PKF PERSPECTIVES

TAX INCREASE PREVENTION ACT OF 2007 and MORTGAGE FORGIVENESS DEBT RELIEF ACT OF 2007

In the final days before it adjourned for 2007, Congress passed two long-awaited new tax acts, the **Tax Increase Prevention Act of 2007** (the so-called ***AMT Patch***) and the **Mortgage Forgiveness Debt Relief Act of 2007 (*Mortgage Relief Act*)**. These new acts were signed into law by President Bush on December 20, 2007. Key provisions are summarized below.

AMT Patch for 2007

Boosted AMT Exemption Amounts

The alternative minimum tax (AMT) is the excess, if any, of the tentative minimum tax for the year over the regular tax for the year. In arriving at the tentative minimum tax, an individual begins with taxable income, modifies it with various adjustments and preferences, and then subtracts an exemption amount (which phases out at higher income levels). The result is alternative minimum taxable income (AMTI), which is subject to an AMT tax rate of 26% or 28%.

Under pre-Act law, an individual's AMT exemption amounts for 2007 (before the phaseout) were as follows: $45,000 for married individuals filing jointly and surviving spouses; $33,750 for unmarried individuals; and $22,500 for married individuals filing separately.

These pre-Act law exemption amounts were identical to the exemption amounts that were in effect for 2000, and were far lower than the AMT exemption amounts that were in effect for 2006.

Under the new Act, the AMT exemption amounts (before phaseout) for 2007 for individuals are:

- $66,250 for married individuals filing jointly and surviving spouses (up from $62,550 for 2006);
- $44,350 for unmarried individuals (up from $42,500 for 2006); and
- $33,125 for married individuals filing separately (up from $31,275 for 2006).

This is a temporary fix only. Absent Congressional action, the AMT exemption amounts for individuals for 2008 will revert to the levels they were at for 2000.

The Act does not tinker with the AMT phaseout rules. Thus, the AMT exemption amounts for individuals for 2007 are as follows:

- married individuals filing jointly and surviving spouses, $66,250, less 25 percent of alternative minimum taxable income (AMTI) exceeding $150,000 (zero exemption when AMTI is $415,000);
- unmarried individuals, $44,350, less 25 percent of AMTI exceeding $112,500 (zero exemption when AMTI is $289,900); and
- married individuals filing separately, $33,125 less 25 percent of AMTI exceeding $75,000 (zero exemption when AMTI is $207,500), but AMTI of married individuals filing separately is increased by the lesser of $33,125 or 25 percent of the excess of AMTI (without regard to the exemption reduction over $207,500).

Personal Nonrefundable Credits May Offset AMT and Regular Tax

Under pre-Act law, personal nonrefundable credits for 2007, other than the child credit, the adoption credit, and low income saver's credit, could not exceed the excess of regular tax liability over the tentative minimum tax (determined without regard to the alternative minimum foreign tax credit).

Under the Act, for tax years beginning in 2007, the combined total of the following credits is limited to the sum of: (1) regular tax liability reduced by the foreign tax credit, and (2) the AMT:

- dependent care credit
- credit for the elderly and permanently and totally disabled
- mortgage credit
- child tax credit
- Hope and Lifetime Learning credits
- adoption credit
- lower income saver's credit
- nonbusiness energy property credit for energy-efficient improvements to a principal residence
- residential energy efficient property credit for solar electric, solar hot water, and fuel cell property added to a residence; and
- first-time D.C. home buyer credit.

As with the AMT exemption amounts, the credit fix, namely allowing credits to offset AMT and regular tax, is temporary—it is just for 2007.

Mortgage Forgiveness Debt Relief Act of 2007

The Mortgage Relief Act generally allows taxpayers to exclude from income up to $2 million of mortgage debt forgiveness on their principal residence, effective for indebtedness discharged on or after January 1, 2007 and before January 1, 2010. It also includes a number of important tax changes not connected to mortgage debt tax relief.

Current Law

Unless a specific exception applies, income realized by a debtor from the discharge of indebtedness is included in his gross income. Generally, the discharge of indebtedness amount equals the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. In certain circumstances, taxpayers reduce tax attributes such as, basis in property, by the amount of excluded discharged debt.

New Law

The Mortgage Relief Act, effective for indebtedness discharged on or after January 1, 2007 and before January 1, 2010, generally allows taxpayers to exclude from income up to $2 million of mortgage debt forgiveness on their principal residence.

Specifically, the Mortgage Relief Act provides that gross income doesn't include any discharge of “qualified principal residence indebtedness.” Qualified principal residence indebtedness is “acquisition indebtedness on a taxpayers's principal residence”, up to a $2 million limit ($1 million for married individuals filing separately). “Principal residence” has the same meaning as under the home sale exclusion rules. Acquisition indebtedness of a principal residence is indebtedness incurred in the acquisition, construction, or substantial improvement of an individual's principal residence that is secured by the residence. It includes refinancing of debt to the extent the amount of the refinancing does not exceed the amount of the refinanced indebtedness.

The basis of the taxpayer's principal residence is reduced by the excluded amount, but not below zero.

The mortgage forgiveness exclusion only applies with respect to a taxpayer's principal residence. Thus, while interest for a taxpayer's vacation home may be deductible, debt forgiven with respect to a taxpayer's vacation home is not excludible.

Extension of Treatment of Mortgage Insurance Premiums as Interest

Current Law

Under pre-Mortgage Relief Act law, the rules treating qualified mortgage insurance premiums as deductible qualified residence interest apply only if the amounts: (1) are paid or accrued before January 1, 2008; (2) are not properly allocable to any period after December 31, 2007; and (3) are paid or accrued with respect to a mortgage insurance contract issued after December 31, 2006.

New Law

The Mortgage Relief Act extends the rules treating qualified mortgage insurance premiums as deductible qualified residence interest for three years. Thus, they apply if the amounts: (1) are paid or accrued before January 1, 2011; (2) are not properly allocable to any period after December 31, 2010; and (3) are paid or accrued with respect to a mortgage insurance contract issued after December 31, 2006.

Co-ops Can Qualify Under Two Additional Tests

Current Law

Tenant-stockholders of cooperative housing corporations (i.e., co-ops) are entitled to certain important tax benefits. All tenant-stockholders may deduct amounts paid or accrued to the corporation to the extent they represent the shareholder's proportionate share or separately allocable share of the real estate taxes and mortgage interest paid by the corporation.

A co-op is a corporation that meets the following four requirements:

1 It has one class of stock;

2 Each of its stockholders is entitled, solely by reason of ownership of stock in the corporation, to occupy a dwelling owned or leased by the cooperative;

3 None of its stockholders are entitled to receive any distribution not out of its earnings and profits, except on the co-op's complete or partial liquidation; and

4 Under pre-Mortgage Relief Act law, 80% or more of its gross income for the tax year in which the taxes and interest are paid or accrued must be derived from tenant-stockholders.

New Law

Effective December 20, 2007, the Mortgage Relief Act adds two alternate methods of meeting the 80% test in 4, above. In addition to the present 80% test, the fourth requirement is met if, for the tax year in which the taxes and interest are paid or accrued:

a at all times during that tax year, 80% or more of the total square footage of the corporation's property is used or available for use by the tenant-stockholders for residential purposes or purposes ancillary to residential use; ***or***

b 90% or more of the corporation's expenditures paid or incurred during the tax year are paid or incurred for the acquisition, construction, management, maintenance, or care of its property for the benefit of tenant-stockholders.

This provision apparently addresses the problem that some co-ops face because of the increasingly profitable rental market. As a result, co-ops charging market-rate rent find that they are receiving too much commercial rent (i.e., totaling more than 20% of gross income).

These two alternatives will make it easier for co-ops to take advantage of the commercial rental market and still qualify as a co-op.

New Exclusion for Volunteer Firefighters and Emergency Medical Responders

Current Law

The IRS took the position that reductions or rebates of property taxes by State or local governments on account of services performed by members of qualified volunteer emergency response organizations were in-kind payments for services, and, as such, were taxable income to the volunteers.

Specific statutory exclusions are provided where a reimbursement is for expenses incurred in performing volunteer services under certain government programs (e.g., the Foster Grandparent program). Under pre-Mortgage Relief Act law, there was no specific statutory exclusion for reimbursements received by volunteer emergency medical responders.

New Law

The Mortgage Relief Act provides, effective for tax years beginning after December 31, 2007 and before January 1, 2011, an exclusion from gross income to members of qualified volunteer emergency response organizations for:

1 any qualified State or local tax benefit; ***and***

2 any qualified payment.

A qualified State or local tax benefit is any reduction or rebate of State or local income, real property, or personal property taxes on account of services performed by individuals as members of a qualified volunteer emergency response organization. The amount of State or local taxes taken into account by a taxpayer in determining his deduction for taxes is reduced by the amount of any qualified State or local tax benefit (i.e., the itemized deduction for real estate tax is reduced by the excluded benefit).

A qualified payment is a payment (whether reimbursement or otherwise) provided by a State or political subdivision on account of the performance of services as a member of a qualified volunteer emergency response organization.

The amount of these payments is limited to $30 multiplied by the number of months during the year that the taxpayer performs such services. The expenses paid or incurred by the taxpayer in connection with the performance of services are taken into account for a charitable contribution deduction only to the extent they exceed the amount of excluded qualified payments. Therefore, the maximum exclusion for a qualified payment in a year is $360 ($30 × 12 months).

A qualified volunteer emergency response organization is any volunteer organization which is: (1) organized and operated to provide firefighting or emergency medical services for persons in the State or its political subdivision; and (2) required (by written agreement) by the State or political subdivision to furnish firefighting or emergency medical services in the State or political subdivision.

Home Sale Exclusion Liberalized for Surviving Spouse

Current Law

For gains on the sale of one's principal residence, the up-to-$500,000 exclusion is available only if a husband and wife file a joint return for the year of sale. Thus, if the principal residence home is sold in a year after the year of a spouse's death—when a joint return would no longer be available—the surviving spouse can only get a maximum home sale exclusion of $250,000.

New Law

Effective for sales and exchanges after December 31, 2007, surviving single spouses qualify for the up-to-$500,000 exclusion if the sale occurs not later than two years after their spouse's death and the requirements for the $500,000 exclusion were met immediately before the spouse's death.

The measuring period is two years from a spouse's death. Thus, a sale or exchange in the second tax year following a spouse's death will not qualify for the relief provision if it occurs more than two years from the spouse's death.

Basis Step-up Is Unaffected

Regardless of the home sale exclusion, where the spouses jointly owned the residence, the surviving spouse's basis in the decedent's half of the property is stepped-up to its date-of-death or alternate-valuation-date value. That is, half of the pre-death gain on the property will be eliminated since the gain (sales proceeds - property basis) on the decedent's half of the property will only be the difference between the fair market value of the property on the date of sale and on the date of the spouse's death (or alternate valuation date).

Revenue Raising Provisions

To offset the cost of the new tax breaks, the Mortgage Relief Act includes the following revenue raisers:

- Extension of the period for calculating the monthly failure-to-file-penalty for partnership returns from 5 to 12 months and an increase in the per-partner penalty amount from $50 to $85 per partner, effective for returns required to be filed after the enactment date, December 20, 2007.
- Imposition of 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 the enactment date. 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.
- Increasing the required installment amount for estimated tax payments by corporations with assets of $1 billion or more that is otherwise due in July, August, or September of 2012 by 1.50 percentage points.

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