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2008 Tax Season

Dear Client:

Just before departing for the holidays, Congress passed three new laws that include significant tax changes. This letter explains what you need to know about the changes.

Tax Increase Prevention Act of 2007 Provides One-year AMT Patch

On December 19, the House passed the Tax Increase Prevention Act of 2007. In reality, this legislation does nothing more than provide a one-year alternative minimum tax (AMT) patch for 2007. Congress had to take this action to avoid the political fallout that would have resulted from millions of additional taxpayers getting hit with the dreaded AMT. Thanks to the new law, the AMT exemption amounts were increased for 2007, and you are allowed to use personal tax credits to offset your 2007 AMT bill, as in prior years. These two fixes will keep the number of AMT victims about the same as last year.

Tax Changes Included in New Mortgage Relief Act

On December 20, President Bush signed into law the Mortgage Forgiveness Debt Relief Act of 2007 (the Mortgage Relief Act). The centerpiece of this legislation is a temporary taxable income exclusion for qualifying discharges of home mortgage debt. (A discharge of debt occurs when a lender lets a borrower off the hook for some or all of a loan balance.) The Mortgage Relief Act also includes a variety of other tax changes.

Income Exclusion for Qualifying Home Mortgage Debt Discharges. Under our federal income tax rules, debt discharge income (DDI) is taxable unless an exception applies. The Mortgage Relief Act creates a retroactive new exception for qualifying discharges of home mortgage debt that occur in 2007-2009. Specifically, the new exception generally allows a homeowner to exclude from taxable income up to \$2 million of DDI from "qualified principal residence indebtedness," which means debt that was used to acquire, construct, or improve the taxpayer's principal residence and is secured by that residence. The basis of the taxpayer's principal residence is reduced by the excluded amount, but not below zero.

Observation: The new exception only applies with respect to debt that is used to acquire, construct, or improve the taxpayer's principal residence. Therefore, it won't help with DDI from home equity loans that were used for other purposes nor will it help with DDI from vacation home mortgages.

Liberalized Home Sale Gain Exclusion for Surviving Spouses. As you probably know, you can have a federal-income-tax-free home sale gain of up to \$250,000 if you are unmarried, or up to \$500,000 if you file jointly with your spouse. However, if you are an unmarried surviving spouse, you are not allowed to file a joint return for years after the year in which your spouse dies. Therefore, the larger \$500,000 home sale gain exclusion was not available if you sold your principal residence in a year after the year of your spouse's death. Effective for sales after 12/31/07, a provision in the Mortgage Relief Act allows an unmarried surviving spouse to take advantage of the larger \$500,000 exclusion if the home sale occurs within two years after the spouse's death and all the other requirements for the \$500,000 exclusion were met immediately before that spouse's death. Note that the two-year period starts on the deceased spouse's date of death. Therefore, a home sale that occurs in the second calendar year after the year of death, but more than 24 months after the date of death, will not qualify for the larger \$500,000 exclusion.

Mortgage Insurance Premium Deduction Extended for Three Years. Subject to limitations, premiums for qualified mortgage insurance on debt used to acquire a qualified personal residence is treated as deductible home mortgage interest. Before the Mortgage Relief Act, this favorable rule only applied to premium amounts that were paid during 2007. The new law extends the favorable rule for three more years to cover premium amounts paid through the end of 2010.

Warning: Unfortunately, a phase-out rule may make the mortgage insurance premium deduction off limits for you. If you have adjusted gross income (AGI) above \$100,000, the deduction is phased out by 10% for each \$1,000 of AGI (or any fraction thereof) in excess of \$100,000 (therefore, the deduction is fully phased out when your AGI reaches \$109,001). If you use married filing separate status and have AGI above \$50,000, the deduction is phased out by 10% for each \$500 of AGI (or any fraction thereof) in excess of \$50,000 (therefore, the deduction is fully phased out when your AGI reaches \$54,501).

Liberalized Qualification Rules for Residential Co-ops. A tenant-stockholder of a cooperative housing corporation (co-op) is allowed to deduct amounts paid or accrued by the corporation to the extent they represent that stockholder's proportionate share of real estate taxes and interest. The Mortgage Relief Act adds two new ways for buildings to qualify as co-ops, which means more individuals will be able to take advantage of the favorable co-op tax rule.

Temporary Income Exclusion for Volunteer Firefighters and Emergency Medical Responders. Another change included in the Mortgage Relief Act provides a new exclusion from taxable income for members of volunteer emergency response organizations for: (1) any qualified state or local tax benefit and (2) any qualified payment. A *qualified payment* is a payment or reimbursement from a state or political subdivision on account of your performance of services as a member of a qualified volunteer emergency response organization. The qualified payment exclusion is limited to \$30 multiplied by the number of months during the year that you perform such services. This favorable new provision is effective for 2008–2010.

More Student Housing Eligible for Low-income Housing Credit. The Mortgage Relief Act allows certain full-time students who are single parents and their children to live in housing units eligible for the low-income housing tax credit.

Limitation on Tax Return and Information Disclosures to Partners, S Corporation Shareholders, and Estate and Trust Beneficiaries. The law permits disclosures of federal tax returns and/or return information to certain persons who are materially affected such as partners, shareholders, and beneficiaries (among others). The new law provides that for inspections or disclosures relating to partnership, S corporation, trust, or estate tax returns, the information inspected or disclosed cannot include any supporting schedule, attachment, or list that includes taxpayer identity information of any person other than the entity making the return or the person conducting the inspection or receiving the disclosure.

Three New Revenue Raisers. The Mortgage Relief Act includes the following three new revenue raisers (otherwise known as tax increases).

- **Failure-to-file Partnership Returns Will Be More Expensive.** The new law extends the period for charging the monthly partnership return failure-to-file-penalty from five to 12 months and increases the monthly per-partner penalty from \$50 to \$85.
- **New Failure-to-file Penalty for S Corporations.** The new law imposes a monthly penalty for failing to file an S corporation return or failing to provide information required to be shown on the return. The penalty amount is \$85 per shareholder per month up to a maximum of 12 months.
- **One-time Corporate Estimated Tax Payment Increase.** The new law increases the amount of estimated tax payments for corporations with assets of \$1 billion or more. The change only applies to estimated payments due in July, August, or September of 2012. The required payment amount equals 117.25% of the amount that would otherwise be due. The subsequent payment of an affected corporation is correspondingly reduced.

Two Tax Changes Included in New Energy Act

On 12/19/07, President Bush signed the new Energy Independence and Security Act of 2007 (the Energy Act). This legislation includes two tax changes.

Extension of FUTA Surcharge Rate. The Federal Unemployment Tax Act (FUTA) imposes a 6.2% tax rate on the first \$7,000 paid annually to each employee. The 6.2% rate consists of a 6% permanent rate plus a .2% temporary surtax. The Energy Act extends the temporary .2% surtax through 12/31/08. The combined FUTA rate will continue to be 6.2% through the end of 2008.

Slower Writeoffs for Major Oil Company G&G Expenditures. Under prior law, major integrated oil companies could amortize geological and geophysical (G&G) expenditures over five years. The Energy Act imposes a longer seven-year amortization period for G&G amounts paid or incurred by major integrated oil companies after 12/19/07.

Conclusion

You now understand the basics about all the tax changes included in the three new laws. Please contact us if you have questions or want more information. In addition, be aware that there will probably be at least one more new tax act in early 2008 to extend a number of popular breaks that expire at the end of 2007. We will keep you posted as events dictate.

Very truly yours,

McDavid & Company, CPA's