



Year End Tax Law Changes
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Three Bills Close Out the Year

Congress passed three separate tax bills before leaving town for the holiday recess. While the AMT patch in the *Tax Increase Prevention Act of 2007* got all of the attention in the final weeks, two others bills also made changes to the tax law that we'll need to deal with. Congress passed the *Mortgage Forgiveness Debt Relief Act of 2007* and the *Tax Technical Corrections Act of 2007*, both of which have provisions you might not expect to be in the bills based on their titles. The technical corrections bill was taken from language found in the *Heroes Earnings Assistance and Relief Tax Act of 2007*, a bill for which the House and Senate could not come to a conference agreement on prior to adjourning.

All of the bills are awaiting the signature of the President, but all are expected to be signed by the President.

AMT Fix Extended (Yet Again....)

The House and Senate were able to pass a stand-alone AMT patch for 2007 that did not contain any offsetting revenue raisers, giving us a very simple bill that accomplishes its single task. The big hitch for those of us in tax practice is that our tax projection software has generally been using the law as it would have existed without a change, so projections made earlier in December may need to be modified. BNA rolled out a software update to their income tax projection software on December 20 to take into account the changes in the law.

Like last year, this year's fix is only for a single year so we will once again likely be facing this problem next December. As well, tax projection software will again be presuming the lower exemptions apply after 2007, so we will need to factor that into any tax planning we might be undertaking that is impacted by these changes.

The exemptions are raised to the following levels:

- \$66,250 for a married couple filing a joint return (up from \$45,000)
- \$44,350 for unmarried taxpayers (up from \$33,750)
- \$33,125 for married couples filing a separate return (up from \$22,500)

As before, these exemptions are phased out for taxpayers at higher income levels.

The bill also allows nonrefundable personal tax credits to be offset against the alternative minimum tax for 2007, another provision that had expired at the end of 2006.

Mortgage Bill

A bill that came in under the radar for most of us was the *Mortgage Forgiveness Debt Relief Act of 2007* that passed with little fanfare. That bill not only contained relief for individuals whose homes were taken in foreclosure when the fair value of the home was less than the outstanding balance of the mortgage, but also had some other items—some taxpayer friendly, and some not so. We'll look at few of the provisions, though this is not a full review of the bill.

Discharge of Indebtedness on Principal Residence

When a taxpayer's residence is taken to pay off the mortgage, the property is worth less than the balance of the mortgage, the mortgage was not nonrecourse and the lender does not pursue the taxpayer to collect the remaining balance on the loan, there are considered to be two transactions.

1. There is a sale of the residence for its fair value. That sale is taxed under §121, with gain potentially excluded if the taxpayer meets the 2 out of 5 year tests for both ownership and use.

2. Since the mortgage is a recourse mortgage, the taxpayer owes the lender the balance of the loan. However, quite often the lender recognizes that it will not be able to collect that balance and forgives the rest of the debt. Under §108 that amount is ordinary income to the taxpayer unless the taxpayer qualifies for exclusion under the provisions of §108.

The latter results in a significant tax bill unless the taxpayer can show they are insolvent both before and after the forgiveness.

Congress has granted relief to certain taxpayers facing that situation for 2007-2009. The §108 gain is excluded from income so long as:

- The residence was the taxpayer's principal residence as defined in §121 [§108(b)(5)]
- The debt is no more than \$2,000,000 of acquisition indebtedness as defined in §163(h)(3)(B) (ignoring the \$1,000,000 limit in that section) [§108(b)(2)]
- The exclusion does not apply if the debt forgiveness is given in exchange for services performed for the lender or any other reason not related to the homeowner's financial condition [§108(b)(3)]

Any amount excluded under this provision reduces the basis of the residence of the taxpayer (though not below zero). What this is meant to do is to get a very rough equivalence with what would have been true had the property actually been sold for the amount of the debt. However, a taxpayer can elect to have the solvency provisions apply instead of these rules—which might be preferable if the taxpayer is insolvent but will end up with a taxable gain under §121 if the basis reduction applied.

Surviving Spouse §121 Exclusion

Surviving spouses are allowed a full \$500,000 exclusion on the sale of their principal residence in certain cases for sales or exchanges taking place after December 31, 2007 [§121(b)(4)]. To qualify for this exclusion

- Taxpayer must be unmarried (that is, if the taxpayer remarries the special exclusion is lost)
- The sale occurs no later than 2 years after the death of the spouse
- Just prior to the death of the deceased spouse the property would have met the general requirements for the \$500,000 exclusion per §121(b)(2)(A).

Note that this applies in addition to the basis step-up that will take place if the deceased spouse owned any portion of the residence, or even the 100% step-up that takes place if the residence was held as community property.

Mortgage Insurance Deduction

The bill extended the provision allowing for some taxpayers to deduction mortgage insurance premiums paid on mortgage insurance contracts issued after January 1, 2007 through 2010.

Failure to File Partnership Returns

The penalty under §6698 for failing to file a partnership return is changed in two ways.

- The penalty is increased from \$50 per partner to \$85 per partner per month. Note this amount was bumped one more time to \$86 to pay for the exclusion from income for distributions from Hokie Spirit Memorial Fund passed by the Congress.
- The penalty applies for up to 12 months, up from the prior five month limitation.

The new limits apply to returns required to be filed after December 19, 2007.

Failure to File S Corporation Returns

A penalty similar to the partnership noted above was added by the Congress for S corporations. Previously S corporations filing a return late faced only a penalty for willful failure to file an information return under §7203 if it owed no entity level tax. New §6699 is added to the IRC that provides for this penalty.

The penalty applies against the S corporation itself and it can be waived if reasonable cause is shown for the failure to file.

Technical Corrections Act

Congress also passed a bill containing various technical corrections to prior tax bills—but some of these “technical corrections” make what most would see as substantive (though often favorable) changes in the operations of the various provisions.

AMT Refundable Credit

The *Tax Relief and Health Care Act of 2006* added a provision that allowed for a “long term” minimum tax credit to be refundable in certain limited situations. The new law liberalizes this credit. Under the prior law the refundable amount was limited to the greater of:

- \$5,000 *or*
- 20% of the long-term unused minimum tax credit

Unfortunately, the fact that the 20% was applied to the unused credit entering the year meant that if a taxpayer was generating new long-term minimum tax credit, you kept getting 20% of a decreasing number. More than a few observers felt that Congress fouled

this one up last year, since they meant for the credit to be refunded in full over five years in qualified cases—but the way the formula worked a significant amount would remain unusable.

Now the law has added one more item to the list of amounts to be refundable—you compare the first two tests to the following and, again, take the greatest of the three:

- AMT refundable credit amount for the previously tax year before any reduction by reason of adjusted gross income.

This new provision allows a full recovery over five years for cases that aren't otherwise limited due to excess income.

The provision is retroactively effective as if it had been included in the *Tax Relief and Health Care Act of 2006*.

S Corporation Contributions of Appreciated Property

The *Pension Protection Act of 2006* contained a provision that caused the basis of a shareholder's interest to be reduced only by the basis of the property donated. However, the law didn't address the general limitation on deductions for an S corporation shareholder being limited to the shareholder's basis in the stock—even though the basis would not be reduced by the excess of the fair value over the basis.

The Technical Corrections Act corrects this problem, retroactive to the effective date of the *Pension Protection Act of 2006*.

Other Provisions

The act actual made changes involving the tax computation where the foreign earned income exclusion is concerned, required that a charity's certification for the donation of personal property now has to indicate that there is substantial use by the charity, changes to the penalties for incorrect appraisals, repeal of the limits on estate and gift tax deductions (but not the income tax deduction) for certain transfers of fractional interests in personal property, changes to designated Roth contribution treatments for qualified plans, and various other issues.