

Late 2007 Tax Enactment (including AMT)

Dear Clients and friends,

As you probably know, new laws carrying important tax changes for individuals were enacted in late December 2007. 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 pro-taxpayers changes as well. A brief description of these new tax breaks follows.

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 addbacks for property and income tax deductions and dependency exemptions), and then subtract an exemption amount (which phases out at higher levels of income). The result is multiplied by an AMT tax rate of 26% or 28% to arrive at the tentative minimum tax. You pay the AMT only if the tentative minimum tax exceeds your regular tax bill.

Although it was originally enacted to make sure that wealthy individuals did not escape paying taxes, the AMT has wound up ensnaring many middle-income taxpayers. One reason is that many of the tax figures (such as the tax brackets, standard deductions, and personal exemptions) used to arrive at your regular tax bill are adjusted for inflation, but the tax figures used to arrive at the AMT are not.

For 2007 only, a new law provides some relief. It increases the maximum AMT exemption amount over its 2006 level by \$3,700 for married taxpayers filing joint returns, and by \$1,850 for unmarried individuals and 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.

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.

Homesale 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 homesale 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.

Tax relief for volunteer responders. Tax relief is on the way for volunteer firefighters and emergency medical responders, thanks to a little publicized provision in one of the late-breaking 2007 tax laws. It creates an income tax exclusion for qualified state or local tax benefits (such as reduction or rebate of state or local income or property tax) and qualified reimbursement payments (up to \$360 a year) granted to members of qualified volunteer emergency response organizations (e.g., state or local organizations whose

members provide volunteer firefighting or emergency medical services (EMS)). The new exclusion applies for the 2008 through 2010 tax years.

Please keep in mind that I've described only the highlights of the new laws enacted late in 2007. If you would like more details on any aspect of this legislation, please call me at your earliest convenience.

Very truly yours,
Paresky Flitt & Company, LLP