

Monthly Tax and Accounting Newsletter

Gregg Harvey, CPA

About This Newsletter

This monthly Newsletter is a free service provided by Gregg Harvey, CPA. It is emailed every month to clients and to select members of the Rochester Regional Chamber of Commerce.

This Month's Contents:

Michigan SBT and the new "Small Business and Work Opportunity Tax Act of 2007" makes up most of this month's newsletter. Also, information on the IRS reward claims program, a primer on "nexus" and potential accounting rule changes are included.

Michigan SBT Changes Coming

Lawmakers began enacting the new state business tax, but most businesses still will not be able to tell if they'll pay more or less under the new rules. We'll all have to wait for more details.

Action on the long-awaited tax deal started with House passage of a bill to cut the personal property tax by 67.5 percent on manufacturers and 23 percent on commercial businesses such as clothing stores and restaurants. But lawmakers are still drafting the rest of the bills necessary to enact the so-called Michigan Business Tax.

Under the new plan, the state would collect at least as much revenue as from the hated and expiring Single Business Tax (\$1.9 billion a year) but most Michigan businesses would get tax breaks.

From a small business perspective, most smalls won't get hit too hard by the 5 percent profits tax in the new plan, but will be by the other key element, a 0.75 percent tax on gross receipts.

Construction and real estate businesses would pay slightly more, but these businesses in particular will need to see the details. Michigan insurers get an increase from 1 percent to 1.25 percent in the tax they pay on premiums, but they get tax credits for such things as covering high-risk drivers, so they may not oppose the plan. A new tax on capital stock will double the levy on banks

Michigan SBT – A Little Background

Until this year, Michigan has levied a Single Business Tax (SBT), which is a modified value-added tax (VAT). The base of the SBT is, in its simplest form, is the difference between a firm's sales and the cost of materials.

The SBT consisted of two brackets; all taxable receipts under \$45,000 were not taxed, while all receipts over that threshold were taxed at a 1.9% rate.

Among states levying corporate taxes, no state had a corporate rate lower than Michigan's, however if the SBT were converted into a corporate income tax the rate would need to be in excess of 14% to yield similar revenues.

The Michigan Department of Treasury Office of Revenue and Tax Analysis conducted a study of the SBT in 2003. They determined that in order to raise an equal amount of revenue as the SBT, a

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Corporate Income Tax of 14.83 percent would be necessary.

The analysis covered a time span of 22 years, from 1977 to 1999. 14.83 percent was the average rate that would have been required to raise equal revenue during the 22 year period. However, during that time the analogous rate was as high as 58.17 percent in 1992. In 2004, corporate tax collections reached \$182 per capita, ranking it 8th highest nationally

Other Michigan Tax Quick Facts

Tax Freedom Day is the day when Americans finally have earned enough money to pay off their total tax bill for the year. In 2007, Michigan taxpayers had to work until April 27th to pay their total tax bill, ranking it 22nd in the nation. That's three days earlier than national Tax Freedom Day (April 30th). The Tax Freedom Days of neighboring states were: Indiana, April 23rd (ranked 30th nationally); Ohio, April 29th (ranked 18th nationally); and Wisconsin, May 2nd (ranked 13th nationally).

Estimated at 11.2% of income, Michigan's state/local tax burden percentage ranks 14th highest nationally, above the national average of 11.0%. Michigan taxpayers pay \$4,202 per capita in state and local taxes, and per capita state income is \$37,538.

Michigan ranks 27th in the Tax Foundation's State Business Tax Climate Index. The Index compares the states in five areas of taxation that impact business: corporate taxes; individual

income taxes; sales taxes; unemployment insurance taxes; and taxes on property, including residential and commercial property. Neighboring states ranked as follows: Indiana (12th), Ohio (49th), and Wisconsin (38th).

Michigan's personal income tax system consists of a simple 3.9% tax on an individual's federal adjusted gross income (with some modifications). Among states levying individual income taxes, Michigan's flat tax rate is 3rd lowest nationally. Michigan's 2004 individual income tax collections were \$630 per person, which ranked 31st highest nationally.

Michigan levies a 6% general sales or use tax on consumers, above the national median of 5%. State and local governments combined collect approximately \$781 per capita in sales taxes, which ranks 26th highest nationally. Michigan's gasoline tax stands at 19.875 cents per gallon, ranking 31st highest nationally. Additionally, Michigan's 6% general sales tax is levied on the sale of gasoline purchases. Michigan's cigarette tax stands at \$2.00 per pack of twenty, which ranks 4th highest nationally. The sales tax was adopted in 1933, the gasoline tax in 1925 and the cigarette tax in 1947.

Michigan is one of the 37 states that collect property taxes at both the state and local levels. As in most states, local governments collect far more. Michigan's localities collected \$9,886,721,000 in property taxes in fiscal year 2004, which is the latest year the Census Bureau published state-by-state property tax collections. At the

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state level, Michigan collected \$2,091,933,000 in property taxes during FY 2004. That brings its combined state/local property tax collections to \$11,978,654,000, or \$1,186 per capita, ranking 15th highest nationally.

Michigan taxpayers receive less federal funding per dollar of federal taxes paid than the average state. Per dollar of federal tax collected in 2004, Michigan citizens received approximately \$0.85 in the way of federal spending. This ranks the state 38th nationally and represents a slight rise from 1992, when Michigan received \$0.83 per dollar of federal taxes paid (ranked 42nd nationally). Neighboring states and the amount of federal spending they received per dollar of federal taxation paid were as follows: Indiana (\$0.97), Ohio (\$1.01), and Wisconsin (\$0.82).

New Federal Tax Law Changes

The “Small Business and Work Opportunity Tax Act of 2007” (H.R. 2206), which became law in late May, provides additional funds for the Iraq war, increases the Federal minimum wage from \$5.15 to \$7.25 over two years, provides approximately \$5 billion in tax breaks for small business, and makes technical corrections to the Pension Protection Act of 2006.

Specific tax incentives include:

- Extending the work opportunity credit (WOTC) for 3 ½ years (through August 31, 2011) as well as its availability to disabled veterans and rural counties with decreasing populations;

- Increasing the section 179 expensing limit to \$125,000 and extending through 2008 business limits in the gulf Opportunity Zone;
- Modernizing S corporation rules (see below);
- Freezing the minimum wage to calculate the tip credit; and
- Waiving the individual and corporate AMT limitations on the WOTC and the tip credit.

Some of the revenue raising proposals that offset the tax package include:

- Expanding the “kiddie tax” to apply to those who under age 19 or, for full-time students, under age 24;
- Extending to 36 months the amount of time the IRS has to provide taxpayers with notices of deficiency before the agency must suspend the imposition of interest and penalties on underpayments;
- Reducing the amount of credits taxpayers may claim under the FICA/tip tax credit because of the minimum wage increase;
- Permanently extending IRS user fees for letter rulings, determination letters, opinion letters, or other similar ruling or determination;
- Increasing the penalty for bad checks and money orders sent to the IRS; and creating a new penalty for refund claims that have no reasonable basis.

Changes to S Corporation Provisions

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The new act contains several improvements to S Corp provisions that have long been advocated:

- Capital gains from the sale of securities, including S corporation stock, are no longer passive investment income.;
- Selling a partial interest in a QSub will now trigger tax on only the percentage of assets sold to an unrelated party.
- All pre-1983 earnings and profits of S corporations are now eliminated. This will simplify recordkeeping and dividend/distribution calculations for aged S corporations with C corporation history.
- Interest deductions are now permitted for electing small business trusts that borrow money to acquire S corporation stock.

Also, unincorporated businesses whose only owners are a husband and wife are often required to file partnership returns on Form 1065. Effective for 2007 tax years, these couples may elect to file as sole proprietors as long as they both materially participate and file a joint return. Each spouse will be required to file separate Schedules C (or E or F, as the case may be) rather than a single, combined schedule in order to preserve proper credits under the Social Security system.

To the extent taxpayers were filing partnership returns for these so-called "qualified joint ventures," an election to be treated as sole proprietors will clearly ease reporting requirements going

forward. However, it is unclear whether those currently filing as partnerships will, upon election, face potential taxation under the liquidation and termination rules of subchapter K, as guidance has not yet been issued on that point

Did You Have a Foreign Bank Account During 2006?

If you have a foreign bank accounts it is your responsibility to file the "Report of Foreign Bank and Financial Accounts" (Treasury Form TD F 90-22.1) on or before June 30, 2007. This is also disclosed in Question 7, Part III, Schedule B of the Form 1040.

This 90-22.1 form is required to be filed by U.S. citizens and residents who have a financial interest in or signature or other authority over any financial accounts (including bank, securities or other types of financial accounts in a foreign country), if the aggregate value of such accounts exceeded \$10,000 at any time during 2006. The interpretation of an interest in a foreign bank or securities account is very broad and includes, in some instances, a direct or indirect interest as well as a beneficial interest in a foreign bank or securities account.

There is now an additional civil penalty (up to \$10,000) that may be imposed on any person who violates this reporting requirement (without regard to willfulness). The penalty may be waived if any income from the account was properly reported on the income tax return, and there was reasonable cause for the failure to report. This new civil

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penalty provision is effective with respect to failures to report occurring on or after October 22, 2004.

The lack of disclosure of foreign financial accounts has become a priority for Congress and IRS. The IRS's Offshore Voluntary Compliance Initiative allowed partial amnesty until April 15, 2003, but some taxpayers still interested may still be able to work out a voluntary compliance arrangement with the IRS.

IRS Reward Claims

The Internal Revenue Service recently received important tips from informants hoping to cash in on a law offering sharply higher rewards in cases involving large amounts of tax cheating and other violations.

Since the law was enacted in December, the IRS has received about 20 reward claims, some involving hundreds of millions of dollars. Under that law, informants generally may collect as much as 30% of whatever the IRS eventually collects, including penalties and interest.

Congressional advocates hope the new law will help the IRS collect significantly larger amounts of back taxes.

Here is a primer on how the law works, what to watch out for if you're considering turning someone in, and a few of the unanswered questions about the law and the informants program that IRS lawyers are struggling with.

The law generally sets a reward floor of 15% -- and a cap of 30% -- of the collected proceeds, including penalties and interest. Smaller rewards may be handed out in certain circumstances, such as if a reward is principally based on public information, including a court case or the media. Congress limited the new program to tips involving large amounts of money. The law applies to someone with information involving a business or, in the case of an individual, someone whose gross income exceeds \$200,000 for any year in question. Whatever the case, the taxes, penalties and interest in dispute must exceed \$2 million. Also, the information must be submitted as a statement "under penalties of perjury."

To file a claim under the law, use IRS Form 211, available on the IRS Web site at www.irs.gov.

Informants still can file claims for smaller amounts, but they'll be limited to the old law, under which the reward typically can't exceed 15% of the amount recovered. The reward ceiling generally has been \$10 million in recent years, although that ceiling and the percentage may be increased under special agreements.

Another big change: Under the old law, the IRS typically wouldn't pay a reward to tipsters who "substantially" participated in the wrongdoing they reported. The new law allows the IRS to pay rewards to people who were involved but only under certain circumstances.

Another tricky question is whether to approach the IRS on your own or hire a

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professional to represent you. The answer depends on the details of your situation. If it's a very simple case and the evidence you have is overwhelming, you may be able to handle it on your own and thus avoid paying a lawyer.

Changes to Non Profits Form 990

Iowa Sen. Grassley and Montana Sen. Baucus urged the government to collect more and better information on nonprofit organizations. In a letter to Treasury Secretary Paulson, they said the IRS "must particularly recognize that the Form 990 is not adequate to encompass vital information regarding major parts of the nonprofit sector - especially hospitals and universities." The IRS is already at work redesigning its Form 990.

Tax Planning – New Kiddie Tax Rules

A new tax law affects parents who make gifts to a child in order to take advantage of a lower tax rate on children's investment income.

The law marks the second time in just over a year that Washington has extended the reach of the so-called kiddie tax, which subjects a child's income to a parents' higher tax rate.

What prompted Congress to further expand the kiddie tax were reports that some wealthy parents were planning to take advantage of a tax-law change designed for low-income people that will be effective next year. By extending the reach of the kiddie tax, Congress

effectively eliminated many of the benefits of this strategy.

But the changes to the kiddie tax could affect many other parents who have made gifts of stock and other securities to a child.

Under current law, investment income above a certain level (generally \$1,700 for 2007) for a child 17 years old or younger typically is subject to the parents' tax rates, assuming the parents' rates are higher than the child's. That is still the law for this year. (Before the law was changed last year, the kiddie tax applied only to children younger than 14.)

Under the new law, the age limit will increase starting next year to children who are 18, or under 24 if the child is a full-time student. This expanded provision won't apply to some children with paid jobs. A congressional summary says the expanded provision applies "only to children whose earned income does not exceed one-half of the amount of their support."

Congressional staffers estimate the expanded kiddie-tax provision will raise more than \$1.4 billion over a decade.

The new law could give a boost to 529 college-savings plans, because investments in these accounts aren't subject to the kiddie tax. Parents might invest a child's money in investments that generate little or no taxable income, such as municipal bonds.

The tax-saving strategy that touched off the latest law change, which was outlined in this column on Jan. 17,

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involved people in high tax brackets transferring ownership of large amounts of stock, mutual-fund shares and other assets to children in lower tax brackets. Under current law, the top tax rate on long-term capital gains and most corporate dividends this year generally is 15%. But for taxpayers whose income puts them in the two lowest ordinary income brackets (10% and 15%), the rate is only 5% this year -- and zero next year. For people in higher brackets, the top long-term capital-gains rate on securities sales is to remain 15% next year, as is the rate on most types of dividends.

Anticipating this change, some investment advisers had been suggesting that high-income family members consider making gifts of securities that have gone up in value over the years to low-income family members, who could then sell those securities, tax-free, next year. The new law doesn't affect transfers to elderly parents or other relatives.

What else can taxpayers do?

One tip is to put a child's money in investments that generate little or no taxable income. For instance, a child's funds could be invested in growth-oriented stocks or mutual funds that produce little or no current income; tax-exempt municipal bonds or municipal-bond funds; land expected to appreciate in value; closely held family business stock that pays low or no cash dividends; or U.S. series EE savings bonds for which you can defer reporting interest income.

To help with college tuition, consider setting up a 529 college-savings plan. Contributions are made with after-tax dollars, but the money comes out tax free for college, and therefore would not be reported for income tax purposes.

But trust-fund babies need to watch out. Income generated by a trust for which a child is the beneficiary may be subject to the kiddie tax, depending on how the trust was set up.

And before making sizable gifts to children or other family members, keep in mind that those gifts may backfire in some cases. Gifts could make a student ineligible for college financial aid, for example. Or they could make a senior's Social Security benefits subject to tax, or increase the tax on those benefits.

Thus, consider getting advice from tax and financial planners before making gifts. Also ask about any gift-tax or estate-tax consequences. You can give away as much as \$12,000 this year to anyone you want without any tax considerations. You don't even have to report your gift.

What is Nexus?

Your company may be "doing business" in a state and not even realize it until it's too late.

If you are doing business in a number of states you may be subject to closer scrutiny by state and municipal tax assessors as they increasingly monitor activity in their state and go after unpaid taxes to increase their revenue stream. Many companies who owe taxes may not be aware that they are required to

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pay taxes in these states or of the technicalities inherent in nexus tax issues, and the need for sound tax planning.

Nexus describes the amount and degree of business activity that must be present before a state can tax an entity's income. If a taxpayer has nexus in a particular state, the taxpayer generally must pay and collect/remit taxes in that state. In general, nexus is created for income, and/or sales/use tax purposes, if an entity:

- derives income from sources within the state;
- owns or leases property in the state;
- employs personnel in the state (employees or independent contractors);
- has personnel (employees or independent contractors) travel to another state; or
- has capital or property in the state, including inventory in storage or on consignment.

The amount of activity or connection that is necessary to create nexus is defined specifically by state statute or case law and/or regulation and, consequently, varies significantly from state to state.

Accounting

Pretty soon the bottom line may not be, well, the bottom line.

In coming months, accounting-rule makers are planning to unveil a draft plan to rework financial statements, the

bedrock data that millions of investors use every day when deciding whether to buy or sell stocks, bonds and other financial instruments.

One possible result: the elimination of what today is known as net income or net profit, the bottom-line figure showing what is left after expenses have been met and taxes paid.

In its place, investors might find a number of profit figures that correspond to different corporate activities such as business operations, financing and investing.

Another possible radical change in the works: assets and liabilities may no longer be separate categories on the balance sheet, or fall to the left and right side in the classic format taught in introductory accounting classes.

The move is being undertaken by accounting-rule makers in the U.S. and internationally, and ultimately could affect companies and investors around the world.

The project is aimed at providing investors with more telling information and has come about as rule makers work to one day come up with a common, global set of accounting standards. If adopted, the changes will likely force every accounting textbook to be rewritten and anyone who uses accounting to relearn how to compile and analyze information that shows what is happening in a business.

The effort to redo financial statements reflects changes in who uses them and for what purposes. Financial statements

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were originally crafted with bankers and lenders in mind. Their biggest question: Is the business solvent and what's left if it fails? Stock investors care more about a business's current and future profits, so the net-income line takes on added significance for them.

The goal of the accounting-rule makers is to better reflect how businesses are actually run and divert attention from the one number.

At the same time, public companies today are more global than local, and as likely to be involved in services or lines of business that involve intellectual property such as software rather than the plants and equipment that defined the manufacturing age.

For more information on anything covered in this Newsletter, please contact me. I provide tax, accounting, consulting, and other business services such as payroll and medical billing.

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For More Information

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