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TAX DEVELOPMENTS

Late 2007 Form 1040 Developments

In a frenzy of last-minute activity, Congress made a number of changes to the tax law in late December. Remarkably, some of these affected the 2007 Form 1040. Here is a brief update:

The AMT “Patch”

Most middle and upper income 1040 filers are aware of the threat of the Alternative Minimum Tax (AMT). In today’s tax environment, most substantive 1040s need to have two tax computations: the regular tax and AMT. An individual is required to pay the greater of the two calculations.

While the regular income tax rates are indexed for inflation, this has never occurred with the AMT. As a result, Congress needs to constantly increase the amount of income exempt from the AMT, in order to prevent the AMT from becoming the prevailing tax in most returns. Had Congress not updated the exemption for 2007, most joint tax returns with income above approximately \$70,000 would have been subject to the AMT!

But, as expected, we received a last-minute AMT “patch.” The AMT exemption for 2007 for single filers was increased by roughly \$2,000 over the prior year amount, while the joint exemption was increased by \$3,700.

The important point to understand is that these increased exemption amounts for 2007 simply preserve the status quo. The AMT exemption was bumped over the 2006 amount only to compensate for the small inflation-indexing that occurred in the regular income tax rates. Stated differently, we will continue to have the same tight relationship between the two tax systems. As a result, taxpayers who have larger deductions in the categories that reduce regular tax and do not reduce AMT essentially will face the same probability of incurring

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AMT as in the past. The types of deductions, which tend to push a 1040 into the AMT, include high state income taxes, larger residential real estate taxes (such as from two homes), and a greater number of dependency exemptions.

AMT Refundable Credit Improved

When AMT is incurred as the greater tax, in some cases that AMT becomes a tax credit carryforward to future years that can offset regular income tax. Beginning in 2007, there is a new refundability feature to that AMT credit carryover, making it much more likely that the taxpayer will recover some portion of prior AMT payments.

Unfortunately, this new refundable credit comes with a number of restrictions. First, the AMT must have been paid more than three years earlier to qualify for this new feature. Further, the credit availability is only for AMT arising from timing differences, such as AMT triggered by the exercise of stock options or from differences between regular and AMT depreciation rules (AMT from high state and local taxes or personal exemptions does not fit these rules). Finally, upper income filers are not eligible for this new refundable credit. Single filers above \$279,000 and joint filers above \$357,000 of adjusted gross income are totally ineligible.

For those fortunate enough to qualify to use this new tax credit, Congress further improved it in a late December tax bill. Previously, the refundable credit was under a declining calculation, which would have taken many years to recover. Under the revised computation, we will typically be able to secure the refunds of the more-than-3-year-old prior AMT over a five year period. Please be assured that we will be testing the possibilities on this new credit in all returns that we prepare that had any prior AMT.

Home Mortgage Debt Forgiveness

In recognition of the housing deflation that is occurring in many parts of the country, Congress has added a new provision allowing a taxpayer to exclude up to \$2 million of mortgage debt forgiveness without taxation. The exclusion only applies to debt related to the acquisition or substantial improvement of an individual's principal residence. It is not available for home equity debt, nor for debt forgiveness related to a seasonal or vacation residence debt. This new provision is available for debt discharged on or after January 1, 2007, and before 2010.

For taxpayers who do receive this tax-free debt forgiveness, the tax basis of the residence must be reduced by the amount of excluded debt. But in most cases, that will be of no consequence, due to the ability to apply a separate provision allowing the tax-free sale of a principal residence.

Example. Phil, a single individual, purchased a home about two years ago in a highly leveraged transaction and has current debt on that residence of \$300,000. Phil is forced to sell the home, but only realizes sales proceeds of \$270,000, which are entirely paid to the lender.

The lender forgives the remaining \$30,000 of Phil's debt. The \$30,000 of debt forgiveness is tax-free to Phil under this new provision, but he must reduce his tax cost in the home by this \$30,000 amount. If Phil should have a gain on the home after this reduction in its tax cost, he has a separate \$250,000 gain exclusion available under the general rules applicable to the sale of a principal residence (\$500,000 gain exclusion if Phil was a joint filer selling his residence).

Mortgage Insurance Premium Deductibility

Beginning 2007, a new homeowner who incurs a mortgage insurance premium, where that mortgage insurance contract originated in 2007, is allowed to deduct the insurance premium as if it was residential interest expense. This new deduction is limited to those who have adjusted gross income under \$110,000.

As originally enacted, any prepayment of the mortgage insurance premiums in 2007 was not deductible. But a last-minute IRS Notice now allows any prepaid mortgage insurance to be amortized over the shorter of the mortgage term or 84 months. Prepayments might occur with respect to new home acquisitions using VA or FHA financing.

Cash Contribution Rules for 2007

Beginning with the 2007 Form 1040, an individual must have either a cancelled check, credit card charge or a receipt from the charity to support a cash contribution. Stated differently, any "greenback" donations are no longer deductible unless the taxpayer has a receipt from the charity, regardless of how small the amount! Estimates and notations are no longer sufficient to support the deductibility of cash contributions.

New for the 2008 Form 1040

As always, there are a number of changes coming our way for the 2008 individual tax year. Here are some opportunities, as well as pitfalls, of which you should be aware:

IRA Limits

A number of years ago, Congress set in place a series of gradual increases in the IRA contribution limits. Effective in 2008, we have now reached the final increase. The annual IRA funding limit, whether for a traditional deductible IRA or a Roth IRA, is now \$5,000 per year. If an individual is age 50 or over by the end of the tax year, the limit is \$6,000. (For 2007, these amounts were both \$1,000 less.)

Caution: A full Roth IRA contribution can only be made if the taxpayer's modified adjusted gross income is under \$95,000 for single filers and \$150,000 for joint filers. With respect to

traditional deductible IRAs, there are income-sensitive limits only if the individual (or spouse) is a participant in another retirement plan.

2008 Mileage Rates

The business mileage rate for 2008 has increased to 50.5¢ per mile, up from 48.5¢ in 2007. The allowance for mileage for medical or moving expenses has decreased to 19¢ per mile (formerly 20¢), whereas the rate for charitable driving remains at 14¢ per mile.

0% Capital Gain and Dividend Rates

There is something about a tax rate of zero that really gets attention! For the first time ever, lower income filers will be able to report capital gains and dividends at no federal tax cost. While this might seem to be a tax rate that should be avidly pursued, there are a significant number of restrictions that apply.

For starters, this 0% rate in 2008 is not dramatically different than previous years, during which dividends and capital gains have been taxed at 5%. Secondly, to qualify, the capital gain or dividend must fall into the lower tax brackets. Roughly, that means less than \$32,000 of taxable income for a single filer and \$65,000 for a joint filer. Finally, any capital gain or dividend is considered the top portion of an individual's income. The ordinary income is considered to fill up the lower brackets first, followed by the capital gain or dividend income as the top tier.

In most cases, lower bracket returns are those of either retirees or children/young adults. But both groups have problems in receiving the full benefit of this new 0% rate. For the elderly, the big issue is the complicated formula that increases the taxability of Social Security benefits as income increases.

Example. Fred and Ethel are retirees collecting Social Security benefits and have read about the new 0% capital gain rate. They check their tax return and learn that they can absorb about \$10,000 of capital gain at 0%. Accordingly, they sell a few stocks and recognize \$10,000 of capital gains in 2008. While the \$10,000 capital gain has a 0% cost, the extra \$10,000 of income causes about \$8,000 of additional Social Security benefits to become taxable as ordinary income. This cost Fred and Ethel about \$2,000 of additional federal income tax!

For those under age 24, who generally will be in the lower tax brackets to which the 0% rate applies, the new "kiddie tax" may rear its ugly head. Starting in 2008, in a corresponding law change (discussed in later paragraphs), many under age 24 will find their parents' top tax rate applied to their income rather than their own lower rates. Accordingly, the 0% normally applicable to the capital gains and dividend income of a child or young adult will be taxed at mom and dad's 15% rate.

In summary, while the 0% rate is intriguing, its limits are more severe than advertised. Please check with us if you have family members who may benefit from the 0% capital gain and dividend rate, and we will assist in determining applicability. In some cases, it may be possible to make gifts of appreciated stocks or other securities to these family members, allowing them to subsequently recognize the gain at a 0% rate.

Expanded Kiddie Tax Rules

In an earlier newsletter, we explained that Congress has expanded the “kiddie tax” beginning in 2008. For the last several years, the kiddie tax, which taxes a child at the parents’ top tax rate, has only applied to those under age 18. In its simplest form, the kiddie tax imposes the parent tax rate on the investment income of the child that is in excess of \$1,700.

Beginning with the 2008 tax year, the kiddie tax is expanded in a complicated manner to potentially reach children through age 23. The kiddie tax applies to those who have their 18th birthday during the year, and also to those who are in full-time student status (defined as in full-time enrollment at least five months of the year) and who have attained their 19th through 23rd birthday during the particular tax year. Further, for the kiddie tax to apply to this age 18-23 group, the wages and self-employment income of the individual may not exceed half of the amounts expended for the individual’s support for the year.

Example. Bart is a full-time college student, age 20, whose items of support for 2008 total \$30,000. This support includes Bart’s room, board, tuition, health care, and recreational expenditures for the year, less any scholarships that reduce the outlay for his tuition. Bart’s W-2s from summer employment and part-time work at school during the year total \$7,000 for 2008. As a result, Bart is subject to the kiddie tax, because his wage income of \$7,000 does not exceed 50% of his \$30,000 of support for 2008. Accordingly, if Bart has interest, dividends, capital gains and other unearned income in excess of \$1,700, that excess will be taxed at his parents’ top tax rate.

Strategies. For those with 18-23 year olds who will face this new kiddie tax in 2008 and after, there are some actions that can help. New investments that are intended as savings for college might be directed toward state-sponsored 529 plans. These investments can be liquidated during college years without any taxation if the funds are expended for higher education, thus avoiding the reach of the new kiddie tax.

For those who are liquidating investments already in the student’s name, kiddie tax may now be inevitable. But recognize that a child will likely qualify for a Hope or Lifetime Learning tax credit based on the higher education tuition expenditures. This tax credit can be as large as \$2,000, and may offset some or all of the additional kiddie tax imposed in the child’s return. In some cases, there is a special election that we can make to decline the student’s dependency exemption in the parent return, in order to qualify the child’s tax return for one of these college credits.

Finally, as a practical matter, recognize that where kiddie tax applies, parent taxable income will now be disclosed within the child's return! In this situation, most parents will want to control access to that child's tax return to assure confidentiality with respect to their personal income.

BUSINESS DEVELOPMENTS

Health Insurance for S Corporation Owners

For many years, the tax law has treated more-than-2% owners of S corporations as non-employees with respect to tax-free fringe benefits. The effect has been that the health insurance benefits provided by the S corporation to its owners are not tax-free fringes, but rather must be reported as compensation on the Form W-2 of the owner. The owner then claims the 100% self-employed health insurance deduction to offset the extra W-2 income. This all has the effect of allowing a full deduction for the health insurance, although we go through a complicated series of steps involving the 1040 to get that result.

Several years ago, the IRS advanced the position that the health insurance policy for the S corporation owner must be in the name of the S corporation. The IRS asserted that the S corporation could not simply reimburse the premium costs if the policy was owned by the individual shareholder.

Now, in an important change in position, the IRS has conceded that it makes no difference whether the health policy is personally owned or owned by the S corporation. In either case, the S corporation may pay or reimburse the premium, and, therefore, qualify the owner for full deductibility of that premium. We are still required to go through the steps of W-2 inclusion and claiming the offsetting deduction. But at least the IRS has dropped its former position regarding the ownership of the health insurance policy. Further, if a shareholder of an S corporation did not claim the health insurance deduction in the past due to this IRS position, but otherwise had the S corporation make the premium payment, amended returns may be possible.

Spousal Employment and Health Benefits

Many small businesses are organized as proprietorships (one owner) or partnerships. And it is common in those small businesses that the spouse of an owner may provide part-time or even full-time services to the business. In those cases, by formally employing that spouse, it becomes possible for the business to provide tax deductible health insurance, and sometimes additionally a medical reimbursement plan, both of which are tax free fringe benefits to that spouse-employee.

In our Spring newsletter, we commented on a tax court case that had scrutinized one of these spousal employment arrangements. That case disallowed the fringe benefits due to the inability of the taxpayer to document that actual services were rendered by the spouse to the business, and that the compensation and fringe benefit package were reasonable in exchange for the value of those services.

Fortunately, a recent tax court case has rebuffed IRS attempts to further narrow the spousal employment opportunity. The case involved a proprietor who employed his spouse for part-time services. As part of that arrangement, the business deducted several health insurance policies. In one case, the insurance policy was issued in the employee-spouse's name, whereas another insurance policy was solely in the proprietor's name. The tax court disagreed with the IRS position that the health policy in the proprietor's name could not be part of the employee fringe benefit plan. Because the business had paid all of the premiums and did so under an employer-provided health plan arrangement, the proprietorship was allowed to claim all of the premiums as a business expense (*Frahm*, TC Memo 2007-351).

For those small business proprietorships and partnerships that either have spousal employment arrangements or could benefit from these, we can assist in assuring that they are properly structured to qualify for tax deductibility.

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