

TAXOLUTIONS



►► *ideas on taxes*

CONGRESS APPROVES SWEEPING HOUSING RESCUE PACKAGE

Following months of negotiations, in late July, large bipartisan majorities in both the House and Senate passed the Housing and Economic Recovery Act of 2008. President Bush signed the bill into law on July 30, 2008. This bill is intended to provide relief to homeowners struggling to avoid foreclosure, prevent the possible collapse of mortgage giants Fannie Mae and Freddie Mac, and inject new life into the ailing real estate market by offering tax incentives to homeowners and certain categories of homebuyers. But, while the legislation contains breaks for some taxpayers, revenue-raising provisions included in the bill could lead to bigger tax liabilities for other groups, especially those who own second homes.

Among the taxpayers who stand to benefit from the new law are first-time homebuyers. Provided they have had no “ownership interests” in a principal residence during the past three years, buyers who purchase a home between April 9, 2008 and June 30, 2009 may claim a tax credit equal to 10% of the purchase price, up to \$7,500. The credit must, however, be paid back interest-free in equal installments over 15 years. The entire outstanding amount owed on the credit becomes due if the taxpayer sells the home during this period,

though only up to the gain realized in the sale. The debt is cancelled if the homeowner dies during the period.

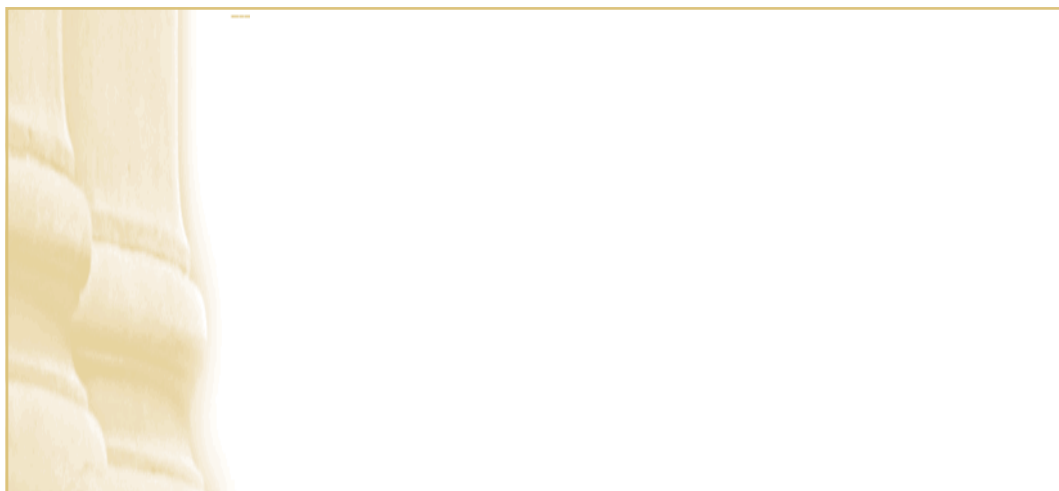
Eligibility for the first-time buyer credit starts to phase out for single filers with adjusted gross incomes (AGIs) of \$75,000 and for married couples filing jointly with AGIs of \$150,000. Single taxpayers with incomes above \$95,000 and joint filers with AGIs over \$170,000 can no longer claim the credit.

For 2008 only, the legislation provides some tax relief on mortgage interest to homeowners who take the standard deduction on their federal taxes instead of itemizing. Under the new law, non-itemizing single filers can claim a tax deduction on their state and local prop-

erty taxes of up to \$500, and married couples filing jointly are eligible to deduct up to \$1,000. Taxpayers who owe less than these amounts in property taxes are only eligible to claim a deduction up to the amount paid in property taxes.

The new law could, however, mean higher taxes down the line for owners of second homes or rental property. Under the legislation, taxpayers who have a second home that later becomes their primary residence will be permitted to exclude a smaller percentage of the gain if the property is sold within a certain timeframe than was previously the case. This is because, starting in 2009, the law pro-rates the exclusion—\$250,000

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LEGISLATION PROVIDES RELIEF TO HOMEOWNERS FACING FORECLOSURE

As a growing number of Americans are feeling the effects of the mortgage crisis, Congress has taken action to shield struggling homeowners from additional financial hardship by offering tax breaks to people who lose their homes due to foreclosure or who refinance their mortgages in an effort to avoid foreclosure.

Signed into law on December 20, 2007, the Mortgage Forgiveness Debt Relief Act allows taxpayers whose mortgage debt on a principal residence was partly or entirely discharged during 2007, 2008, and 2009 to claim special federal income tax relief. While debt forgiveness normally results in taxable income, debt reduced through mortgage restructuring or discharged in connection with a foreclosure may qualify for this relief.

The new law permits taxpayers to exclude debt forgiven on their principal

residence if the balance of the loan was less than \$2 million, or \$1 million for a married person filing separately. To qualify, the debt must have been used to purchase, build, or substantially improve the taxpayer's principal residence, and it must have been secured by that residence. Debt used to refinance qualifying debt is also eligible for the exclusion, but only up to the amount of the mortgage principal prior to the refinancing. Generally, the law does not provide tax relief for debt forgiveness on second homes, rental property, business property, credit cards, or auto loans.

"I am happy that Congress came together to give bipartisan support for this common sense bill to help alleviate the pressure American families are feeling due to the sub-prime mortgage crisis," said Rep. Charles B. Rangel (D-NY),

chairman of the House Ways and Means Committee and sponsor of the bill.

"It is just not right or fair that families struggling through a foreclosure would then face a tax bill in addition to losing their homes when they have seen no increase in their net worth. This bill rights that wrong and provides tax relief to millions of American families," Rangel added.

The legislation also extends through 2010 a tax deduction that allows taxpayers to deduct all or part of their private mortgage insurance premiums from their taxable income. This deduction was previously available in 2007 only. Essentially, this provision enables taxpayers to treat mortgage insurance premiums as mortgage interest for tax filing purposes. This deduction phases out at adjusted gross income levels above \$100,000.

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of the capital gain on the sale for single filers or \$500,000 for married couples filing jointly—to reflect the portion of the time that the home is used as a primary residence relative to the total length of ownership.

To help Americans in danger of losing their homes, the law creates a program that will allow some homeowners to trade in their current mortgages for a fixed-rate loan worth no more than 90% of a home's current value. The new loans will be insured by the Federal Housing Administration (FHA) and supplied by FHA-approved lenders only. To qualify for the program, the troubled mortgage must be on a primary residence and must have been taken out before January 1, 2008. In addition, distressed borrowers will have to demonstrate that their income to mortgage debt ratio was greater than 31% as of

March 1, 2008. Participants in the program will have to pay a 1.5% insurance premium to the FHA, and borrowers will be required share no less than half of their new equity and appreciation with the FHA when the home is sold.

The legislation also contains new rules designed to curb abuses in the reverse mortgage market, as well as restrictions on the ability of lenders to foreclose on the homes or raise the mortgage interest rates of military veterans who have recently returned from active duty.

Under the new law, the limit on the size of the mortgage loans that can be purchased by government-sponsored enterprises (GSEs) Fannie Mae or Freddie Mac is raised to \$625,500, or up to 115% of the local median purchase price. At the same time, the law grants the U.S. Treasury Department the authority to

ensure the financial stability of GSEs by extending credit to these companies as needed.

"This legislation will help stabilize the housing market and begin to revive our economy," said Jack Reed (D-RI), a Senate Banking Committee member and author of several provisions of the bill.

"The housing crisis is perhaps the most significant economic issue that we face, and this bill will go a long way toward bringing stability and confidence back to the markets," Reed continued. "For the first time in over a generation, we are passing legislation to update, modernize, and strengthen the institutions that undergird both our mortgage and housing markets. I believe it will help stabilize our economy by ensuring access to decent, safe, and affordable housing for millions of American families." ■

HEART ACT EASES TAX BURDEN FOR MILITARY SERVICE MEMBERS

Signed into law by President Bush on June 17, 2008, the Heroes Earnings Assistance and Relief Tax (HEART) Act of 2008 eases the tax burden for active duty military service members and their families, while closing certain loopholes for wealthy expatriates and federal contractors with operations abroad.

In response to complaints that some families of troops serving overseas did not receive payments under the Economic Stimulus Act of 2008, or received a reduced amount due to the absence of a Social Security number for a spouse or child, the legislation stipulates that married active duty military personnel who file a joint return are entitled to receive a full economic stimulus rebate check, even if a family member does not have a Social Security number because he or she is a foreign national.

The new law also permanently extends provisions that treat combat pay as earned income for the purposes of the Earned Income Tax Credit (EITC) and that allow reservists called up for at least six months' active duty to take distributions from 401(k) and other tax-advantaged retirement plans without incurring penalties.

Under the HEART Act, employers have the option of amending their flexible spending accounts (FSAs) to permit active duty reservists to take FSA balances as a taxable cash distribution. The law also provides small employers with a 20% tax credit (up to \$4,000) of the salary differential they pay an employee who is called up for active military duty, and it allows veterans to purchase homes using qualified mortgage bonds, even if they are not first-time homebuyers.

The HEART Act further modifies retirement plan protections for reservists who are killed or become disabled while serving in the military. Under the legislation, the day prior to the date of

death is to be treated as the date the employee returned to work for purposes of triggering payment of benefits under a qualified plan, and an employer is permitted to make certain contributions to a qualified retirement plan on behalf of an employee who is killed or becomes disabled in combat. The law also permits recipients of military death benefit gratuities to roll over the amounts received, tax-free, to a Roth IRA or an Education Savings Account.

"I worked to get this bill to the President's desk because tax relief for America's military men and women is the right thing to do," said Senate Finance Committee Chairman Max Baucus (D-MT). "This bill helps our fighting forces and our veterans purchase their own homes, save for their retirements, and put their kids through college. It helps businesses keep reservists on the payroll while they are overseas. This new law provides timely and appropriate tax relief to those who sacrifice for our freedom."

This \$1.2 billion tax package is paid for in part by imposing new taxes on wealthy expatriates, increasing the penalties for failure to file tax returns, and closing a loophole sometimes used by American companies with subsidiaries abroad. Under the new law, foreign subsidiaries of U.S. companies performing work under a federal contract are treated as U.S. employers for employment tax purposes.

Following the date of enactment, high net worth individuals who renounce their citizenship or terminate their long-term residency in the U.S. are subject to income tax on the net unrealized gain on their property to the extent that



the fair market value of the property on the day prior to expatriation exceeds \$600,000. The law also levies taxes on certain types of gifts and bequests made by expatriates, and mandates a 30% withholding tax on qualifying deferred compensation to expatriates. The higher penalties for failure to file tax returns will be in effect for returns that are due to be filed after December 31, 2008.

A co-sponsor of the provision that closed the loophole on federal contractors, Sen. Barack Obama (D-IL) said the HEART Act "will provide much needed tax relief to our brave service members and hold American companies accountable for paying taxes and guaranteeing that employees receive the benefits they are entitled to through their employment." ■

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Additionally, the new law extends the period of time during which a surviving spouse may take advantage of the \$500,000 home sale gain exclusion available to joint filers, before again being treated as a single taxpayer entitled to a \$250,000 exclusion only. Under the previous rules, a surviving spouse was eligible to claim the \$500,000 home sale exclusion when filing a joint return with the deceased spouse's estate, which was only permitted for the tax year in which the spouse died. The sale of a home that had been jointly owned and occupied by a married couple now qualifies for the \$500,000 gain exclusion, provided the sale occurs no later than two years after the date of death of the filer's spouse.

Prior to signing the bill, President Bush said the legislation will make it easier for borrowers with sub-prime and adjust-

able rate mortgages who would not otherwise be able to afford their monthly



payments to stay in their homes "by ensuring that refinancing a mortgage does not result in a higher tax bill."

Until the passage of this law, the President noted, if the value of a home

declined and the bank or lender forgave a portion of the mortgage, the tax code treated the amount forgiven as money that can be taxed. "And of course, this makes a difficult situation even worse," Bush observed. "When you're worried about making your payments, higher taxes are the last thing you need to worry about."

The President praised the bill for creating a three-year window for homeowners to refinance their mortgages and pay no taxes on any debt forgiveness that they receive. "It's a really good piece of legislation," President Bush said. "The provision will increase the incentive for borrowers and lenders to work together to refinance loans—and it will allow American families to secure lower mortgage payments without facing higher taxes." ■

Coping with the "Kiddie" Tax Expansion

In 2008, an expansion of the so-called "kiddie tax" will make it more challenging for parents to transfer investment income to a child to take advantage of the child's lower tax rate, even if the primary goal is to save for the child's education.

The limit on the so-called "kiddie tax" increased to \$900 in 2008, up from \$850 in 2007. The first \$900 of unearned income in the child's name is tax-free, while the next \$900 of unearned income is taxed at the child's tax rate. Any amounts above the \$1,800 mark are then taxed at the parents' marginal rate.

While the kiddie tax originally applied to children up to 14, the cutoff age rose to 18 in 2006 and increased to age 19 in 2008. In addition, in 2008, full-time college students under the age of 24 will also be taxed at their parents' rate on unearned income in excess of \$1,800, unless the students' earned income is greater than one-half of their support.

The kiddie tax applies to non-wage, or unearned income, but not to income earned by the child through a part-time or full-time job. Unearned income is generally investment and capital gains income that includes interest, dividends, rents, profits on property sales, and certain types of royalties. Congress acted to tighten the rules on giving appreciated stocks and mutual funds to children after it became apparent that some wealthier families intended to exploit the 0% rate on capital gains taxes in effect in 2008–2010 by shifting a portion of their investments to their children, who would then be able to sell these assets tax-free.

The revised kiddie tax will have the biggest impact on families who saved for their child's college education by placing money into custodial accounts, bonds, or other savings vehicles, at a time when tax-free education savings accounts were not yet widely available.

Parents can avoid being hit by the kiddie tax in the future by saving for their children's education using tax-advantaged savings accounts. While contributions to Section 529 plans are made with after-tax dollars, earnings grow tax-deferred, and withdrawals are tax-free when used for qualified post-secondary education costs. Coverdell Education Savings Accounts (ESAs) offer similar advantages, but the tax-free distributions from these accounts may also be used to pay for qualified K-12 school expenses through 2010. Because of the much lower contribution limits and income phase-outs on Coverdell ESAs, 529 plans tend to be more suitable savings vehicles for affluent families.

In some cases, parents may also wish to encourage their older children to take paid employment, which generates earned income that will be taxed at lower rates.