusion of \$250,000. A new law provides relief for sales and exchanges after Dec. 31, 2007—it allows a surviving spouse to qualify for the up-to-\$500,000 exclusion if the sale occurs not later than 2 years after the spouse's death, provided the requirements for the \$500,000 exclusion were met immediately before the spouse's death and the survivor has not remarried as of the date of the sale.

Since we live in a community property state, the full residence will get a step up in basis upon the death of the first spouse. Therefore, this new law will only benefit those whose house appreciates more than \$250,000 in the two years following the first spouse's death.

There were a couple of business related changes which are worth noting.

Partnership failure to file penalty increased: Under old law, any partnership required to file a return for any year, which failed to file on time (including extensions) or whose return failed to show the information required, was liable for a monthly penalty equal to \$50 times the number of persons who were partners during any part of the tax year, for each month or fraction of a month for which the failure continued. However, the total penalty could not be imposed for more than five months.

The Mortgage Relief Act extends the period for calculating the monthly failure-to-file-penalty for partnership returns from 5 to 12 months and increases the per-partner penalty amount from \$50 to \$85 per partner, effective for returns required to be filed after Dec. 20, 2007. Note also that under the Virginia Tech Victim's Relief Act, for tax years beginning in 2008 only, the dollar amount per partner is increased by \$1. Thus, for tax years beginning in 2008, the per-partner penalty for failure to file a partnership return is \$86.

New failure to file penalty for S corporation returns: Under old law, there was no penalty for failure to file an S corporation return. The Mortgage Relief Act imposes a monthly penalty for any failure to timely file an S corporation return or any failure to provide the information required to be shown on such a return, effective for returns required to be filed after Dec. 20, 2007. The penalty, assessed against the S corporation, is \$85 times the number of shareholders in the S corporation during any part of the tax year for which the return was required, for each month (or a fraction of a month) during which the failure continues, up to a maximum of 12 months. Since calendar year S corporation returns are due March 15th instead of April 15th like personal returns, some people will forget to file their S returns on time. This late filing can now become expensive – fast.

As usual, this newsletter just recaps the laws. Please contact me if you have specific questions. I will be visiting with many of you over the next 4 months. I look forward to it.

Thanks,

Tim

And,

Disclaimer: By nature of a newsletter, this information is in summary form and does not necessarily detail every requirement, restriction or tax planning opportunity. Prior to executing any tax strategy, you should consider non-tax implications - you may cost yourself more than you save in taxes. Please use this information with these limitations in mind. If you are considering executing a particular tax strategy, please contact me so we can discuss the specifics.

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