TJAGLCS Practice Note

Tax Law Note

Update for 2007 Federal Income Tax Returns

There are a few changes that legal assistance attorneys should be aware of when completing and filing tax returns for military taxpayers this tax season. Most of these changes relate to recent tax legislation for the Alternative Minimum Tax (AMT),[1] mortgage debt relief,[2] deductions for charitable cash contributions,[3] and a number of credits including the Hope and Lifetime Learning Credit,[4] Adoption Credit,[5] and Earned Income Credit.[6] In addition, to aid legal assistance clients with tax planning for future years, legal assistance attorneys should be aware of a change in the taxation of unearned income of minors[7] which will take effect in 2008.

Key Changes for 2007

Expired Provisions

For the last two years taxpayers affected by Hurricanes Katrina, Rita, and Wilma have been granted certain tax benefits under the Katrina Emergency Tax Relief Act of 2005[8] and the Gulf Opportunity Zone Act of 2005.[9] These benefits included waiver of penalties and delayed repayment of loans from Individual Retirement Arrangements (IRAs) and qualified employer plans,[10] increased limits on amounts allowed for the Hope and Lifetime Learning Credits,[11] and authorization of additional exemptions for housing individuals displaced by Hurricane Katrina.[12] Those tax benefits expired in 2006 and will not be authorized for 2007 federal income tax returns.[13]

Alternative Minimum Tax

The Tax Increase Prevention Act of 2007, passed on 26 December 2007, amended the AMT.[14] Many taxpayers were concerned about the AMT because it increases the tax liability of the taxpayer.[15] The AMT does this by eliminating many deductions and credits normally allowed to the taxpayer, ultimately increasing the taxpayer's tax liability.[16] A taxpayer would have to pay the AMT if his or her taxable income was more than the AMT exemption amount based on filing status.[17]

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[1] Tax Increase Prevention Act of 2007, Pub. L. No. 110-166, 121 Stat. 2461.

[2] Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, 121 Stat. 1809.

[3] I.R.C. § 170(a) (LEXIS 2008).

[4] *Id.* § 25A.

[5] *Id.* § 23.

[6] *Id.* § 32.

[7] *Id.* § 1(g).

[8] Pub. L. No. 109-73, 119 Stat. 2016.

[9] Pub. L. No. 109-135, 119 Stat. 2577.

[10] §§ 101, 103, 119 Stat. 2016.

[11] § 1400O, 119 Stat. 2577.

[12] § 302, 119 Stat. 2016.

[13] § 1400O, 119 Stat. 2577; §§ 101(d)(1), 103(a) and 302(a), 119 Stat. 2016.

[14] Pub. L. No. 110-166, 121 Stat. 2461.

[15] Internal Revenue Service, Topic 556—Alternative Minimum Tax, *available* at www.irs.gov (follow "Alternative Minimum Tax" hyperlink) (last visited Jan. 29, 2008).

[16] *Id.*

[17] *Id.*

The Tax Increase and Prevention Act of 2007, temporarily increases the exemption amount before the taxpayer becomes liable for the AMT. This amount is now $44,350 for single taxpayers and $66,250 for taxpayers married filing jointly.[18] However, due to the late action taken by Congress, filing for certain federal income tax returns will be delayed until 11 February 2007.[19] This will affect federal income tax returns utilizing these forms: (1) Internal Revenue Service (IRS) Form 8863, Education Credits; (2) IRS Form 5695, Residential Energy Credits; (3) Schedule 2, IRS Form 1040A, Child and Dependent Care Expenses for Form 1040A Filers; (4) IRS Form 8396, Mortgage Interest Credit; and (5) IRS Form 8859, District of Columbia First-Time Homebuyer Credit.[20]

Mortgage Interest and Debt Forgiveness

On 20 December 2007, the President signed the Mortgage Forgiveness Debt Relief Act of 2007.[21] This statute amends § 108(a) of the Internal Revenue Code (IRC) allowing taxpayers to exclude from gross income the discharge of indebtedness on their principal residence.[22] At this time, the statute only applies to discharges of indebtedness on or after 1 January 2007 to 1 January 2010.[23]

Even though the taxpayer's discharge of indebtedness is not included in gross income, the amount that is excluded from gross income will reduce the taxpayer's basis in his or her principal residence.[24] Even though the basis in the home is reduced, the Mortgage Forgiveness Debt Relief Act of 2007 prevents the basis in the home from being reduced below zero.[25] This can affect taxpayers at a later date when they sell the home and realize capital gains.

A taxpayer realizes capital gains on the amount earned on the sale of the home above the taxpayer's basis in the home.[26] Currently, taxpayers who sell a home that they have lived in for two of the last five years are allowed to exclude the following amounts of capital gains on the sale: $500,000 if married filing jointly; and $250,000 if filing as a single taxpayer.[27] For example, if a taxpayer has a basis of $750,000 in a town home purchased in Alexandria, Virginia and that taxpayer later goes into arrears on his mortgage and has $350,000 of indebtedness discharged, he can exclude that amount from gross income. However, the taxpayer's basis in his town home is now $400,000. If that taxpayer were to sell the town home for $800,000, he could only exclude $250,000 of that total amount from gross income and would have to include a capital gain of $150,000 in gross income. If the basis had not been reduced to $400,000, the taxpayer could have excluded the entire amount earned on the sale because the taxpayer's basis in the home was $750,000 and only realized capital gains on the sale in the amount of $50,000, well below the $250,000 exclusion amount.

Section 2(h)(2) of the Mortgage Forgiveness Debt Relief Act of 2007 increases the amount allowed for acquisition indebtedness from $1,000,000 to $2,000,000.[28] Acquisition indebtedness is debt incurred for the purchase, construction, or significant renovations of a home.[29] Under § 163(h)(3)(B) of the IRC, taxpayers are limited to a maximum amount of indebtedness on which they receive a deduction for mortgage interest paid.[30] If the taxpayer incurs acquisition indebtedness

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[18] 121 Stat. at 2461.

[19] News Release, I.R.S., Alternative Minimum Tax (AMT)—How It Affects Filing Season 2008 (Dec. 28, 2007), *available* at www.irs.gov/newsroom/article/0,,id=1766055,00.html.

[20] *Id.*

[21] Pub. L. No. 110-142, 121 Stat. 1809.

[22] *Id.*

[23] § 2(a)(1)(E), 121 Stat. 1809.

[24] *Id.* § 2(h)(1).

[25] *Id.*

[26] I.R.C. § 121.

[27] *Id.* § 121(a). However, military taxpayers have a special rule under IRC § 121(d)(9), which allows military members to suspend the five-year time period for up to ten years. *See also* INTERNAL REVENUE SERVICE, PUBLICATION 3, ARMED FORCES TAX GUIDE (2006).

[28] § 2(h)(2), 121 Stat. 1809.

[29] I.R.C. § 163(h)(3)(B).

[30] *Id.*

over this amount, he will not be allowed to take a deduction for the entire amount of mortgage interest paid.[31] The change in the amount of acquisition indebtedness now means that taxpayers who purchase a home over $1,000,000 but less than $2,000,000 can take the entire amount of mortgage interest paid as a deduction.

Finally, the statute also amends IRC § 163(h)(3)(E)(iv) allowing for the treatment of mortgage insurance premiums paid or accrued after 1 January 2007, as mortgage interest until 31 December 2010.[32] As a result of the amendment of IRC § 163 (h)(3)(E)(iv), premiums paid or accrued by a taxpayer for qualified mortgage insurance[33] are deductible on Form 1040, Schedule A as mortgage interest.[34] Nonetheless, the amount a taxpayer can deduct is subject to phase out by 10% per every $1000 the taxpayer's adjusted gross income exceeds $100,000.[35] If the taxpayer is married filing separately, the deduction is reduced by 10% for every $500 the adjusted gross income exceeds $50,000.[36]

Unearned Income for Minors

A "kiddie tax" is incurred by all children who receive unearned income.[37] As of 1 January 2006, children who were under the age of eighteen received their first $850 of unearned income tax free.[38] The second $850 is taxed at the "kiddie tax" rate of 15% and anything over $1700 is taxed at the parent's marginal rate.[39] Starting 1 January 2008, the "kiddie tax" applies to children under the age of nineteen or under the age of twenty-four, if they are a full time student.[40] This means that parents who were contemplating giving their college-age children capital assets, may want to rethink when they give them due to the increased tax consequences of the "kiddie tax."

Deductions

There are two changes in the realm of deductions to discuss. The first is the tuition and fees deduction.[41] Last year the Tax Relief and Health Care Act of 2006 extended this above the line deduction along with a few others through tax year 2007.[42] As was last year, single taxpayers with an adjusted gross income (AGI) of $65,000 or less and married filing jointly taxpayers with an AGI of less than $130,000 will be able to deduct $4000 for higher education tuition and fees.[43] A deduction of $2000 is available to single taxpayers with an AGI of less than $80,000 and married filing jointly taxpayers with an AGI of less than $160,000.[44] However, in order to take the deduction this year, taxpayers will have to fill out IRS Form 8917, Tuition and Fees Deduction.[45]

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[31] *Id.*

[32] § 3(a), 121 Stat. 1809.

[33] "Qualified mortgage insurance is mortgage insurance provided by the Veterans Administration, the Federal Housing Administration, or the Rural Housing Administration, and private mortgage insurance (as defined in § 2 of the Homeowners Protection Act of 1998 as in effect on December 20, 2006)." INTERNAL REVENUE SERVICE, PUBLICATION 936, HOME MORTGAGE INTEREST DEDUCTION (2007).

[34] *Id.*

[35] *Id.*

[36] *Id.*.

[37] I.R.C. § 1(g) (LEXIS 2008).

[38] Pub. L. No. 109-222, 120 Stat. 345 (2006) (codified at I.R.C. § 1(g)(2)(A)).

[39] I.R.C. § 1(g).

[40] Revenue Proc. 2007-66; 2007 I.R.B. 45.

[41] *See* Internal Revenue Service, Form 1040, Line 34 (2007).

[42] Pub. L. No. 109-432, 120 Stat. 2922 (2006).

[43] INTERNAL REVENUE SERVICE, PUBLICATION 970, TAX BENEFITS OF EDUC. (2007).

[44] *Id.*

[45] *Id.*

Second, the rules applying to deductions for charitable cash contributions have been amended for this tax year. In order to deduct cash contributions of any amount the taxpayer must have a written record of the contribution.[46] The type of records required to take the deduction include a cancelled check or bank statement showing the name of the charity, the date the contribution was made and the amount of the contribution.[47] In addition to the bank records, a written communication from the charity will also meet the new requirements.[48] The written communication must include the name of the charitable organization, the date the contribution was made, and the amount of the contribution.[49]

Credits

Several adjusted gross income limits on credits have increased for 2007. Those most common to military taxpayers are the Hope and Lifetime Learning Credit,[50] Adoption Credit,[51] Additional Child Tax Credit,[52] and the Earned Income Credit.[53] As a result of these increases, more taxpayers are eligible to take advantage of these credits.

The Hope Scholarship and Lifetime Learning Credits are two separate educational credits available to taxpayers and their dependents.[54] The Hope Scholarship Credit is authorized for money spent on qualified tuition and related expenses[55] during the first two years of a student's post-secondary education.[56] For 2007, the maximum amount for the Hope Scholarship Credit is $1650.[57] This amount consists of 100% of qualified tuition and related expenses not in excess of $1100 plus 50% of those expenses in excess of $1100, but not more than $2200.[58] Alternatively, the Lifetime Learning Credit applies to the expenses paid for any level of higher education.[59] The taxpayer is allowed to take 20% of costs up to $10,000 of qualified tuition and related expenses for a maximum of $2000.[60] For 2007, both these credits are reduced once the taxpayer's adjusted gross income reaches between $47,000 and $57,000 for all single, head of household, and married filing separate filers.[61] Married filing jointly taxpayers will have these credits reduced when the adjusted gross income is between $94,000 and $114,000.[62] Finally, these credits are eliminated for single taxpayers whose adjusted gross income is $57,000 or more, and for married filing jointly taxpayers whose adjusted gross income is $114,000 or more.[63]

Second, taxpayers adopting an eligible child[64] can receive a credit for qualified adoption expenses which include reasonable and necessary adoption fees, court costs, attorney fees, and other expenses directly related to the adoption of the

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[46] INTERNAL REVENUE SERVICE, PUBLICATION 526, CHARITABLE CONTRIBUTIONS (2007).

[47] *Id.*

[48] *Id.*

[49] *Id.*

[50] I.R.C. § 25A.

[51] *Id.* § 23.

[52] *Id.* § 32(n).

[53] *Id.* § 32.

[54] *Id.* § 25A.

[55] Qualified tuition and related expenses consist of tuition and mandatory fees paid by the taxpayer on behalf of himself, his spouse, or any dependent of the taxpayer for which the taxpayer is allowed the dependency exemption. *Id.* § 25A(f).

[56] *Id.*

[57] I.R.C. § 25A(b)(1); Rev. Proc. 2006-53.

[58] I.R.C. § 25A(b)(1); Rev. Proc. 2006-53.

[59] I.R.C. § 25A(c)(2)(B).

[60] *Id.*

[61] I.R.C. § 25A(b)(1); Rev. Proc. 2006-53.

[62] I.R.C. § 25A(b)(1); Rev. Proc. 2006-53.

[63] I.R.C. § 25A(b)(1); Rev. Proc. 2006-53.

[64] "An eligible child is an individual who has not attained the age of 18 as of the time of the adoption or who is physically or mentally incapable of caring for himself." I.R.C. § 23(d)(2).

eligible child.[65] The taxpayer can take this credit either the year after the expenses are incurred or in the year the adoption is completed.[66] For 2007 the maximum credit allowed for adoption expenses is $11,390.[67] This credit, however, reduces once a taxpayer's adjusted gross income exceeds $170,820 and is completely phased out once a taxpayer's adjusted gross income reaches $210,820 or more.[68]

Finally, the Additional Child Tax Credit and the Earned Income Tax Credit have new minimum and maximum income levels for 2007. First, the minimum amount of earned income used to figure the Additional Child Tax Credit for 2007 is now $11,750.[69] This is an increase from the 2006 amount of $11,300.[70] On the other hand, the maximum amount a taxpayer may earn before they are disqualified from the Earned Income Credit has increased to $37,783 if the taxpayer has more than one qualifying child and is a head of household filer and $39,783 if the taxpayer is married filing jointly.[71] If the taxpayer has one qualifying child the taxpayer must earn less than $33,241 if filing head of household and $35,241 if filing married filing jointly.[72] Finally, if the taxpayer does not have a qualifying child, the taxpayer must earn less then $12,590 if filing single and $14,590 if married filing jointly.[73] Also, the amount of the earned income credit has increased for 2007 to $2853 if the taxpayer has one qualifying child, $4716 if the taxpayer has more than one qualifying child, and $428 if the taxpayer does not have a qualifying child.[74]

[65] *Id.* § 23(d)(1).

[66] *Id.* § 23(a)(2)(A) & (B).

[67] *Id.* § 23(b)(1); Rev. Proc. 2006-53.

[68] I.R.C. § 23(b)(2)(A); Rev. Proc. 2006-53.

[69] Rev. Proc. 2006-53, 2006 I.R.B. 47.

[70] *Id.*

[71] Rev. Proc. 2006-53.

[72] *Id.*

[73] *Id.*

[74] *Id.*

Appendix

There are six different marginal tax brackets for tax year 2007: 10%, 15%, 25%, 28%, 33%, and 35%.[75]

1. Married Individuals Filing Joint Returns and Surviving Spouses:

Taxable Income *Over*	*But Not Over*	Marginal Tax Rate
$1	$15,650	10%
$15,650	$63,700	$1565 + 15% of amount over $15,650
$63,700	$128,500	$8772.50 + 25% of amount over $63,700
$128,500	$195,850	$24,972.50 + 28% of amount over $128,500
$195,850	$349,700	$43,830.50 + 33% of amount over $195,850
$349,700		$94,601 + 35% of amount over $349,700

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

Taxable Income *Over*	*But Not Over*	Marginal Tax Rate
$1	$7825	10%
$7825	$31,850	$782.50 + 15% of amount over $7,825
$31,850	$77,100	$4386.25 + 25% of amount over $31,850
$77,100	$160,850	$15,698.75 + 28% of amount over $77,100
$160,850	$349,700	$39,148.75 + 33% of amount over $160,850
$349,700		$101,469.25 + 35% of amount over $349,700

3. Heads of Households:

Taxable Income *Over*	*But Not Over*	Marginal Tax Rate
$1	$11,200	10%
$11,200	$42,650	$1120 + 15% of amount over $11,200
$42,650	$110,100	$5837.50 + 25% of amount over $42,650
$110,100	$178,350	$22,700 + 28% of amount over $110,000
$178,350	$349,700	$41,810 + 33% of amount over $178,350
$349,700		$98,355.50 + 35% of amount over $349,700

4. Married Individuals Filing Separate Returns:

Taxable Income *Over*	*But Not Over*	Marginal Tax Rate
$1	$7825	10%
$7825	$31,850	$782.50 + 15% of amount over $7,825
$31,850	$64,250	$4386.25 + 25% of amount over $31,850
$64,250	$97,925	$12,486.25 + 28% of amount over $64,250
$97,925	$174,850	$21,915.25 + 33% of amount over $97,925
$174,850		$47,300.50 + 35% of amount over $174,850

[75] I.R.C. §1(a)-(d), (i)(2); Rev. Proc. 2006-53, 2006 I.R.B. 48.

5. Estates and Trusts:

Taxable Income *Over*	*But Not Over*	Marginal Tax Rate
$1	$2150	15%
$2150	$5000	$322.50 + 25% of amount over $2,150
$5000	$7650	$1035 + 28% of amount over $5,000
$7650	$10,450	$1777 + 33% of amount over $7,650
$10,450		$2701 + 35% of amount over $10,450

The 2007 Standard Deduction amounts are:

1. Married filing jointly or qualifying widow(er) – $10,700.

2. Single – $5350.

3. Head of household – $7850.

4. Married filing separately – $5350.[76]

Reduction of Itemized Deductions. (IRC § 68) Otherwise allowable itemized deductions are reduced if AGI in 2007 exceeds:

1. Married filing separately - $78,200.
2. All other returns - $156,400.[77]

The amount of the 2007 Personal Exemption is $3400.

2007 Phase Out Amounts for personal exemptions under IRC § 151(d)(3) are:

Taxpayer	Begins After	Fully Phased Out*
Married filing jointly	$234,600	$357,100
Single	$156,400	$278,900
Head of household	$195,500	$318,000
Married filing separately	$117,300	$178,550[78]

* Phase-out occurs at rate of 2% for each $2500 or part of $2500 ($1250 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 $1133.

[76] *Id.*

[77] *Id.*

[78] *Id.*