

New Changes in Your 2007 Tax Return

On the surface, the 2007 tax return you will be filing soon may look a lot like the one you filed for 2006. However, there are a number of new developments “behind the lines.” New rulings and tax law changes in the last year can have a significant impact on your tax bill for 2007.

We can provide you with the details on these new developments. But here is a quick look at some of the key changes that affect your 2007 return.

Alternative Minimum Tax. The alternative minimum tax (AMT) is a separate income tax system that operates parallel to the regular income tax. Originally designed to ensure that high-income taxpayers paid at least a minimum tax, the AMT now hits an increasing number of middle-income taxpayers. The tax rules provide for an exemption amount that helps limit the impact of the AMT. Congress increased the exemption amount for 2007, reducing the number of taxpayers that might have otherwise been subject to the AMT.

On a related note, the AMT has created headaches for many employees who exercised employer-sponsored incentive stock options (ISOs). These employees paid an AMT when the ISOs were exercised, only to see the price of the underlying stock drop after the exercise. So they paid tax on profits that never materialized. If you are in this boat, a new law provision provides relief. Starting with 2007, you may be able to recoup a portion of the AMT you paid on the exercise of the ISOs. The details of the relief provision are complicated, but we can help you take advantage of it.

Mortgage Insurance Premiums. Beginning with 2007, you may be entitled to claim a deduction for premiums paid for mortgage insurance in connection with the purchase of a home. The insurance contract must have been issued after 2006 and the deduction is reduced if your income exceeds \$100,000.

The Form 1098 mortgage interest statement you receive for 2007 should show not only the total interest paid during the year, but also the deductible mortgage insurance premiums paid during the year. The premiums appear in box 4 of Form 1098. You should contact the mortgage insurance issuer to determine the deductible amount if it is not reported in box 4. Once you have that figure in hand, we can help you calculate the exact amount of your deduction.

Medical Expenses. If you itemize your deductions, you can deduct your out-of-pocket medical expenses to the extent that they exceed 7 ½% of your adjusted gross income. The IRS recently ruled that some costs can qualify for the itemized medical expense even if they are not prescribed by a doctor. The IRS ruling specifically okayed deductions for three types of expenses without a doctor's order—the cost of an annual physical, the cost of a full-body scan to detect diseases or abnormalities, and the cost of an at-home pregnancy test. Similar diagnostic-type expenses may also fall into the deduction category.

Dependency Exemption. The IRS recently announced that it is making it easier for taxpayers to claim dependency exemption for children who are not related to them. For example, suppose a taxpayer lives with and supports a friend and the friend's child. In the past, a dependency exemption could not be claimed for an unrelated child who lived with his or her parent. So the taxpayer was out of luck. The new IRS announcement provides relief: The taxpayer can claim the exemption for the child as long as the parent (1) is not required by law to file an income tax return and (2) does not file a return or files a return only to get a refund of withheld tax.

There is more good news. The new IRS announcement is retroactive. If you have been in a situation like this in the past and didn't claim the exemption, you may be entitled to a refund. We can help you file an amended return to claim your refund.

Charitable Donations. Beginning with 2007, you cannot deduct a cash donation to a charity, regardless of the amount, unless you keep a bank record (such as a canceled check) or a written communication from the charity. The written communication must include the name of the charity, date of the contribution, and amount of the contribution.

The IRS recently announced that a special rule applies in the case of donations to charitable campaign organizations like the United Way. For purposes of the new “written communication” requirement, the communication must include not only the name of the umbrella organization, but also the name of each charitable organization that receives funds from the umbrella organization. Otherwise, no deduction can be claimed.

Job-Related Lodging. Generally speaking, you can claim a business expense deduction for lodging only if you are out of town overnight in connection with your job. But the IRS recently created an exception: In certain cases, you may be able to deduct the cost of local lodging, such as a hotel near your job site. The IRS says that local lodging is deductible if (1) the lodging is on a temporary basis and (2) the lodging is necessary so that you can participate in or be available for a bona fide business meeting or function of your company.

Mortgage Foreclosures. A recent tax law change provides relief to taxpayers who have been hit by the recent wave of mortgage foreclosures. Under prior law, a taxpayer had to pay income tax on a foreclosure when the outstanding mortgage exceeded the value of his or her home. For example, suppose the outstanding mortgage was \$300,000 at the time of the foreclosure and the mortgage lender sold the home for \$270,000. The taxpayer had to pay tax on the \$30,000 difference because it represented debt owed that was forgiven by the lender. Under the new law change, no tax is owed on debt forgiveness if it involves a (1) mortgage on a taxpayer’s principal residence and (2) the debt forgiveness does not exceed \$2 million. The relief provision applies to debts forgiven in 2007, 2008 and 2009.

Business Equipment and Machinery Write-Offs. Businesses normally write off their equipment and machinery purchases over a period of years through depreciation deductions. However, Section 179 of the tax code gives a special break to small businesses that allows quicker write-offs. You can expense—claim an immediate deduction—for the full cost of your equipment and machinery purchases, up to a maximum dollar amount. Congress raised the maximum Section 179 deduction to \$125,000 in 2007 (up from \$112,000 in 2006). The Section 179 deduction is phased out once your total equipment and machinery purchases for the year exceed a threshold amount. But Congress also raised the threshold to \$500,000 (up from \$450,000).

Family Businesses. In the past, many “mom and pop” businesses were required to file a partnership return. Even though a couple had no formal partnership agreement, their business was treated as a partnership for tax purposes if they carried on the business together and shared in the profits and losses.

A new law change gives couples another option. Starting in 2007, spouses in a “qualified joint venture” can file as separate sole proprietors if they so wish. To qualify, both spouses must materially participate in the business, and both spouses must elect to have the new law provision apply. If spouses choose the sole proprietorship route, each spouse would file a Schedule C with their Form 1040, reporting the spouse’s share of the business’s income and expenses. We can help you decide which filing option is best for you and your business.

If you have questions about any of the new changes, please contact us. We can help you get maximum benefits from the changes.