

# Many non-business tax law changes go into effect in 2008

## Tax Changes for Individuals Due to New Provisions


*Lowest capital gain tax rate reduced to 0%.* As discussed in greater detail at Weekly Alert ¶ 1 1/17/2008 ), beginning this year and continuing through at least 2010, a zero tax rate applies to most long-term capital gain and dividend income that would otherwise be taxed at the regular 15% rate and/or the regular 10% rate (last year, a 5% rate applied to such income). The zero tax rate is available only for a noncorporate taxpayer who has a net capital gain and/or qualified dividend income.

Net capital gain generally is the excess of net long-term capital gains over net short-term capital losses, subject to certain netting rules. But the zero tax rate doesn't apply to collectibles gain or Code Sec. 1202 gain (gain taxed on sales of certain small business stock), both taxed at a maximum rate of 28%, or to unrecaptured Code Sec. 1250 gain, which is taxed at a maximum rate of 25%. ( Code Sec. 1(h)(1) through Code Sec. 1(h)(6) )

For tax years beginning after 2007, a 0% tax applies to so much of the adjusted net capital gain (net capital gain reduced by collectibles gain, Code Sec. 1202 gain, or unrecaptured Code Sec. 1250 gain, and increased by qualified dividend income)—or, if less, taxable income—that doesn't exceed the excess (if any) of:


- (1) the amount of taxable income that would be taxed at a rate below 25% (without taking the special capital gains rates into account), over
- (2) taxable income reduced by the adjusted net capital gain. ( Code Sec. 1(h)(1)(B) )

The balance of the taxpayer's adjusted net capital gain is taxed at 15%. ( Code Sec. 1(h)(1)(C) )

 **RIA observation:** The amount of taxable income that would be taxed at the regular tax rate below 25% (in (1), above) is the amount that would be taxed at 10% or 15%, since those rates are the only regular tax rates that are below 25%. As a result, the amount at (1) for a particular taxpayer can't exceed the “top” (also known as the break-point) of the 15% rate bracket for his filing status.

*Kiddie tax broadened.* For 2007, a child subject to the kiddie tax pays tax at his or her parents' highest marginal rate on the child's unearned income over \$1,700 if that tax is higher than the tax the child would otherwise pay on it. ( Code Sec. 1(g) ) The parents can instead elect to include on their own return the child's gross income in excess of \$1,700 (for 2007). ( Code Sec. 1(g)(7) ) A child is subject to the kiddie if he or she has not attained age 18 before the close of the tax year; either parent of the child is alive at the end of the tax year; and the child does not file a joint return for the tax year. ( Code Sec. 1(g)(2)(A) )

For 2008 (technically for tax years beginning after May 17, 2007), a 2006 tax law has expanded the kiddie tax to apply to children age 18, and children over age 18 but under age 24 who are full-time students—if their earned income doesn't exceed one-half of the amount of their support. ( Code Sec. 1(g)(2)(A) )

 **RIA observation:** The 2006 tax law did not change the kiddie tax rules for children who are under age 18. Rather, it expanded the kiddie tax to apply where:


- ... the child turns age 18, or turns age 19-23 if a full-time student, before the close of the tax year;
- ... the child's earned income for the tax year doesn't exceed one-half of his or her support;
- ... the child has more than the inflation-adjusted prescribed amount of unearned income (i.e., \$1,800 for 2008);
- ... the child has at least one living parent at the close of the tax year; and
- ... the child doesn't file a joint return for the tax year.

See Weekly Alert ¶ 11 6/7/2007 for further discussion of the broadened kiddie tax and planning to deal with it.

*Itemized deduction phaseout reduced.* A higher-income taxpayer's itemized deductions (other than those for medical expenses, investment interest, nonbusiness casualty and theft losses, and gambling losses) are reduced if his adjusted gross income (AGI) exceeds an inflation-adjusted amount. His itemized deductions generally are reduced by the lesser of:


- ... 3% of the excess of adjusted gross income over the applicable amount, or
- ... 80% of the itemized deductions otherwise allowable for the tax year.

For 2008, the phaseout begins at \$159,950 of AGI (\$79,975 for marrieds filing separately). However, under a 2001 tax law change that applies for the first time in 2008, a taxpayer will lose only 1/3 of the amount he would otherwise lose under the regular reduction computation. ( Code Sec. 68(f) )

 **RIA illustration :** For 2008, Sam, a calendar year unmarried taxpayer has AGI of \$201,000 and \$20,000 of itemized deductions, consisting of \$9,000 of taxes, \$6,000 of mortgage interest, \$3,000 of charitable contributions to his church, and \$2,000 of miscellaneous itemized deductions. Sam's total itemized deduction of \$20,000 is reduced by \$410.50 [ $\$201,000 \text{ AGI} \text{ minus } \$159,950 = \$41,050 \times .03 = \$1,231.50 \times 1/3 = \$410.50$ ]. Thus, his total itemized deduction is \$19,589.50 [ $\$20,000 \text{ minus } \$410.50 = \$19,589.50$ ].

*Personal exemption phaseout reduced.* The personal exemption amount of a taxpayer whose AGI exceeds an inflation-indexed threshold amount is reduced by an applicable percentage. This applicable percentage is 2% for each \$2,500 (or fraction thereof) by which the AGI of a taxpayer (other than a married taxpayer filing separately) exceeds the appropriate threshold amount. For married persons filing separately, the applicable percentage is 2% for each \$1,250 (or fraction of that amount) by which his AGI exceeds the threshold amount. The applicable percentage can't exceed 100%. The inflation-adjusted threshold amounts for 2008 are \$239,950 (joint returns and surviving spouses), \$199,950 (head of household), \$159,950 (unmarried individuals), and \$119,975 (married persons filing separately).

However, under a 2001 law change that applies for the first time in 2008, a taxpayer will lose only 1/3 of the amount he would otherwise lose under the regular phase-out computation. ( Code Sec. 151(d)(3)(E) )

 **RIA illustration :** For 2008, a married couple with two children have AGI that triggers the phaseout of personal exemption amounts. Assume that without the 2001 law change, the overall amount they could deduct for personal exemptions would have to be reduced by \$900. For tax year 2008, the couple would have to reduce their personal exemptions by only \$300 (1/3 of \$900).

*Forgiven mortgage debt tax relief.* Addressing the subprime lending crisis, a late 2007 law change provides tax relief for homeowners whose mortgage debt is forgiven. Prior to the enactment of this law, a homeowner could be taxed on the amount of forgiven mortgage debt. For example, before this law, an individual with a \$200,000 mortgage whose lender foreclosed on the home and sold it for \$180,000 would have had to report \$20,000 of income from the forgiven debt. The result would have been the same if the lender restructured the loan and reduced the principal amount to \$180,000. Under the new law, a taxpayer does not have to pay federal income tax on up to \$2 million of debt forgiven for a qualifying loan secured by a qualified principal residence (e.g., one to buy or renovate a residence). ( Code Sec. 108(a)(1)(E) , Code Sec. 108(h)(2) ) The change applies to debts discharged from Jan. 1, 2007 to Dec. 31, 2009.

*Homesale exclusion liberalized for surviving spouse.* A qualifying taxpayer may exclude up to \$250,000 (\$500,000 for joint return filers) of gain from the sale or exchange of property that the taxpayer has owned and used as his or her principal residence. Married taxpayers filing jointly for the year of sale may exclude up to \$500,000 of home-sale gain if (1) either spouse owned the home for at least 2 of the 5 years before the sale; (2) both spouses used the home as a principal residence for at least 2 of the 5 years before the sale; and (3) neither spouse is ineligible for the full exclusion because of the once-every-2-year limit on the exclusion.

Before a late 2007 law change, the up-to-\$500,000 exclusion was available only if a husband and wife filed a joint return for the year of sale. Thus, if the home was sold in a year after the year of a spouse's death—when a joint return would no longer be filed—the surviving spouse could only get a maximum homesale exclusion of \$250,000. A new law provides relief for sales and exchanges after Dec. 31, 2007—it allows a surviving spouse to qualify for the up-to-\$500,000 exclusion if the sale occurs not later than 2 years after the spouse's death, provided the requirements for the \$500,000 exclusion were met immediately before the spouse's death and the survivor has not remarried as of the date of the sale. ( Code Sec. 121(b)(4) )

*Tax relief for volunteer responders.* Tax relief is on the way for volunteer firefighters and emergency medical responders, thanks to a little publicized provision in one late-breaking 2007 tax law change. It creates an income tax exclusion for qualified state or local tax benefits (such as reduction or rebate of state or local income or property tax) and qualified reimbursement payments (up to \$360 a year) granted to members of qualified volunteer emergency response organizations (e.g., state or local organizations whose members provide volunteer firefighting or emergency medical services (EMS)). ( Code Sec. 139B ) The new exclusion applies for the 2008 through 2010 tax years. See Weekly Alert ¶ 80 12/20/2007 for further discussion of this provision.

*Mortgage insurance deduction extended.* Mortgage insurance premiums will continue to be deductible after 2007, thanks to another late 2007 relief provision for homeowners. Originally, this deduction was available only for 2007. It now applies through 2010. ( Code Sec. 163(h)(3)(E)(iv) ) Basically, it allows taxpayers to treat amounts paid during the year for qualified mortgage insurance as home mortgage interest—and thus deductible in most instances. The special rule for home mortgage interest is phased out at higher levels of adjusted gross income (AGI). The insurance must be in connection with home acquisition debt, the insurance contract must have been issued after 2006, and the taxpayer must pay the premiums for coverage in effect during the year. See Weekly Alert ¶ 80 12/20/2007 for further discussion of this provision.

*IRA contribution limit increased.* In general, an individual who isn't an active participant in certain employer-sponsored retirement plans, and whose spouse isn't an active participant, may make an annual deductible cash contribution to an IRA up to the lesser of: (1) \$5,000 (increased from \$4,000 for 2007), plus an additional \$1,000 for those age 50 or older, or (2) 100% of the compensation that's includible in his gross income for that year. If the individual (or his spouse) is an active plan participant, the deduction phases out over a specified dollar range of MAGI.

## **Tax Changes for Individuals Due to Expired Provisions**

The following tax changes for 2008 involve tax provisions that expired at the end of 2007 but may be reinstated by Congress.

*Credits reduced by AMT calculation.* Personal tax credits (other than the adoption credit, the child tax credit and the credit for elective deferrals and IRA contributions) can't exceed the excess of regular tax liability over tentative minimum tax. ( Code Sec. 26(a)(1) )



**RIA observation:** This credit limit may reduce a taxpayer's personal credits even if he has no AMT liability.

For 2007, the above personal credits could be claimed up to the sum of regular tax liability (reduced by the foreign tax credit) and the AMT.

*Decreased AMT exemption amount.* In 2008, the AMT exemption amount will be decreased to \$33,750 for unmarried individuals, \$45,000 for marrieds filing jointly or qualifying surviving spouses, and \$22,500 for marrieds filing separately. ( Code Sec. 55(d) ) For 2007, the AMT exemption amounts were \$44,350, \$66,250, and \$33,125, respectively.

*Educator expenses.* The above-the-line deduction for educator expenses doesn't apply for post-2007 tax years. ( Code Sec. 62(a)(2)(D) )

*Tuition and fees deduction.* The above-the-line deduction for higher-education expenses isn't available for tax years beginning after 2007. ( Code Sec. 222(e) )

*D.C. first-time homebuyer credit.* This credit does not apply to homes purchased after 2007. ( Code Sec. 1400C(i) )

*Option to claim state & local sales tax as itemized deduction instead of deducting state & local income tax.* This option is no longer available for tax years beginning after 2007. ( Code Sec. 164(b)(5)(I) )

*Tax-free distributions from IRAs for charitable purposes.* The special rule for IRA distributions to charities has expired. Under this rule, which applies for distributions in tax years beginning in 2006 and 2007, an exclusion from gross income, not to exceed \$100,000, is allowed for otherwise taxable IRA distributions by taxpayers age 70 1/2 and older from a traditional or Roth IRA that are qualified charitable distributions. ( Code Sec. 408(d)(8) )

*Election to include nontaxable combat pay as earned income for purposes of the earned income tax credit.* For tax years beginning after 2007, taxpayers no longer may elect to treat combat pay as earned income for purposes of the earned income credit. ( Code Sec. 32(c)(2)(B)(vi) )

*Penalty-free withdrawals for individuals called to active duty.* A provision giving early withdrawal penalty relief for active duty reservists has expired. Under this rule, the Code Sec. 72(t) 10% early withdrawal penalty tax does not apply to a distribution from an IRA (or attributable to elective deferrals under a Code Sec. 401(k) plan, Code Sec. 403(b) annuity, or certain similar arrangements) that's (1) made to reservists ordered or called to active duty after Sept. 11, 2001, and before Dec. 31, 2007, for a period of more than 179 days or for an indefinite period, and (2) made during the period beginning on the date of the order or call to duty and ending at the close of the active duty period. ( Code Sec. 72(t)(2)(G) )

*Credit for nonbusiness energy property.* For property placed in service after 2007, a taxpayer can no longer claim a lifetime nonrefundable credit of up to \$500 for making qualifying energy saving improvements to his home (only \$200 for qualifying window expenditures). ( Code Sec. 25C )

## **How Economic Stimulus Act of 2008 benefits individuals and businesses**

On Feb. 13, President Bush signed H.R. 5140, the “Economic Stimulus Act of 2008” (Stimulus Act) into law. The centerpiece of the Stimulus Act, which is designed to bolster the sagging economy, is a provision that puts extra cash into the hands of most Americans. Most will receive a rebate check in 2008 from the U.S. Treasury based on filing status and income on the 2007 return they file in 2008. Some will get a tax credit in 2009 when they file their returns for tax year 2008, and still others (depending largely on income in tax years 2007 and 2008) may receive a combination of a rebate check in 2008 and an income tax credit in 2009. See ¶ 14 for details.

The Stimulus Act also encourages businesses to buy more capital goods and equipment in 2008 by:

... Increasing the \$128,000 expensing limit under Code Sec. 179 to \$250,000 and boosting the overall investment limit from \$510,000 to \$800,000, effective for tax years beginning in 2008. See ¶ 16 for details.

... Permitting a bonus first-year depreciation deduction of 50% of the adjusted basis of qualified property (most personal property and software) acquired and placed in service after Dec. 31, 2007, and before Jan. 1, 2009. The otherwise applicable “luxury auto” cap on first year depreciation increases by \$8,000 for vehicles that qualify. Bonus depreciation will be allowed for alternative minimum tax (AMT) as well as for regular tax purposes. See ¶ 3 for details.