

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:

This month's contents include: Year end tax planning suggestions; buy or lease your next vehicle; AMT update; expiring environmental tax credits; gifting a remainder interest in a home; a couple of interesting recent cases.

Review Your Tax Situation Before Year End

Tax planning is a year round process. For most taxpayers one important step of the process is to work through an income tax projection each summer or fall. That's the only way to ensure that you won't be surprised with either a huge tax refund or balance due next April.

A big flaw in the tax system is the annual reconciliation called the Form 1040 that every taxpayer completes and submits to the IRS each winter. The first step is to complete the required tax forms, taking advantage of all the tax breaks available to minimize your income tax liability for the year. In step two, you add up all the taxes you paid in during the year through withholdings and estimated tax payments.

Step three is where things really get exciting. Now is the time to compare your tax liability with the taxes you paid in during the year. If the taxes paid in

exceed your tax liability, you'll be getting a refund from the IRS. Otherwise, expect to write a check on April 15th.

While the small percentage of taxpayers who actually plan ahead and work through a tax projection during the year are generally not surprised by the amount of taxes they owe or will have refunded, it's fair to say that most everyone else compares step three with rolling the dice at a casino.

A leading culprit of this uncertainty is the benign looking W-4 form. On the surface, the form seems easy enough to complete. Simply fill in your name, marital status, how many allowances you're claiming, and whether you want any additional taxes withheld from your pay.

Like the W-4 form, the rules governing the withholding tables are simple enough to understand as well. Less taxes are withheld for people claiming to be married than those who claim single. Plus, less taxes are withheld with each additional allowance that is claimed.

So what causes the W-4 form to backfire so often? There are two major underlying problems:

- Each employer withholds taxes as if they're your only employer
- If you tell your employer that you're married, the withholding tables assume that your spouse doesn't work.

If you work for more than one employer, or if both you and your spouse work, you need to be very careful when you

November, 2007

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complete the W-4 Form. It's not uncommon for an individual with multiple employers, or a married couple comprised of two working spouses, to owe thousands of dollars in taxes because not enough taxes were withheld throughout the year due to how the W-4 was completed.

Tax planning for salaried individuals tends to be pretty straightforward. For the majority of people on salary, their income doesn't generally fluctuate much from year to year. And if there is a big fluctuation, their withholdings are automatically adjusted accordingly.

Self-employed individuals don't have that luxury. Usually, their income changes significantly from year to year. Plus, chances are good that the person is remitting their taxes through quarterly estimates based on their prior year's tax return. The combination of these two factors results in the potential for big surprises for self-employed individuals each winter.

Some surprises are great, such as surprise birthday parties or perhaps receiving a sizeable gift from a long, lost relative you never met. When it comes to taxes, surprises generally aren't so great.

If you work with a CPA or plan to start working with one for the first time, now's the time to touch base with your tax preparer and spend a few minutes working through a tax projection.

For do-it-yourselfers, you have a few options. Either re-enter this year's projected information into your 2006 tax program and see how it comes out. For the most part, the tax rules didn't change

substantially since last year, so this will give you a good idea as to where you stand with your taxes for 2007.

Another suggestion is to make a copy of your 2006 tax return, and pencil in this year's numbers in the margin of each form. Even though this method is less precise, you should still be able to get a sense of this year's projected tax liability.

However you decide to work through the math, taking a little time now will not only help you avoid any surprises next winter, but will also give you the remaining months of 2007 to adjust your withholdings and quarterly estimates based on your tax projection

Whether to Buy or Lease Your Next Vehicle

Buying or leasing? What's better for your next car? This is a very common question taxpayers ask their tax advisors all the time. Ironically, one of the most important factors to consider is not even tax related.

The first question you need to ask yourself is how long you generally keep your cars. If you prefer to get a new car every three or four years, take a look at leasing your vehicles. If you're frugal and hope to keep your car for at least seven or eight years, then buying probably makes the most sense for you.

Whether you own or lease your vehicle, you can only claim a tax deduction based on the percentage of the miles driven during the year that are business miles, including:

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Deductible Miles:

- Driving between job sites
- Driving between your home and a temporary job site where you'll be working for less than one year
- Driving to meetings, conferences, interviews, and seminars

Non-Deductible Miles:

- Commuting between your home and a regular place of business
- All other personal miles driven

From a tax perspective, you can claim your automobile deduction based on either the standard mileage rates or on actual expenses incurred. The standard mileage rate for 2007 is \$0.485 per business mile driven, and is the same whether you own or lease your car.

If you drive relatively few miles during the year, with most of those being business miles, you're generally better off basing your deduction on the actual miles driven. To calculate your deduction this way, make sure to include the amount you spend on gas, insurance, repairs, and parking at home. These expenses are generally similar whether you own or lease your vehicle.

Don't forget to also include in your calculations the lease payments if you lease a car or a factor for depreciation if you own the car. One drawback to owning is that the IRS limits the depreciation you can claim based on a car costing no more than \$14,800. For this reason, people who lease generally get a larger tax break when basing their deduction on actual expenses incurred.

Here are some other factors to consider when deciding whether to lease or buy your next car:

- Leasing generally provides you with the opportunity to get a more expensive vehicle for less money down and a smaller monthly payment.

- If you're acquiring a car through your business, leasing does a better job of matching the cash flows of providing a company car with the deductions you're allowed to claim.

On the other hand:

- If you plan to get a hybrid vehicle, you only qualify for the tax credit if you purchase the vehicle. When you lease a hybrid, the leasing company is the one who gets the tax credit.

- Most lease contracts limit you to just 12,000 miles (or less) per year. If you drive more than the maximum miles allowed under your lease, expect to be penalized at the end of the lease term for each additional mile driven.

Since the auto industry is so competitive, the deals they offer for buying versus leasing tend to be quite equivalent. And thanks to the internet, you now have plenty of information available, as well as access to a variety of tools, to help you find the best deals. So is it better to lease or to buy your next vehicle? It depends.

Alternative Minimum Tax Update

On New Year's Day 2007, the Alternative Minimum Tax (AMT) went

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Monthly Tax and Accounting Newsletter

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from bad to worse. Due to a stop-gap provision that expired at the end of 2006, many more taxpayers could end up paying a lot more AMT this year. Experts predict that the number of people being hit by the AMT is on track to jump six-fold, from 4 million taxpayers in 2006 to 23 million taxpayers in 2007.

What is the AMT? When you calculate your taxes, you're supposed to calculate them two ways. First, you figure your tax liability under the regular tax system. And then you re-calculate your taxes using the AMT rules. Whichever tax is higher is the one that you pay.

When calculating the ATM, certain tax breaks aren't allowable, including your personal exemptions and your standard deduction if you don't itemize. Itemizers are required to back out their state income taxes, real estate taxes, a portion of allowable medical expenses, all miscellaneous itemized deductions, and interest paid on home equity debt not used to purchase or improve a principal residence or second home. Anyone who realizes significant capital gains or exercises and holds Incentive Stock Options (ISO's) generally ends up paying the AMT as well.

Each summer, my CPA firm starts preparing income tax projections for my clients who don't want to be surprised by the outcome of their tax return the following winter. What I discovered once I started working on our 2007 projections is that taxpayers are going to get clobbered by the AMT this year.

What is causing this AMT catastrophe? The biggest culprit is the AMT

exemption that you're allowed to claim each year. The purpose of this exemption is to protect middle-income taxpayers from paying the AMT.

If Congress doesn't do something about the current AMT rules, the allowable AMT exemption for married couples will be cut from \$62,550 as allowed in 2006 to just \$45,000 in 2007. That's a reduction of \$17,550, or 28%.

For single individuals, the reduction isn't quite as dramatic, with the AMT exemption decreasing to \$33,750 in 2007 from \$42,500 in 2006. That's a reduction of \$8,750, or 20% of the 2006 amount.

When you factor in that the AMT tax rate is 26% for the first \$175k of AMT income (at which point the rate increases to 28%), the decreased exemption costs middle income married couples up to \$4,563 in extra taxes. Single individuals should expect to pay as much as \$2,275 in additional AMT due to the decrease in the exemption.

So the big question is whether Congress will act on the AMT before it's too late. One positive sign comes directly from the IRS. A few years back, the IRS developed an on-line AMT Assistant for Individuals. Go to this application and you'll see that this tool has not yet been updated for the 2007 rules. Hopefully that means that the IRS doesn't expect the current rules to be around for long.

When you factor in that next year is an election year, most analysts are optimistic that Congress will do something about the current AMT crisis. With taxes due April 15, and then

November, 2007

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Election Day just six and a half months later, there could be a lot of angry people voting with their pocketbooks if taxpayers end up paying the kind of AMT that I've seen in my projections

Environmental Tax Breaks

The tax code is full of a continually changing array of tax breaks. While some tax breaks are permanent, others are instituted for a set number of years. Tax-savvy taxpayers should pay attention.

Back in 2005, the Energy Tax Incentives Act of 2005 became law, rewarding those businesses and individuals for making certain energy efficient improvements. All of the Act's provisions had a limited shelf life, however, with most slated to expire at the end of 2007.

Then, during 2006, President Bush signed the Tax Relief and Health Care Act of 2006 into law. Among its many provision, this Tax Act extended some of the tax breaks of the 2005 Energy Tax Incentives Act through 2008.

Let's look at when certain environmentally friendly tax breaks are set to expire.

December 31, 2007

You only have until the end of this year to make energy efficient improvements to your principal residence and still qualify for the \$500 tax credit. The credit is equal to 10% of the money spent on the installation of certain energy efficient improvements to your

home, including insulation and exterior windows, doors, and skylights.

You can also take a tax credit for "qualified energy property" including up to \$50 spent per circulating fan, \$150 on furnaces or hot water boilers, and \$300 on heat pumps, water heaters, and central air conditioning.

The total combined tax credit applies for purchases made during 2006 and 2007, and is limited to a lifetime max of \$500 per dwelling, with no more than \$200 of the credit to be taken for replacement windows and skylights.

What should you do if you were eligible for this tax credit in 2006, but forgot to claim it on the tax return you originally filed? Don't worry, you have until April 15, 2010 to file a Form 1040X, Amended Tax Return, for 2006 with the IRS.

More information about the Residential Energy Property Credit is available on IRS Form 5695, Residential Energy Credits.

December 31, 2008

The following two other provisions of the 2005 Energy Tax Act were extended for one additional year through 2008:

- Energy Efficient New Home: Contractors are eligible for a tax credit of up to \$2,000 for each new (or significantly rehabilitated) home "substantially completed" and sold prior to December 31, 2008, provided the home meets certain energy savings criteria. If you're in the market for a

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brand new home, make sure the builder passes this lucrative tax break on to you.

• **Energy Efficient Commercial Improvements:** If you own a commercial building or condo, you're eligible to claim an immediate deduction of up to \$1.80 per square foot (versus depreciating the costs incurred over 39 years) by making major energy saving improvements to your building's lighting, hot water, and HVAC systems prior to December 31, 2008. Upgrading insulation, metal roofs, and exterior doors and windows also counts towards this deduction.

With energy costs on the rise, many individuals are looking for ways to make their homes, cars, and businesses more energy efficient. If making environmentally friendly expenditures is in your plans, why not beat the clock to take advantage of these expiring tax breaks and let the government subsidize a portion of the costs incurred?

Gifts of Remainder Interest in a Home

One of the first decisions tax-payers must make when planning their estates is what to do with the principal home. With the changing and sometimes down-trodden real estate market, this can be a difficult and time-consuming task for heirs, particularly if they do not reside in the same state and have no desire to keep or maintain the home.

Homes can be on the market for months or sometimes years depending on their location, condition, and asking price. Often, heirs need to sell the home within

nine months to provide the liquidity to pay estate taxes and any final costs associated with administering the estate. They may have to absorb a large reduction in the sales price to expedite the sale.

One solution is to have the taxpayer gift a remainder interest in the home to a qualified Sec. 501(c)(3) charity.

Benefits to the taxpayer include

- (1) an income tax benefit for the charitable deduction of the remainder interest;
- (2) the value of the home will be out of the taxable estate;
- (3) the taxpayer can continue to reside in the home for the rest of his or her life; and
- (4) the taxpayer will relieve the heirs of the burden of selling the home.

Gifts of a remainder interest requires the property ownership to be divided into two separate interests: a life estate and a remainder interest.

A life estate gives the holder the power to retain ownership until death. If the taxpayer is married, the life estate can be structured to last until the second spouse's death.

A remainder interest gives the holder the right to take ownership when the life estate has ended. The home will need to be appraised at the time of the gift to determine the value of both the life estate and the remainder interest.

The IRS has published tables that are used to value the life interest in the property. The difference between the

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Monthly Tax and Accounting Newsletter

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appraised value and the life interest is the remainder interest. This latter amount qualifies as a charitable deduction that the taxpayer could use to offset taxable income, subject to the limits for charitable contributions.

In determining the value of the charitable remainder interest for purposes of the deduction, straight-line depreciation is taken into account if the property is depreciable. However, for estate and gift tax purposes, the value of a charitable remainder interest is determined without taking depreciation into account. For a description and an example of how to determine the value of a charitable remainder interest in a personal residence for charitable deduction purposes, see Regs. Sec. 1.170A-12(b).

Only remainder interests in personal residences and farms are eligible under this provision (Sec. 170(f)(3)(B)(i)). A personal residence does not have to be the taxpayer's principal residence to qualify, so the taxpayer can take a deduction for a vacation home.

A farm is broadly defined to include any land used by the taxpayer or his or her tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock and the improvements on the land (Regs. Sec. 1.170-7(b)(4)).

The gifting of a remainder interest is not recommended on debt-encumbered property because it could result in undesirable tax consequences to both the donor and the charity.

In this situation, possible solutions would be to transfer the debt to another property or to pay off any underlying mortgage prior to making the gift. Although ownership transfers at death, the donor is still responsible for paying the real estate taxes, property insurance, and maintenance expenses of the home during his or her lifetime.

This type of planning is especially beneficial for an individual with multiple properties who wishes to make a substantial lifetime charitable donation. It enables the individual to provide a home for his or her spouse or beneficiaries in the form of a life interest.

When the life interest terminates, the property goes directly to the charity that received the remainder interest. This relieves both the donor and his or her beneficiaries of the burden of selling the property and paying any capital gain or estate taxes.

Increasingly, universities are benefiting from gifts of a remainder interest in houses and land. The university typically sells the donated property in order to support its programs and initiatives.

Conservation groups such as public or private land trusts are another type of recipient of remainder interests when the donor is gifting farmland or property near a river or lake.

Clearly, gifting with a remainder interest can be tailored to suit many types of individual needs while reaping tax benefits and fulfilling philanthropic interests.

November, 2007

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Case: Forfeited Pre-Paid Tuition

Here is the case that I recently consulted on, that may be useful to you. Several CPA's also consulted on the case and are labeled by numbers here:

An individual signs his children up for private school and prepays the tuition. However, the family moves out of town, so the children don't attend the school. The individual can get a refund but chooses not to. He figures it will be a charitable deduction.

However the school says that they have a strict policy of not giving a charitable receipt where the original payment involved tuition. They say that there is too much opportunity to mess around (my term, not theirs).

This looks like a valid donation, looking at it as a receivable from the school that the individual forgave. However, we're stuck without a receipt. As an aside, school says it's now too late to request refund.

CPA #1:

This would definitely be a charitable donation. Have the client send a letter to the school documenting that he is forgoing the refund of the tuition to them for charitable purposes. It is a valid amount due the taxpayer, so naturally forgiveness of a debt would be a donation as long as her properly stated such. That is an offer and their not refunding him the money would be the execution of the contract. You would rarely get a charitable donation receipt for the forgiveness of a debt. The

assumption here is that the school is a valid charity.

CPA #2:

The money is no longer the client's to give. There is no refund to forgo at this point. It is not due the taxpayer because the taxpayer missed the deadline for obtaining the refund on prepaid tuition. How can there be a forgiveness of debt when there is no debt?

CPA #1, Again:

But from the story, as stated above, he gave the refund to the school when there was a valid debt. The mention of the validity of the debt only came up retroactively as to him taking the refund, then turning around and donating it to get a receipt. The school is not the final arbitrator of who gets a deduction; only if they will give a receipt for the donation. The amount of debt is also well defined - the payment to the school. The time of the donation would be when he forgave the debt.

CPA #3:

The formal tuition policies will dictate whether or not it is a charitable deduction. If at the time he took children out and notified the school he was due some amount of refund then that amount is what was "donated." If the school policies reads that tuition is due on day 1 and no refund is given for any semester in progress, even if he pulls the kids on Day 2, the money for that semester is lost.

CPA #4:

November, 2007

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We used to see formal tuition policies that said tuition was tax-deductible as a contribution. This did not get far. If he took his children out of school and told them he wanted a refund, he would have received a refund, if that is what the school's guidelines said.

Result:

Planning to take the deduction.

Case: Married But Filed Single

Here is another recent interesting case:

American citizen, lives in US; used to live in Canada. Had a Canadian CPA but now wants someone closer to home.

Files as single, wage and self-employment income; no problem so far. Turns out he's married. And not just recently--10 years. Spouse is a Canadian citizen living full-time in Canada. "We each file as single because we keep our financial lives separate--I pay US tax on my work here and she pays Canadian tax on her work there."

There are no kids or dependents, and no way to claim Head of Household instead. There's no divorce in the works, let alone any sort of decree--they just choose to live apart. .Appears he's stuck with married filing separate status.

Result:

After the marriage penalty fix of a few years ago, it turns out that for the open years, his income tax is the same if filed single or Married Filing Single. The tax rate doesn't start skewing on single vs. MFS until \$64250 (for 2006).

For More Information

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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November, 2007

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