PUBLICATION

End of the Year Tax Legislation for 2007

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At the end of 2007, Congress passed and President Bush signed several pieces of tax legislation that affect individuals and businesses. This legislation included the Mortgage Forgiveness Debt Relief Act of 2007 (MFDA), the Tax Technical Corrections Act of 2007 (TTCA), and the Tax Increase Prevention Act of 2007 (TIPA). The following discusses some of the important changes to the Internal Revenue Code (Code) included in these pieces of legislation.

Individual Tax Provisions

AMT Patch. TIPA provides a one year patch for the alternative minimum tax (AMT) and is expected to save as many as 25 million taxpayers from facing an average tax increase of $2,000 for the 2007 tax year. The AMT patch raises the AMT exemption amounts for 2007 as follows:

$44,350 for single taxpayers and heads of households;
$66,250 for married couples filing jointly; and
$33,125 for married filing separately.

The new law also allows taxpayers to apply most nonrefundable personal credits to offset the AMT. These credits include the dependent care credit as well as HOPE and Lifetime Learning education credits.

Liberalized AMT refundable credit amount. TTCA liberalizes the AMT refundable credit for tax years beginning prior to 2013 by providing that an individual's AMT refundable credit amount for a tax year is the greatest of (1) $5,000; (2) 20% of the long-term unused minimum tax credit; or (3) the AMT refundable credit amount (if any) for the prior tax year before any reduction by reason of adjusted gross income. This change gives the taxpayer an AMT refundable credit amount of at least $5,000 for a tax year, provided the individual's long-term unused minimum tax credit is at least $5,000. This law will allow taxpayers to more effectively utilize long-term unused credits under the AMT.

Mortgage forgiveness debt relief. MFDA excludes from gross income any discharge of indebtedness income by reason of discharge of qualified principal residence indebtedness. Qualified principal residence indebtedness for this purpose is capped at $2,000,000 (or $1,000,000 in the case of married individuals filing separate returns). Relief is available only for a taxpayer's principal residence, and not a vacation home. Taxpayers using this relief must reduce the basis in their principal residence (but not below zero) to the extent that amounts are excluded from income. The reduction in basis could result in a taxpayer recognizing gain on a later sale of the home. Such gain may be excluded under the general rules for excluding home sale gain, though (up to $250,000 for individuals and $500,000 for married couples filing jointly). The new exclusion for debt discharge applies to discharges occurring on or after January 1, 2007 and before January 1, 2010.

Surviving spouse's home sale deduction. MFDA extends the time during which a surviving spouse may sell the principal residence and use the joint filers' $500,000 home sale gain exclusion rather than the individual exclusion of $250,000 gain. The surviving spouse will be entitled to the $500,000 exclusion for sales that occur no later than two years after the death of the spouse.

Donated property deductions limited. TTCA requires that donated property must be "substantially related" to the donee's exempt purpose where the donee disposes of the property within three years of contribution. If the donated property qualifies as "applicable property" and such property is not "substantially related," then the donor's charitable deduction is subject to reduction or recapture where the donee disposes of the property within three years of contribution. Applicable property is defined as charitable deduction property that is tangible personal property whose use is identified by the donee as related to the purpose or function that is the basis of the donee's exemption and is property for which a deduction in excess of the donor's basis is allowed. The new law does not define "substantially related."

The new law does provide a safe harbor for avoiding a reduction and/or recapture if the donee provides a written certification signed under penalty of perjury by an officer of the donee organization which states that donated property was "substantially related" to the donee's exempt status and describes how the property was used and how such use furthered that purpose.

Penalty for substantial and gross valuation misstatements now applies to incorrect estate and gift tax appraisals. TTCA modifies the 2006 Pension Protection Act to include the penalty for substantial and gross valuation misstatements to any person who prepares a property appraisal and knows, or reasonably should have known, that the appraisal would be used in connection with a return or a refund claim, and the appraisal results in a substantial estate or gift tax valuation misstatement under Section 6662(g) of the Code.

Business Tax Provisions

Modification of active business definition under Section 355. TTCA includes clarifying changes to the definition of an active trade or business under Section 355 of the Code, which was expanded in 2006. All members of the corporation's separate affiliated group are treated as one corporation in determining if a corporation meets the Section 355 active trade or business test. If a corporation becomes a member of a separate affiliated group by reason of a recognition transaction, the new member's business is treated as acquired in a transaction in which gain or loss was recognized in whole or in part. The new law also clarifies that the rules are not intended to disqualify from Section 355 treatment any transaction that both occurred under and satisfied prior law.

Partnerships treated as leases and tax-exempt loss deferral. Section 470, as amended in 2004, contained provisions designed to discourage abusive sale-leaseback transactions. Taxpayers viewed those provisions as being too expansive, and Treasury has avoided implementation of such provisions while Congress considered revision. Taxpayers were concerned about how Section 470 applied to property owned by a partnership with one or more tax-exempt entities as a partner. Under TTCA, Congress clarified the scope of Section 470's loss deferral provisions to certain partnerships with tax-exempt investors by providing a cross-reference to Section 7701(e). If a partnership is recharacterized as a lease under Section 7701(e), and a provision of Section 168(h) (other than Section 168(h)(6)) applies to cause the property characterized as leased to be treated as tax-exempt use property, then the loss deferral rules of Section 470 will apply. Section 7701(e) includes various factors that may cause a partnership to be treated as a lease. These factors, as applied to a tax-exempt partner, include among other things the tax-exempt entity's physical control or use of the property, importance of use to the tax-exempt entity, relatively small investment by taxable partners, and disproportionate allocation of deductions among the taxable and tax-exempt partners.

Deferral of losses on positions in identified straddles. A straddle exists where a taxpayer holds offsetting positions in actively traded personal property. The Code provides special rules for identified straddles. If there is a loss on a position in an identified straddle, the TTCA provides that the loss increases the basis of the offsetting positions in that identified straddle. Section 1092 of the Code contains a formula to calculate the basis increase in offsetting positions with unrecognized gain. If there is no unrecognized gain, taxpayers must use a reasonable method to allocate the loss among the offsetting positions. The new law also clarifies the identification rules for straddles.

Clarified look-through rule for related controlled foreign corporations (CFCs). TTCA clarifies that, in calculating Subpart F income from a related CFC, certain items may be included in foreign personal holding company income (FPHCI). FPHCI generally includes dividends, interest, income equivalent to interest, rents and royalties. A look-through rule, however, provides that certain dividends, interest, rent and royalties received or accrued from a CFC which is a related person may be excluded from FPHCI to the extent the items are attributable to the related CFC's income. The technical corrections act provides that, notwithstanding the general look-through rule, these items will be FPHCI in some cases. Interest, rents, and royalties will be treated as subpart F income if the payment creates or increases a deficit of the payor if the deficit arises from an activity that could reduce income of the payor or a qualified chain member.

Energy-related tax provisions. In TTCA, Congress clarified several provisions related to energy credits and deductions. The same rules for filing claims with respect to fuel mixtures apply to the alternative fuel credit under Section 6427 of the Code. The new law also clarified the definitions of alternative fuel and related terms, the national megawatt capacity limitation that the IRS may allocate under Section 45J, and various rules related to Leaking Underground Storage Tank Trust Fund tax. The new law also made several amendments to provisions related to alternative energy credits under Section 45.