



10 tax laws you gotta know

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This filing season, the biggest beneficiaries of new tax laws are homeowners.

Unfortunately for some, any joy about a new tax break is tempered by the fact that it was created because they were having trouble paying their mortgages.

On a more positive note, another new law now allows some homeowners to deduct a common insurance cost.

A similar good news/bad news theme runs through other 2007 tax legislation.

A last-minute compromise on Capitol Hill granted millions of taxpayers a reprieve from the costly alternative minimum tax. But at the same time, the law means millions might have to wait to submit their returns and get any refunds.

And while one law made it easier for some to give to their favorite charities, another will have some philanthropic filers scrambling to find receipts.

Here's a look at 2007's new tax laws, combined with some provisions carried over from 2006 that could affect your current tax bill. For your 2008 tax planning purposes, we also take a peak at a couple of laws that took effect Jan. 1.

New tax laws

Several tax code changes will affect 2007 returns, but in many cases they are designed for very specific taxpayer circumstances. A few carryover provisions will offer some tax savings, especially for energy-conscious taxpayers. And a couple of law changes passed last year took effect Jan. 1 and could affect your 2008 tax planning.

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1. Forgiven home debt nontaxable

The year 2007 was dominated by housing woes. Many individuals who took out adjustable-rate mortgages to buy homes discovered that those loan terms, a changing economy and slumping housing market combined into a perfect homeownership storm.

Many individuals lost their houses to foreclosure; others were able to renegotiate more manageable payment terms. But in both cases, many of those homeowners soon discovered that they also owed unexpected taxes related to their real estate transactions.

Tax laws consider debt that a lender forgives as taxable income. In a homeowner's case, for example, if the bank reworks a loan so that the principal is less and writes off that excess, the amount is taxable cancellation of debt income. The same is true in certain situations where a mortgage lender forecloses on a home and sells it for less than the owner's loan principal. For example, if a bank forecloses when the borrower owes \$400,000 on a home and then sells the property for \$310,000 in full satisfaction of the debt, the borrower will usually owe tax on \$90,000.

Although the taxability of debt forgiveness amounts has long been on the tax books, it came as a huge surprise to many homeowners.

"People who didn't have the money to meet their mortgage payments have found that they owe income taxes on tens of thousands of dollars," says Mark Luscombe, principal federal tax analyst with CCH, a tax software and publishing company in Riverwoods, Ill. "It seems like the tax system is kicking them when they're down."

Apparently, politicians thought so, too. Under the Mortgage Debt Forgiveness Act of 2007, some homeowners granted forgiveness of mortgage debt won't have to pay taxes on that amount. But there are some restrictions:

1. There is a limit on the forgiven debt: up to \$2 million or \$1 million for a married person filing a separate return.
2. The tax break also has a time limit. It only applies to mortgage debt discharged by a lender in 2007, 2008 or 2009.
3. The loan also must have been taken out to buy or build a primary residence, not a second or vacation home. If debt is forgiven on those additional properties, the owner will owe cancellation of debt income as usual.

2. Writing off private mortgage insurance

When a homebuyer does not make at least a 20 percent down payment, lenders usually require private mortgage insurance, or PMI. For some loans taken out in 2007, PMI payments are now deductible.

"I don't think there's any question that it's a good idea," says Don Hodson, an enrolled agent with the Financial Enhancement Group in Anderson, Ind. However, Hodson has some concerns about the implementation of this tax break.

"Many people really don't know what PMI stands for or even what it is," he says. "You're actually being asked to purchase an insurance contract to guarantee the balance due. That required cost is actually a cost associated with the purchase and now it can be deducted just like home mortgage interest."

Kathy Harrison-Suits, an enrolled agent with Summit Capital Advisers in Tacoma, Wa., shares Hodson's PMI deduction concerns.

"This is a real area of concern for people," says Harrison-Suits. "Most people don't know what PMI is and my fear is that they're going to assume, 'I pay insurance on my house for my mortgage' and think they are eligible."

In fact, Harrison-Suits has already had some clients call about this tax break, thinking that their homeowner hazard insurance premiums qualify.

And even taxpayers who understand PMI and make such payments might not be able to use this tax break.

"Treasury gives with the right hand and takes away with left," says Hodson, pointing to the deduction's many restrictions.

It is phased out for taxpayers with adjusted gross incomes exceeding \$100,000 (\$50,000, if married filing separately). "It's reduced by 10 percent of every \$1,000 over that \$100,000 base. So if you have \$110,000 income, you can't claim it," says Hodson.

The deduction also applies only to PMI policies issued in 2007, 2008, 2009 or 2010. Originally, the tax break was only for 2007 PMI payments, but it was expanded for the three additional years by the Mortgage Debt Forgiveness Act.

And the mortgage for which the insurance payments are made must be to buy or build a first or second home. If the PMI is in connection with a home equity loan, the funds must be used to improve the property for the premiums to be deducted.

3. AMT relief, delay

As 2007 was winding down, lawmakers reached an agreement for a temporary fix, or patch, to the alternative minimum tax. This costly parallel tax system, commonly referred to as the AMT, snares more filers each year, primarily because it's not indexed for inflation.

Another major problem posed by the AMT: Many common tax breaks used every year by individual taxpayers to lower their IRS bills are not allowed under the alternative system. For example, under the AMT, you cannot deduct state and local taxes.

For the last several years, Congress has increased the amount of income that's excluded from the AMT, thereby saving millions of taxpayers from having to make the tax's additional calculations.

The 2007 patch raised the exemptions to:

- \$66,250 for married, joint return filers.
- \$44,350 for single or head of household taxpayers.
- \$33,125 for married couples who file separate returns.

While the legislation solved one problem, it created a couple of others. First, it is only for tax year 2007. Congress is expected to pass additional measures to take care of 2008 taxes, but until it does, planning by taxpayers is hampered.

Secondly, because the AMT patch became law in late December, tax-filing is delayed for some taxpayers. Five AMT-related forms (Form 8863, Education Credits; Form 5695, Residential Energy Credits; Schedule 2, Child and Dependent Care Expenses for Form 1040A filers; Form 8396, Mortgage Interest Credit; and Form 8859, District of Columbia First-Time Homebuyer Credit) won't be ready for filers until Feb. 11. If you need to file any of those forms, the IRS will not accept your return -- or issue any refund -- until that February date.

4. More donation proof demanded

The IRS got tougher on donation documentation in 2007. Previously, you had to get a receipt or other acknowledgement from a charity if you gave \$250 or more. Now, for a monetary gift of any amount, must be able to produce "a bank record or a written communication" from the charity detailing the group's name and the date and amount of the gift.

A canceled check is fine. If you charge a contribution, your credit card statement should be sufficient. Many charities also already provide a receipt for all monetary gifts, regardless of the amount.

You don't have to send the receipts for your smaller financial gifts with your 1040, but you will need them if the IRS questions your deductions. Without them, the agency will automatically disallow the write-off.

And don't forget about the good-or-better requirement that took effect in August 2006 for noncash gifts. Under this law, if the IRS determines you donated clothing or household items that didn't meet the standard, it can disallow your deduction. So don't even think about dumping worthless items in a charity's donation bin and then deducting the so-called gift.

5. Older philanthropist options

One tax-law change, however, made last year's charitable giving by older philanthropists easier. Individuals 70½ or older were able to transfer money directly from an IRA to a charitable organization. The option is available to either Roth or traditional IRA owners, but it is most beneficial when the money comes from a traditional account, because much of that cash is eventually taxed.

This was the case for taxpayers who had to take required minimum distributions from a traditional IRA. By sending the withdrawal directly to a charity, the donated amount wasn't included in the giver's taxable income, thereby lowering the filer's tax bill a bit.

If you took advantage of this option, remember that you can't double dip by claiming a deduction for the contribution. For this reason, the rollover method appeals to taxpayers who otherwise wouldn't get a tax deduction, such as those who take the standard deduction instead of itemizing.

The direct to charity rollover expired at the end of 2007. However, it should be renewed for the 2008 tax year. The House approved a one-year extension as part of its alternative minimum tax measure, but the charitable provisions were dropped by the Senate and never made it into the final AMT patch.

Look for lawmakers to act early in 2008 to reauthorize this donation option so that older IRA account holders can plan accordingly.

6. 'Enron' retirement catch-up

Before the subprime mortgage mess dominated the news, all eyes were focused on workers who lost their retirement plan money because of corporate improprieties. In an effort to help those individuals, a provision in the Pension Protection Act of 2006 allows certain workers to make larger IRA contributions to make up part of what they lost in their company retirement accounts.

Under this law, dubbed the Enron IRA catch-up provision, if you participated in a 401(k) plan and your employer went into bankruptcy in a prior year, you may be able to contribute up to \$7,000 (instead of the general \$4,000 or \$5,000 limits) to your IRA.

The key, though, is that your employer must have been indicted or convicted in connection with business transactions related to the company's bankruptcy that wiped out employee accounts, hence the Enron nickname. The law also requires that:

- You were a participant in a 401(k) plan under which the employer matched at least 50 percent of your contributions to the plan with stock of the company.
- You were a participant in the 401(k) plan six months before the employer filed for bankruptcy.
- The employer (or a controlling corporation) must have been a debtor in a bankruptcy case in an earlier year.

If you are eligible for and use the Enron IRA option, which will be in effect through 2009, you can't also use the 50-or-older add-on; that is, you can't put an extra \$1,000 into your account on top of the \$7,000.

You can find more on all this provision and other IRA contribution rules in IRS Publication 590.

7. Home energy and tax savings

A carryover tax break from 2006 might be able to help cut your 2007 tax bill, too.

The Energy Tax Incentives Act of 2005 offers taxpayers a tax credit for making energy-efficient home improvements. Credits, which reduce your tax bill dollar for dollar, range from \$50 for the installation of a whole-house circulating fan to \$2,000 for conversion to a solar water-heating system.

Relatively simple upgrades, such as replacing drafty windows and doors, adding insulation and replacing an old heating or air conditioning unit will allow you to shave several hundred dollars off your tax bill.

The one drawback to this tax break, which expired at the end of 2007, is that any energy-efficient home improvements you made last year must be combined with any you made in 2006. And the two-year total allowed is only \$500.

"It came into effect in 2006," says Hodson, "so if you took the full credit then there's nothing left."

You can, however, claim more generous credits if you added solar water, heat or power systems to your house last year. And solar-related credits continue for 2008.

8. Fuel-efficient auto tax savings

Another continuing credit for energy conscious taxpayers is the one allowed for hybrid vehicles. Tax credits, depending on the make and model of the vehicle, range from a couple hundred dollars to several thousand.

However, the credit phases out for the fuel-efficient vehicles once a carmaker sells 60,000 hybrids; eventually the credits are completely eliminated.

That happened to Toyota in 2007, meaning you'll need to pay attention to when you bought your vehicle to determine your precise tax savings. If you purchased a Toyota or one of its Lexus model hybrids after Oct. 1, 2007, you get no tax credit.

The tax break for qualifying automakers continues through 2010, but the credit amounts will be reduced for some vehicles. Honda credits, for example, were cut in half Jan. 1.

9. Popular deductions reappear

The 2007 filing season brings some good news for taxpayers who claim several popular tax deductions, such as those for state sales taxes, college tuition and fees, and classroom expenses. Last year, these tax deductions were approved too late to make it onto the IRS forms. That meant filers had to do some extra work to make sure they claimed them.

But when they were extended in late 2006, they were made effective for 2007, too. So the IRS had plenty of time to get the deductions back on Forms 1040 and 1040A (tuition and

fees and classroom expenses at the bottom of page one on each of these) and, for filers who itemize, on Schedule A (in the deductible taxes section).

There is one addition here for 2007 returns. If you claim the tuition and fees deduction, you now must also file the new Form 8917 and submit it with your 1040 or 1040A.

The deductions are scheduled to expire at the end of 2008, but Congress is expected to renew them again. The IRS and taxpayers hope it will be soon enough to allow them to make it on to 2008 tax forms.

10. 2008 tax changes of note

Some significant tax law changes took effect Jan. 1. While they won't affect your 2007 return due this April, you might find them useful as you devise your 2008 tax strategies. They are:

1. Expansion of the home-sale exclusion for surviving spouses.
2. More changes to the kiddie tax.
3. Zero percent capital gains taxes for some investors.

Under prior tax law, a married couple could exclude up to \$500,000 profit from taxation when they sold their home as long as they met certain conditions. After a spouse's death, the surviving spouse also could claim that exclusion amount if the home was sold in the year his other spouse passed away. In that situation, the widow or widower would be able to file a tax return using the married filing jointly status.

However, if the widow or widower sold the residence the next year or later, the sale exclusion was cut in half. Because many widows and widowers delay making such major decisions after losing a husband or wife, they were penalized by the tax code when they finally did sell their house.

But thanks to a provision in the Mortgage Debt Forgiveness Act, bereaved home sellers get some tax relief. Now a surviving spouse has two years in which to sell a home that was jointly owned and take the \$500,000 gain exclusion.

"This is a significant new benefit, and the surviving spouse continues to be allowed a step up in basis in a jointly owned residence for the deceased spouse's one-half share. The \$500,000 exclusion is in addition to that," says CCH's Luscombe.

Parents also need to pay attention to the Jan. 1 changes to the kiddie tax.

In order to save for their child's college costs, some parents open accounts in the child's name. Not only does this designate the fund for the youngster's use, but it also had the tax advantage of having the earnings taxed at the youth's usually lower rate.

However, when a child's account earns a certain amount (\$1,700 in 2007, \$1,800 in 2008), the kiddie tax kicks in. In essence, the kiddie tax requires that excess earnings be taxed at the parents' highest marginal tax rate (which could be as high as 35 percent) until the child reaches a certain age, at which time the child's lower rates (typically 10 percent to 15 percent) then apply.

In 2007, a child's tax rates took effect when the youth turned 18. For 2008, the parents' higher rates will be collected on investment earnings until the child turns 19 or 24 if the youngster is a full-time student.

This change, says Luscombe, was designed to keep wealthier parents from taking advantage of another 2008 tax-law change, zero percent capital gains on lower-income investors.

Now about that new no taxes due law. Taxpayers in the 10 percent and 15 percent tax brackets can sell long-term assets this year through 2010 and not owe any capital gains on the profits. To qualify for the zero rate in 2008, a married couple must make less than \$65,100 in taxable income; single filers earning less than \$32,550 will pay no tax on their sales of assets they've owned for more than a year.

While the kiddie tax might keep many young investors from taking advantage of this law change, it could be a viable strategy for others such as retirees whose income will allow them to take advantage of the zero capital gains break.

Finally, in addition to the new 2007 tax code changes and prior year carryovers, many pre-existing laws have new dollar amounts this filing year, thanks to inflation adjustments. For details on these tax issues, see Bankrate's companion story, "Old tax laws, new amounts."

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