TJAGLCS Practice Note

Tax Law Note

Tax Law Note: Update for 2008 Federal Income Tax Returns

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There were several pieces of legislation passed in the last six months that will have an impact on properly completing and filing tax returns for military taxpayers for the 2008 filing season. Among these statutes was one specifically for servicemembers called the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act)[1], which contains several sections relating to taxable income and credits for both active duty and reserve servicemembers.

Other legislation passed includes the Housing and Economic Recovery Act of 2008 (Housing Act),[2] providing for additional deductions and credits for home buyers and home owners, and the Emergency Economic Stabilization Act of 2008,[3] better known as the Bailout Bill. The Bailout Bill, while providing economic assistance to financial institutions that own troubled assets also contains several pieces of tax legislation concerning extension of deductions that expired at the end of calendar year 2007,[4] alternative minimum tax relief,[5] and disaster relief.[6] This note will cover key sections of each act that legal assistance attorneys should be aware of when assisting military taxpayers with federal income tax returns.

HEART Act

Recovery Rebate Provided to Military Families[7]

Last tax season many taxpayers were eligible for stimulus payments depending on the taxpayer's filing status and adjusted gross income under the Economic Stimulus Act of 2008.[8] These payments were received by the taxpayer either through electronic funds transfer or the issuance of a check from the Department of Treasury.[9] Those taxpayers who did not meet the filing deadline of 15 October 2008 for the Economic Stimulus Act will not receive the payment prior to the beginning of the 2008 tax filing season.[10] Instead, those taxpayers will be eligible for the rebate as a refundable credit on the 2008 tax return, called the recovery rebate credit.[11]

Generally, taxpayers receive a credit of $300 or $600 if filing single and $600 or $1,200 if filing jointly.[12] The amount received is determined by the taxpayer's tax liability and the taxpayer's qualifying income[13] of at least $3,000.[14] If a taxpayer

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[1] Pub. L. No. 110-245, 122 Stat. 1624 [hereinafter HEART Act].

[2] Pub. L. No. 110-289, 122 Stat. 2654 [hereinafter Housing Act].

[3] Pub. L. No. 110-343, 122 Stat. 3765 [hereinafter Bailout Bill].

[4] *Id.* These specific Code sections can be found in the Bailout Act in Division C, and can be cited as the Tax Extenders and Alternative Minimum Tax Relief Act of 2008.

[5] *Id.*

[6] *Id.* This specific section can also be found in the Bailout Act in Division C, Title VII Disaster Relief and be cited at the Heartland Disaster Tax Relief Act of 2008.

[7] HEART Act, *supra* note 1, § 101.

[8] Pub. L. No. 110-185, 122 Stat. 613 [hereinafter Economic Stimulus Act].

[9] IR-200-18, Feb. 13, 2008; IR-2008-44, Mar. 17, 2008.

[10] IR-200-18, Feb. 13, 2008; IR-2008-44, Mar. 17, 2008.

[11] IR-2008-109, Sept. 23, 2008; *see also* Internal Revenue Service 2008, Form 1040, line 70.

[12] Economic Stimulus Act, *supra* note 8.

[13] Qualifying income is earned income; Social Security benefits, and veteran's payments. *Id*.

[14] *Id*. In tax year 2008, the statute allows taxpayers to

does not have qualifying income due to service in a combat zone and qualified hazardous duty exclusion, the taxpayer can include the amount of excluded income for purposes of determining the rebate recovery credit.[15]

In order for a taxpayer to be eligible for the credit, he or she must have a Social Security number issued by the Social Security Administration.[16] While military members are eligible taxpayers for the credit, the military member's spouse would not be if he does not have a valid Social Security number.[17] As a result, the spouse cannot be included in the calculation for the credit. To alleviate this hardship for military members, section 101 of the HEART Act, changed the requirement for a valid Social Security number for military members with foreign national spouses and now allows military taxpayers to use an individual tax identification number (ITIN) as valid identification for purposes of the rebate recovery credit.[18] Consequently, military taxpayers that received the stimulus payment, absent the additional amount for his foreign national spouse due the requirement for a valid Social Security number, can now claim the additional amount as a credit on the 2008 tax return.

Election to Treat Combat Pay as Earned Income for Purposes of the Earned Income Credit

Military pay earned in the combat zone or qualified hazardous duty area is excluded from gross income.[19] However, in order to qualify for the Earned Income Tax Credit, the taxpayer must have earned income to include as part of the credit calculation.[20] This meant that military taxpayers who served in a combat zone for the entire tax year were not eligible for this credit. To remedy this issue for the military members who would have otherwise qualified for the Earned Income Tax Credit (EIC), but for the combat zone exclusion, section 104 of the Working Families Tax Relief Act of 2004 allowed military taxpayers to include the excluded combat pay as earned income for the purposes of calculating the EIC.[21] This section of the Working Families Tax Relief Act of 2004 which pertains to the EIC was to expire at the end of calendar year 2007, but it has now been made permanent under section 102 of the HEART Act.[22] Therefore, military members from tax year 2008 forward can include otherwise excludable combat pay as earned income for the purpose of qualifying for the EIC.

Treatment of Differential Pay as Wages

When a reservist is called to active duty, some employers voluntarily continue to pay the servicemember differential pay which is pay at the same level of compensation he would have had if the servicemember had not been called to active duty.[23] This differential pay was normally not treated as wages for the purposes of the employer's federal income tax withholding rules because the servicemember was treated as if employment was terminated thereby eliminating the requirement of the employer to comply with the wage withholding rules.[24] Section 105 of the HEART Act amends the definition of wages for the purposes of the federal income tax withholding rules to include differential pay paid by an employer to an employee

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> receive a basic credit (for the first taxable year beginning) in 2008 equal to the greater of the following:
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> > Net income tax liability not to exceed $600 ($1,200 in the case of a joint return).
> >
> > $300 ($600 in the case of a joint return) if: (1) the eligible individual has qualifying income of at least $3,000; or (2) the eligible individual has a net income tax liability of at least $1 and gross income greater than the sum of the applicable basic standard deduction amount and one personal exemption (two personal exemptions for a joint return).

Joint Committee on Taxation, *Technical Explanation of H.R. 6081, The "Heroes Earnings Assistance and Relief Tax Act of 2008," as Scheduled for Consideration by the House of Representatives on May 20, 2008* (JCX-44-08), May 20, 2008, at 2.

[15] *Id.*; *see also* Internal Revenue Serv. 2008, Form 1040 Instructions, Rebate Recovery Credit worksheet.

[16] Economic Stimulus Act, *supra* note 8.

[17] *Id.*

[18] HEART Act, *supra* note 1.

[19] I.R.C. § 112 (LexisNexis 2008).

[20] *Id.* § 32.

[21] Pub. L. No. 108-311, 118 Stat. 1166.

[22] HEART Act, *supra* note 1.

[23] I.R.C. § 3401.

[24] Rev. Rul. 69-136, 1969-1 C.B. 252.

called to active duty.[25] Accordingly, military taxpayers who receive differential pay will received a Form W-2, Wage and Tax Statement from the civilian employer showing the differential pay as gross income with withholdings for federal income tax, Social Security, Medicare, and deferred compensation plans such as a 401(k).[26]

Treatment of Distributions to Individuals Called to Active Duty for at Least 180 Days

Under current law, a taxpayer who receives a distribution from a qualified retirement plan prior to age 59 ½ is taxed an additional 10% on the amount that is includable in gross income.[27] Section 107 of the HEART Act makes permanent the amendments made to section 72(t) of the internal revenue code by the Pension Protection Act of 2006.[28] The Pension Protection Act of 2006 eliminated the 10% early withdrawal penalty from qualified retirement plan, such as an Individual Retirement Arrangement (IRA), 401(k) or a 403(b), by a reservist called to active duty for at least 180 days for withdrawals made between 12 September 2001 and 31 December 2007.[29] The Pension Protection Act also allows reservists who received distributions under this statute to re-contribute up to the same amount within two years after leaving active duty the amount distributed without regard to contribution rule limitations.[30] The amount re-contributed may be more than the $5000 contribution limit in the case of an IRA and more than the $15,500 contribution limit in the case of a 401(k). However, when the reservist re-contributes to his qualified plan to make up for the distribution, he cannot take a deduction for the contribution made under this special repayment rule.[31] Therefore, a reservist called to active duty for 180 days or more may now permanently make withdrawals from their retirement plans without penalty from the time they receive their orders to report up until the day they are released from active duty.[32]

Exclusion of Certain State Payments to Military Personnel

Section 112 of the HEART Act codifies an Internal Revenue Service (IRS) Ruling and a recent memorandum of advice from the Office of Chief Counsel for the IRS (Chief Counsel Advice) concerning state payments to service members.[33] The IRS Ruling specifically states that bonuses paid by states to military personnel who served in enumerated armed conflicts are gifts and therefore not included in gross income.[34] The Chief Counsel Advice further states that refundable income tax credits from states to military members for months served in a combat zone or qualified hazardous duty area are also non-taxable gifts.[35] These payments are considered gifts because a gift "proceeds from a detached and disinterested generosity, and is made out of affection, respect, admiration, charity or like impulses" and not "from any moral or legal duty or from the incentive of anticipated benefit of an economic nature."[36] Therefore, payments to a servicemember or surviving family member in the form of a death gratuity, tax credits, or other bonuses are gifts and not taxable gross income.

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[25] HEART Act, *supra* note 1. Practice note: Be aware of the Social Security withholding limit. For 2008, Social Security Taxes are withheld at a rate of 6.2% of gross income up to $102,000. Anything over that amount is not withheld from gross income. For reserve members receiving differential pay, add up both amounts of gross income to determine if they should receive a credit for Social Security taxes withheld. *See* INTERNAL REVENUE SERV. PUB. 505, TAX WITHHOLDING AND ESTIMATED TAX (Feb. 2008).

[26] HEART Act, *supra* note 1.

[27] I.R.C. § 72(t).

[28] HEART Act, *supra* note 1.

[29] Pub. L. No. 109-280, § 827, 120 Stat. 780.

[30] *Id.*

[31] *Id.*

[32] Pension Protection Act of 2006, Pub. L. No. 109-280, § 1201, 120 Stat. 780 [hereinafter Pension Protection Act].

[33] HEART Act, *supra* note 1, § 112.

[34] Rev. Rul. 68-158, 1968-1 C.B. 47; Chief Counsel Advice 200708003 (Feb. 23, 2007).

[35] Chief Counsel Advice 200708003.

[36] *Id.* (citing Duberstein v. Comm'r, 363 U.S. 278 (1960)).

Housing Act

First-Time Homebuyer Credit

Section 3011 of the Housing Act creates a new credit for first-time homebuyers applying to a purchase of a principal residence by a taxpayer on or after 9 April 2008 and before 1 July 2009.[37] The first-time homebuyer credit allows for a credit of an amount equal to 10% of the purchase price of the principal residence not to exceed $7,500 for all taxpayers except those married filing separately whose credit may not exceed $3,750.[38] The amount of the credit will be reduced by the percentage the modified adjusted gross income exceeds $75,000 for single filers or $150,000 for married filing jointly when divided by $20,000, multiplied by the maximum credit the taxpayer could receive.[39] For example, if a single taxpayer purchases a home to use as his principal residence for $200,000 and the taxpayer has a modified adjusted gross income of $80,000, the taxpayer's credit would be $5,625 ($80,000 – $75,000 = $5,000. $5,000/$20,000 = 0.25. 0.25 x the maximum credit of $7,500 = $1,875. $7,500 – $1,875 = $5,625).[40]

Not every homebuyer is eligible for the credit. The first-time homebuyer credit is not allowed for taxpayer's that were allowed a credit under the District of Columbia first-time homebuyer credit;[41] home purchases financed by qualified mortgages that are exempt from interest under Internal Revenue Code (IRC) section 103; taxpayers who are non-resident aliens; or taxpayers who dispose of the home or the home otherwise ceases to be the principal residence before the end of the tax year.[42]

There are also recapture rules and other rules to be aware of. Under the recapture rules, if a first-time homebuyer credit is allowed, the taxpayer's income is increased by 6 2/3% of the amount of the credit for fifteen taxable years beginning with the second taxable year following the year the purchase is made.[43] For example, if a taxpayer takes the entire $7,500 credit in 2008, beginning in 2010, and for the next fifteen years, the taxpayer must add $500 to his tax liability by recapturing the credit (6 2/3% x the credit amount of $7,500).[44] If the taxpayer disposes of the principal residence or the home ceases to be the principal residence before the end of the fifteen year recapture period, the recapture is accelerated in that the taxpayer's income tax will be increased in the taxable year of disposition by the excess amount of the credit allowed over the recapture amounts taken in the preceding years.[45] This accelerated recapture, however, is not applicable if the taxpayer dies or if the home is involuntarily converted.[46] In the case of transfers between spouses or transfers incident to divorce, the recapture of the credit also is not accelerated, but the spouse that receives the home is then responsible for the recapture amount.[47]

Additional Standard Deduction for Real Property Taxes for Non-Itemizers

Section 3012 of the Housing Act allows an additional standard deduction for real property taxes paid by those taxpayers who do not itemize.[48] The amount of the real property tax deduction is the lesser of the amount of the tax paid as an allowable deduction or $500 for single taxpayers or $1,000 for joint filers.[49] The additional deduction is taken by checking

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37 Housing Act, *supra* note 2, § 3011. In the case of a taxpayer purchasing a home after 31 December 2008 and before 1 July 2009, the taxpayer may elect to treat that purchase as made on 31 December 2008 for purposes of new IRC section 36, created by the Housing Act. *Id.*

38 *Id.*

39 *Id.*

40 Housing Act, *supra* note 2, § 3011.

41 I.R.C. § 1400C (LexisNexis 2008).

42 Housing Act, *supra* note 2.

43 *Id.*

44 *Id.*

45 *Id.*

46 *Id.*; *see* I.R.C. § 1033(a) (LexisNexis 2008) (regarding involuntary conversions).

47 *Id.*

48 *Id.*

49 *Id.*

block 39a, on Internal Revenue Service Form 1040 and adding the applicable amount of real estate tax deduction to the taxpayer's standard deduction.[50]

Gain from Sale of Principal Residence Allocated to Nonqualified Use Not Excluded from Income

The Housing Act amends section 121(b) of the IRC by not allowing the exclusion of the gain on a sale under IRC section 121(a) during periods of nonqualified use, meaning any time that the home was not used as the taxpayer's principal residence beginning for sales after 31 December 2008.[51] Nonqualified use does not include any portion of the five-year period that applies in IRC section 121(a); any time period, not to exceed a total of ten years, that the taxpayer or taxpayer's spouse serves on extended duty; and any other time period, not exceeding two years that the taxpayer is away from the home.[52] That gain during the period of nonqualified use will be allocated to those periods based under the ratio of the aggregate periods of nonqualified use during the ownership of the taxpayer over the total period of time the taxpayer owned the property.[53] Therefore, if a taxpayer sold a home that was their principal residence and later used the home as a rental property, the amount of the capital gain on the sale excluded could be reduced if none of the exceptions to nonqualified use apply. For example, a taxpayer bought a home in 2008 for $200,000 and lived in it for one year and subsequently rented it out for the next six years. If the taxpayer then sold the home for $400,000 in 2014 the taxpayer may not be able to exclude all the capital gain on the sale. Normally, taxpayers are able to exclude capital gain on the sale of a home up to $250,000, if filing single, or $500,000, if married filing jointly, but because the taxpayer in this example did not live in the home for two of the last five years, the taxpayer had nonqualified time. The nonqualified time reduces the exclusion by $142,857 (5/7 multiplied by the amount of gain $200,000 = $142,857). Therefore, the taxpayer can only exclude $107,143 of the amount of capital gain on the sale. This addition to IRC section 121 will not affect servicemembers as long as they meet the exceptions for nonqualified use in IRC section 121(a).

Mortgage Forgiveness Debt Relief Act of 2007[54]

Last year on 20 December, President Bush signed the Mortgage Forgiveness Debt Relief Act of 2007, amending IRC section 108(a) allowing taxpayers to exclude from gross income discharge of indebtedness on the taxpayer's principal residence.[55] The act was to expire 1 January 2010, but it has been extended by the Bailout Bill to discharges of indebtedness on principal residences until 1 January 2013.[56] Even with the exclusion of discharge of indebtedness from gross income, taxpayers need to be aware that the discharge of indebtedness still reduces the basis the taxpayer has in the principal residence by the amount of the discharge and will affect the taxpayer at the time the principal residence is sold.[57]

Expired Provisions Extended by the Emergency Economic Stabilization Act of 2008

Division C of the Bailout Bill, also known as the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (Extension Act), provides for the extension of tax deductions that expired on 31 December 2007.[58] Among those affecting military taxpayers are the deduction of state and local sales taxes,[59] qualified tuition and fees,[60] expenses for elementary and secondary school teachers,[61] and tax-free distributions from individual retirement arrangements.[62]

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[50] Internal Revenue Serv., Form 1040, Lines 39a and 40 (2008).

[51] Housing Act, *supra* note 2, § 3092 (amending I.R.C. § 121(b) by adding a new subparagraph 5).

[52] *Id.*

[53] *Id.*

[54] Pub. L. No. 110-142, 121 Stat. 1809 [hereinafter Mortgage Forgiveness Act].

[55] *Id.*

[56] Emergency Economic Stabilization Act, *supra* note 8, div. A, tit. III, § 303 (Tax Provisions).

[57] Mortgage Forgiveness Act, *supra* note 54, § 2(h)(1).

[58] Pub. L. No. 110-343, 122 Stat. 3765 [hereinafter Extension Act].

[59] I.R.C. § 164(b)(5) (LexisNexis 2008).

[60] *Id.* § 222.

[61] *Id.* § 62(a)(2).

State and Local Sales Tax Deduction

Once again in 2008, taxpayers who itemize can choose between taking a deduction for state and local sales taxes paid or state income taxes withheld.[63] Taxpayers can either use a standard deduction table by state or tally sales taxes paid for the year.[64] For those taxpayers who live in states that do not have an income tax, this would allow for an additional itemized deduction for this year's tax return. Under the Extension Act, the state and local sales tax deduction does not expire until 1 January 2010.[65]

Tuition and Fees Deduction

The tuition and fees deduction has also been extended for tax year 2008.[66] A maximum deduction of $4,000 is available to single taxpayers with an adjusted gross income of $65,000 or less and taxpayers who are married filing jointly with adjusted gross incomes of $130,000 or less.[67] Single taxpayers with an adjusted gross income of $80,000 or less and married filing jointly taxpayers with an adjusted gross income of less than $160,000 may take a deduction of $2,000.[68] Legal assistance attorneys will need to determine whether the tuition and fees deduction or the education credit deduction are more advantageous to the taxpayer by completing the tax return twice and comparing results of the deduction versus the credit.

Deduction for Certain Expenses of Elementary and Secondary School Teachers

The Extension Act also continued the $250 deduction allowed for elementary and secondary school teachers, counselors, principals and classroom aides for expenses for the classroom for tax year 2008.[69] In order for the teacher, counselor, principal or classroom aide to take the $250 deduction, the employee must work at least 900 hours and have out-of-pocket classroom expenses for items such as pens, paper, books and computer software.[70] For educator expenses above the $250 deduction amount, the taxpayer should take a business deduction on IRS Form Schedule A.[71]

Tax Free Distributions from Individual Retirement Plans for Charitable Purposes

Taxpayers can continue to exclude from gross income distributions from a traditional or Roth IRA of up to $100,000 to a tax exempt charitable organization until 31 December 2009.[72] In order to take advantage of the tax free distribution, the taxpayer must have the IRA distribute the money directly to the charitable organization.[73] Prior to this change in the Internal Revenue Code by the Pension Protection Act of 2006, taxpayers would have to withdraw the distribution from the IRA, claim the amount withdrawn in gross income and then take the deduction for the charitable contribution on Internal Revenue

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[62] *Id.* § 408.

[63] Extension Act, *supra* note 58, div. C, § 201.

[64] *See* INTERNAL REVENUE SERV., FORM 1040 INSTRUCTIONS (2008) [hereinafter IRS FORM 1040 INSTR.].

[65] *Id.*

[66] Extension Act, *supra* note 58, div. C, § 202.

[67] INTERNAL REVENUE SERV., PUB. 970, TAX BENEFITS OF EDUC. (2008).

[68] *Id.*

[69] Extension Act, *supra* note 58, div. C, § 203.

[70] I.R.C. § 63 (LexisNexis 2008).

[71] *See* IRS FORM 1040 INSTR., *supra* note 67.

[72] Extension Act, *supra* note 58, § 205 (extending Pension Protection Act, *supra* note 32, § 1201, which expired 31 December 2007). Tax exempt organizations include religious organizations, federal, state and local governments, non-profit school and hospitals, Salvation Army, Red Cross, Goodwill Industries and Veteran's Groups. I.R.C. § 170. Non-deductible charitable contributions include social and sports clubs, civic leagues, labor unions, for profit organizations, foreign organizations, lobbying groups, individuals, and political organizations. *Id.*

[73] Pension Protection Act, *supra* note 32, § 1201.

Service Form Schedule A.[74] Under section 1201 of the Pension Protection Act of 2006, the direct transfer of the money from the IRA to the charitable organization there is no reporting of the money in gross income or a deduction on the Schedule A.[75]

Alternative Minimum Tax Relief

Extension of Alternative Minimum Tax Relief for Nonrefundable Personal Credits, Increased Alternative Minimum Tax Exemption Amount, and Increase of Refundable Credit Amount

The Tax Increase and Prevention Act of 2007 increased the exemption amount taxpayers could have before a taxpayer would be liable for the Alternative Minimum Tax (AMT).[76] The Extension Act sustained the relief for nonrefundable credits and increased the AMT exemption amount for tax year 2008.[77] The exemption amount for tax year 2008 has increased to $46,200 for single taxpayers and $69,950 for married filing jointly taxpayers.[78] This is an increase from the tax year 2007 amounts of $44,350 for single taxpayers and $66,250 for married filing jointly taxpayers.[79] Normally, once a taxpayer comes under the exemption amounts for the alternative minimum tax, the taxpayer is no longer allowed to take nonrefundable credits such as the Child Tax Credit,[80] any Education Credits,[81] or the Child and Dependent Care Credit.[82] However, with the increase in the exemption amount and extension of the allowance of personal nonrefundable credits, many taxpayers who would fall under the AMT will be able to take those nonrefundable personal credits.

Finally, the amount of refundable credits for tax year 2008 for taxpayers who fall under the AMT has also increased. A refundable credit is a credit a taxpayer can receive in excess of taxes owed.[83] For tax year 2008, a taxpayer who is subject to the limitations of the AMT is allowed to take a refundable credit in an amount equal to the greater of 50% of the long-term unused minimum tax credit for that tax year or the amount of refundable credit amount determined for the taxpayer's prior tax year.[84]

Disaster Relief

Heartland Disaster Tax Relief Act of 2008[85]

Congress resurrected the expired provisions of the Katrina Emergency Tax Relief Act of 2005[86] and the Gulf Opportunity Zone Act of 2005[87] for those taxpayers who were victims of the tornados, floods and storms that occurred in the Midwest this spring. The additional tax relief that is available to those taxpayers within the declared Midwestern disaster area[88] include: increased tax deductions for tuition and related expenses; tax-free withdrawals from retirement accounts; suspension of limitations on tax deductions for charitable contributions and personal casualty losses; tax exemptions for cancellations of indebtedness; additional tax exemption for housing displaced persons from the Midwestern disaster area; and

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[74] *Id.*

[75] *Id.*

[76] Pub. L. No. 110-166, 121 Stat. 2461 [hereinafter Tax Increase and Prevention Act].

[77] Bailout Bill, *supra* note 3.

[78] *Id.* div. C, § 102.

[79] Tax Increase and Prevention Act, *supra* note 76.

[80] I.R.C. § 24 (LexisNexis 2008).

[81] *Id.* § 25A.

[82] *Id.* § 21.

[83] INTERNAL REVENUE SERV., PUB. 17, YOUR FEDERAL INCOME TAX (2008).

[84] Bailout Bill, *supra* note 3, div. C, § 103.

[85] *Id.* div. C, tit. VII, § 701 (Disaster Relief).

[86] Pub. L. No. 109-73, 119 Stat. 2016 [hereinafter Katrina Emergency Tax Relief Act].

[87] Pub. L. No. 109-135, 119 Stat. 2577 [hereinafter Gulf Opportunity Zone Act].

[88] The Midwestern disaster area is the presidentially-declared natural disaster areas in the states of Arkansas, Illinois, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin on or after 20 May 2008, and before 1 August 2008. Bailout Bill, *supra* note 3, § 702(b).

an increase in the standard mileage rate for the charitable use of personal vehicles for volunteer use in the Midwestern disaster area.[89]

Taxpayers who attended a qualified educational institution in the Midwestern disaster area for taxable years 2008 and 2009 will be able to take twice the amount in effect currently for the Hope Education and Lifetime Learning credits.[90] Therefore, a student in the Midwestern disaster area could receive a maximum of $4,800 in Hope Education credit and 40% or $4,000 for the Lifetime Learning credit.

Victims of the Midwestern disaster area will also be able to take a distribution of up to $100,000 from their retirement plans without incurring the 10% penalty with withdrawal before age 59 1/2.[91] A qualified Disaster Recovery Assistance distribution is one taken by a person who sustained economic loss by reason of the Midwestern flooding and storm damage and whose principal residence is located in the Midwestern disaster area.[92] The distribution from the retirement plan must be taken on or after the applicable disaster date and five months after the enactment of the Heartland Disaster Tax Relief Act of 2008 which was included in the Bailout Bill.[93] Any amount taken as a qualified Disaster Recovery Assistance distribution requiring inclusion in gross income will be included ratably over the three-taxable-year period beginning with the taxable year of the distribution.[94] Furthermore, taxpayers who receive a qualified Disaster Recovery Assistance distribution may re-contribute all or part of the distribution amount to his or her retirement plan at any time during a three-year period after the date of distribution.[95]

Next, the limitations on charitable contribution tax deductions have been suspended to those taxpayers that contribute to charitable organizations that provided relief to the Midwestern disaster area.[96] Generally, charitable contributions for taxpayers are limited to a maximum of 50% of a taxpayer's adjusted gross income.[97] Under the Heartland Disaster Tax Relief Act of 2008, taxpayers can take 100% of qualified charitable deductions up to the amount of the taxpayer's adjusted gross income over the amount of all other charitable contributions allowed under IRC section 170(b)(1).[98]

Along with the suspended limitations on charitable contributions, the limits on personal casualty losses have also been suspended for those individuals who are part of the Midwestern disaster area.[99] Personal casualty losses are normally reduced by $100 for each casualty loss, with the total amount of casualty losses again reduced by 10% of the taxpayer's adjusted gross income for that tax year.[100] These reductions to casualty losses can be disregarded for victims in the Midwestern disaster area.[101]

Taxpayer's in the Midwestern disaster area also have exclusions on cancellations of indebtedness.[102] Gross income includes debts that the taxpayer is absolved from paying and must be accounted for.[103] The Heartland Disaster Tax Relief Act of 2008 states that gross income will not include any amount of income which would normally be includable in gross income by reason of the discharge of indebtedness of a person whose principal place of abode was in the Midwestern disaster

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[89] *Id.* § 702, 122 Stat. 3765.

[90] *Id.* (citing Gulf Opportunity Zone Act, *supra* note 87, § 1400O).

[91] *Id.* (referring to I.R.C. § 72(t) (LexisNexis 2008)).

[92] *Id.* (citing Gulf Opportunity Zone Act, *supra* note 87, § 1400Q).

[93] *Id.* The Bailout Bill was signed by the President on 3 October 2008, consequently, the last date distributions can be taken is 3 March 2009.

[94] *Id.*

[95] *Id.*

[96] *Id.* (citing Gulf Opportunity Zone Act, *supra* note 87, § 1400S).

[97] I.R.C. § 170(b) (LexisNexis 2008).

[98] Bailout Bill, *supra* note 3, § 702 (citing Gulf Opportunity Zone Act, *supra* note 87, § 1400S,).

[99] *Id.*

[100] I.R.C. § 165(h).

[101] Bailout Bill, *supra* note 3, § 702 (citing Gulf Opportunity Zone Act, *supra* note 87, § 1400S).

[102] *Id.* (citing Katrina Emergency Tax Relief Act, *supra* note 86, § 401).

[103] I.R.C. § 61(a)(12).

area.[104] The exclusion of discharges of indebtedness for these individuals will apply from the applicable disaster date until 1 January 2010.[105]

For 2008 and 2009, those taxpayers who house a Midwestern disaster area displaced person may claim an additional exemption of $500 for each displaced person.[106] A displaced person is a natural person whose principal place of abode on the applicable disaster date was in the Midwestern disaster area, and the person was displaced from that home because of evacuation or damage to the residence.[107] The taxpayer claiming the exemption must have provided the displaced person with housing free of charge in the taxpayer's principal residence for a period of sixty consecutive days within the tax year.[108] The total amount of the exemptions claimed under this section cannot exceed $2,000, and the taxpayer may not have used the displaced person as an exemption in any prior tax year.[109]

Finally, for purposes of computing charitable deductions of mileage for the charitable use of vehicles, the Heartland Disaster Relief Tax Act of 2008, the standard mileage rate for vehicles used for Midwestern disaster area relief will be 70% of the standard mileage rate in effect under IRC section 162(a) at the time of use.[110] The valid dates for this amount of charitable deduction are from the applicable disaster date to 31 December 2008.[111] For tax year 2008, the standard mileage rate from 1 January 2008 to 30 June 2008 is 50.5 cents a mile, with an increase to 58.5 cents a mile from 1 July 2008 to 31 December 2008.[112]

Rules for All Declared Disaster Areas

Section 706 of the Heartland Disaster Tax Relief Act of 2008 applies to all federally declared disaster areas, which would include the area concerning Hurricane Ike.[113] This section allows for the waiver of adjusted gross income limitations for losses in federally declared disaster areas, as well as an increase in the standard deduction by the amount of disaster casualty loss.[114] The waiver of adjusted gross income limitations for losses allow the taxpayer to claim the sum of an individual's net disaster loss (total personal casualty losses over personal casualty gains) plus any excess net disaster losses that exceed 10% of the taxpayer's adjusted gross income, rather than being limited by the normal casualty loss rules.[115] The additional standard deduction allows the taxpayer to add to his or her normal standard deduction the amount of the net disaster loss.[116]

Other Changes in Income, Deductions and Credits for 2008

Income—Unearned Income for Minors

Income earned by investments and interest on bank accounts by children is unearned income and unearned income by children under the age of nineteen or twenty-four, if a full-time student, is subject to the "kiddie tax" starting in tax year 2008.[117] As of 1 January 2008 children under the age of nineteen or twenty-four, if a full-time student, receive the first $900

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[104] Bailout Bill, *supra* note 3, § 702 (citing Katrina Emergency Tax Relief Act, *supra* note 86, § 401).

[105] *Id.*; *see supra* note 88 (providing the applicable disaster dates).

[106] *Id.* (citing Katrina Emergency Tax Relief Act, *supra* note 86, § 302).

[107] *Id.*

[108] *Id.*

[109] *Id.*

[110] *Id.* (citing Katrina Emergency Tax Relief Act, *supra* note 86, § 303).

[111] *Id.*

[112] I.R.C. § 162(a) (LexisNexis 2008).

[113] Bailout Bill, *supra* note 3, § 706.

[114] *Id.*

[115] *Id.*

[116] *Id.*

[117] I.R.C. § 1(g); Rev. Proc. 2007-66.

of unearned income tax free.[118] The second $900 is taxed at the "kiddie tax" rate of 15% and anything over $1,800 is taxed at the parent's marginal rate.[119]

Deductions

The adjusted gross income phase out amounts for the maximum student loan interest deduction of $2,500 of interest paid on qualified student loans has increased for 2008. For single taxpayers the maximum deduction begins to phase out at $55,000 and is completely phased out at an adjusted gross income of $70,000.[120] The maximum deduction phase out amounts for those filing married filing jointly start at $115,000 and the deduction is completely phased out at more than $145,000.[121]

Credits

For tax year 2008 there are several changes to credits. First, the adoption credit for tax year 2008 has increased and the maximum amount allowed for an adoption credit is $11,650.[122] The available adoption credit begins to phase out for taxpayers with an adjusted gross income in excess of $174,730 and is completely phased out for taxpayers with an adjusted gross income of $214,730 or more.[123] Taxpayers would be eligible for this credit for unreimbursed expenses in adopting a child in the current tax year for expenses incurred the previous tax year or in the current tax year if the adoption was completed before the end of the current year.[124]

Next, the additional child tax credit has also increased. Taxpayer's are eligible for the additional child tax credit if the taxpayer is unable to claim the full amount of the child tax credit.[125] For taxable years beginning in 2008, the value used to determine the amount of credit that may be refundable is $12,050.[126] However, the Extension Act reduced this value to $8,500.[127]

Third, the Hope Education and Lifetime Learning credits are two separate education credits available to taxpayers and their dependents.[128] The Hope Scholarship Credit is authorized for money spent on qualified tuition and related expenses during the first two years of a student's post-secondary education.[129] For tax year 2008, the maximum amount of the credit is $1,800; this is an amount equal to 100% of qualified expenses in excess of $1,200 and 50% of qualified expenses in excess of $1,200, but not more than $2,400.[130] The Lifetime Learning Credit is a credit of 20% of qualified education costs up to $10,000 for a maximum of $2,000.[131] These credits begin to phase out at adjusted gross income of $48,000 for single taxpayers and $96,000 for married filing jointly taxpayers.[132]

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118 Rev. Proc. 2007-66.

119 *Id.*

120 *Id.*

121 *Id.*

122 *Id.*

123 *Id.*

124 INTERNAL REVENUE SERV., PUB. 17, YOUR FEDERAL INCOME TAX (2008).

125 INTERNAL REVENUE SERV., PUB. 979, CHILD TAX CREDIT (2008).

126 *Id.*

127 Bailout Bill, *supra* note 3, div. C, § 706.

128 I.R.C. § 25A (LexisNexis 2008).

129 *Id.* § 25A(f).

130 Rev. Proc. 2007-66.

131 I.R.C. § 25A.

132 Rev. Proc. 2007-66.

Finally, the maximum amount a taxpayer can earn before being phased out of the EIC for 2008 is $38,646 if the taxpayer has more than one qualifying child and is a head of household filer and $41,646 if the taxpayer is married filing jointly.[133] If the taxpayer has one qualifying child the taxpayer must earn less than $33,995 if filing head of household and $36,995 if filing married filing jointly.[134] Finally, if the taxpayer does not have a qualifying child, the taxpayer must earn less than $12,880 if filing single and $15,880 if married filing jointly.[135] For 2008, the amount of the earned income credit has increased to $4,824 if the taxpayer has more than one qualifying child, $2,917 if the taxpayer has one qualifying child and $438 if the taxpayer does not have a qualifying child.[136]

Conclusion

The legislative changes to the tax code for the year 2008 are wide ranging. The portions of recent acts referred to in this update are those that will most likely have an effect on the proper completion of military tax returns. This should help ensure the best results for our clients. Hope you have a good tax season.

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[133] *Id.*

[134] *Id.*

[135] *Id.*

[136] *Id.*

Appendix

The tax rates for 2008 are: 10%, 15%. 25%, 28%, 33%, and 35%.[137]

Tax Tables

1. Married Individuals Filing Joint Returns and Surviving Spouses:

Taxable Income Is	The Tax Is
Not over $16,050	10% of the taxable income
Over $16,050 but not more than $65,100	$1,605 + 15% of the excess over $16,050
Over $65,100 but not more than $131,450	$8,962.50 + 25% of the excess over $65,100
Over $131,450 but not more than $200,300	$25,550 + 28% of the excess over $131,450
Over $200,300 but not more than $357,700	$44,828 + 33% of the excess over $200,300
Over 357,700	$96,770 + 35% of the excess over $357,700

2. Unmarried Individuals (Other than Surviving Spouses and Heads of Households):

Taxable Income Is	The Tax Is
Not over $8,025	10% of the taxable income
Over $8,025 but not more than $32,550	$802.50 + 15% of the excess over $8,025
Over $32,550 but not more than $78,850	$4,481.25 + 25% of the excess over $32,550
Over $78,850 but not more than $164,550	$16,056.25 + 28% of the excess over $78,850
Over $164,550 but not more than $357,700	$40,052.25 + 33% of the excess over $164,550
Over 357,700	$103,791.75 + 35% of the excess over $357,700

3. Heads of Households:

Taxable Income Is	The Tax Is
Not over $11,450	10% of the taxable income
Over $11,450 but not more than $43,650	$1,145 + 15% of the excess over $11,450
Over $43,650 but not more than $112,650	$5,975 + 25% of the excess over $43,650
Over $112,650 but not more than $182,400	$23,225 + 28% of the excess over $112,650
Over $182,400 but not more than $357,700	$42,755 + 33% of the excess over $182,400
Over $357,700	$103,791.25 + 35% of the excess over $357,700

4. Married Individuals Filing Separate Returns:

Taxable Income Is	The Tax Is
Not over $8,025	10% of the taxable income
Over $8,025 but not more than $32,550	$802.50 + 15% of the excess over $8,025
Over $32,550 but not more than $65,725	$4,481.25 + 25% of the excess over $32,550
Over $65,725 but not more than $100,150	$12,775 + 28% of the excess over $65,725
Over $100,150 but not more than $178,850	$22,414 + 33% of the excess over $100,150
Over $178,850	$48,385 + 35% of the excess over $178,850

The 2008 Standard Deduction amounts are:

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[137] *Id.*

1. Married filing jointly or qualifying widow(er) — $10,900
2. Single — $5,450
3. Head of household — $8,000
4. Married filing separately — $5,450[138]

Reduction of Itemized Deductions. (IRC § 68) Otherwise allowable deductions are reduced if the AGI in 2008 exceeds:

1. Married filing separately — $79,975
2. All other returns — $159,950.[139]

The amount of the 2008 Personal Exemption is $3,500.

2008 Phase Out Amounts for personal exemptions under IRC § 151(d)(3) are:

Taxpayer	Begins After	Fully Phased Out*
Married filing jointly	$239,950	$362,450
Single	$159,950	$282,450
Heads of household	$199,950	$322,450
Married filing separately	$119,975	$181,225

* Phase out occurs at a rate of 2% for each $2,500 or part of $2,500 ($1,250 in both cases for married filing separately) by which the taxpayer's adjusted gross income exceeds the "Begins After" amount. The exemption amount for taxpayers which adjusted gross income in excess of the maximum phase out amount is $2,333.

[138] *Id.*

[139] *Id.*