

# 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 newsletter includes a review of 2008 tax changes, 2007 filing notes, and an article about the always confusing AMT.

### 2008 Tax News

#### Capital Gains

Filers who are in the 10% or 15% tax brackets get a break: their top rate on long term capital gains fall to 0% in 2008, down from 5% before. Once their income is high enough to push them into the 25% bracket and the balance of the gains is taxed at 15%.

But kids won't receive much benefit from the 0% rate in 2008. That is because Congress substantially stiffened the kiddie tax. The kiddie tax age rises in 2008 to 19 and for full time students whose earned income is less than half of their support, it increases to 24. If the kiddie tax applies a child's unearned income over \$1,800, including capital gains, is taxed at the parents marginal rates.

Surviving spouses have longer to claim the \$500,000 gain exclusion on a primary home. Sales within two years of the spouse's death qualify.

### Medicals

Higher deductible pay-ins are allowed to health saving accounts, up to \$5,800 for those with family coverage and as much as \$2,900 for sole coverage. Account owners born before 1954 can put an extra \$900 in their HSAs. The minimum policy deductibles remain \$2,200 for families and \$1,100 for self-only coverage. The ceiling on out of pocket costs rises to \$11,200 for family coverage and \$5,600 for individual coverage.

And limits on deductibility of long term care premiums are higher. Taxpayers who are age 71 and older can claim as much as \$3,850 per person. Filers ages 61 to 70, up to \$580, and people 40 and younger, \$310. The limit for tax free payouts under such policies rises to \$270 a day.

### Education

The maximum HOPE credit rises to \$1,800 for 2008, up by \$150. The income limitation for the education credits also goes up. The phase out begins at \$96,000 for married couples and \$48,000 for singles.

The income caps increase on tax-free EE bonds used for education. It now starts phasing out at \$100,650 for married couples and \$67,100 for singles. It ends when AGI reaches \$130,650 and \$82,100 respectively.

The student load interest deduction phases out at higher levels for joint filers, beginning when adjusted gross income exceeds \$115,000.

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### Savings Plans

Working taxpayers can salt away more money for retirement. The pay-in limits for IRAs and Roths rise to \$5,000 up by \$1,000. And anyone who was born in 1958 or earlier can kick in an extra \$1,000. But there is no change in the 401(k) or 403(b) contribution caps, which are \$15,500 or \$20,500 for individuals born before 1959. Also the ceiling on SIMPLEs remains \$10,500. Folks aged 50 or older in 2008 can put in \$2,500 more.

Plan pay-ins can be based on up to \$230,000 of salary in 2008. And more folks can claim the tax credit for retirement plan pay-ins., married couples with AGIs up to \$53,000 and singles with AGIs of up to \$26,500.

The pay-in ceiling for defined-contribution plans is \$46,000 in 2008, a \$1,000 increase for Keoghs, profit sharing plans and the like. And the benefit limit for pension plans jumps to \$185,000.

The deduction phase out for regular IRAs begins at higher levels in 2008. For married filers in company plans, it now starts at \$85,000 of AGI and ends at \$105,000. If only one spouse is in a plan, the phase out zone for deducting a pay-in for the uncovered mate starts at \$159,000 of AGI and ends at \$169,000. For singles, the range is \$53,000 to \$63,000.

Ditto for Roth IRAs. The Roth pay-in limit phases out for couples with AGIs of \$159,000 to \$169,000 and, for singles, \$101,000 to \$116,000.

Direct rollovers from company plans into Roth IRAs can be made if your adjusted gross income is \$100,000 or less. This allows you to avoid having to roll the payout to an IRA first and then to a Roth. The amount rolled over to the Roth is taxable in the year transferred.

### Medicare

The basic Medicare part B premium rise to \$96.40 a month. But upper income seniors owe an even higher part B premium.

The fee is based on 2006 AGI plus any exempt interest, EE bond interest used for education, and excluded foreign earned income. The 2008 premium for higher income taxpayers range from \$122.20 a month for married couples with AGI of \$164,000 to \$204,000, and singles with AGI from \$82,000 to \$102,000, to \$238.40 a month for incomes of \$410,000 and \$205,000 or more (married and single, respectively).

These amounts are much higher than the 2007 amounts at the higher incomes. A similar increase is expected for 2009. That's because the 3-year phase in for the higher income part B premiums will be fully effective by then.

### Social Security

The social security wage base rises to \$102,000 in 2008, a \$4,500 increase. In effect that is a tax hike of \$279 for people with higher income. The tax rates themselves are the same as 2007 - 6.2% for FICA and 1.45% for Medicare. Self employed people will pay 15.3% on the first \$102,000 of net earnings and 2.9% above that.

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The nanny tax threshold jumps to \$1,600 in 2008, up from \$1,500.

Social Security benefit checks will be 2.3% larger for 2008.

Earnings limits will rise too. Those who turn 66 in 2008 won't lose benefits if they earn \$36,120 or less before reaching that age. Folks between ages 62 and 66 by the end of 2008 can make up to \$13,560 without losing benefits. There is no cap once a beneficiary reaches 66.

### Personal Taxes

The income tax brackets are wider due to inflation, but there is no change in rates for each bracket. The brackets remain: 10%, 15%, 25%, 28%, 33%, and 35%.

Personal exemptions in 2008 are \$3,500. Of course this is just for the main tax, not the AMT. And exemptions are still reduced gradually as your income rises. They are cut by 2% for each \$2,500 of adjusted gross income over \$239,950 for joint returns, \$159,950 for singles, and \$199,950 for household heads. The phase out ends at \$362,450, \$282,450, and \$322,450 of AGI, respectively. But the cutback in exemptions is reduced by two thirds for 2008 which is good news for upper incomes in the phase out zone. In effect, the highest earners get \$2,333 per exemption for the regular tax.

Upper incomes get a break on the phase out of itemized deductions in 2008 as well. If AGI exceeds \$159,950 itemizations are trimmed by 1% of the excess. In prior years, that was 2%, and

the phase out started at a lower level. You can still never lose more than 80% of your itemized deductions. And your medical expenses, investment interest paid, and casualty losses are exempt for the cutback.

The standard deduction has gone up. Married couples can claim \$10,900 plus \$1,050 for each spouse who is 65 or older. Singles get \$5,450. Those 65 and up can take \$6,800. Household heads get \$8,000 plus \$1,350 once they are 65. Legally blind taxpayers can add another \$1,050 to these amounts.

### Adoption

The adoption credit goes up in 2008. It can now be taken on costs up to \$11,650. Adoptions of special needs kids get the full credit even if costs were less. The break phases out for filers with AGIs between \$174,730 and \$214,730. The exclusion for company paid adoption aid also jumps to \$11,650.

### Mileage Rate and Auto Expenses

The standard mileage rate for business driving is going up 2¢. It will be 50½¢ a mile in 2008. If you use the standard rate in lieu of actual expenses, you must reduce the tax basis of the vehicle by the depreciation component, or 21¢ per mile next year, up 2¢ from 2007.

Firms with fleets of up to four vehicles can claim the standard rate.

But the rate for medical travel and moving drops to 19¢ per mile in 2008, down 1¢. That's because this rate doesn't include fixed costs such as

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depreciation, which is what fueled the rise in the business rate.

The allowance for charitable driving, set by Congress, remains 14¢ a mile.

Remember that the cost of parking and tolls is also deductible but fuel and repairs are not. And note that the allowance can't be used if you depreciated the vehicle before or expensed all or part of its cost.

### **Business Taxes**

Small firms can expense more equipment in 2008, up to \$128,000. And the ability to claim expensing in lieu of taking depreciation phases out dollar for dollar once \$510,000 of assets are placed in use.

Partnerships that file late face a higher penalty, \$85 per partner per month for up to 12 months. The fine is now extended to S firms as well now.

### **Fringe Benefits**

U.S. taxpayers working abroad have a higher exclusion now, \$87,600.

Volunteer firefighters and emergency medical workers get a break - any local real estate tax rebates they get are not taxable.

Employers can pay \$220 a month in tax-free parking, up \$5. The cap on tax-free transit passes rises to \$115 a month.

### **Estate and Gift Taxes**

More estate tax qualifies for an installment payment tax break. If closely held businesses make up more

that 35% of an estate as much as \$576,000 of tax can be deferred with a low 2% interest rate.

The special estate tax valuation of real estate is increasing. Up to \$960,000 of farm or business realty can receive a discount valuation.

Other transfer tax figures do not change. The estate tax exemption remains at \$2 million, though it goes to \$3.5 million after 2008. The top tax rate is stuck at 45%. The lifetime gift tax exemption is still \$1 million. And the annual gift tax exclusion of \$12,000 per donee has not changed.

### **Trust Taxes**

Brackets for trusts and estates have changed. Rates on income that is not paid to beneficiaries range from 15% for less than \$2,200 to 35% over \$10,700.

### **Exempt Groups**

Small exempt groups must file a bare bones return with the IRS. Those grossing \$25,000 or less must e-file basic data about themselves. A failure to e-file for 3 years in a row will cost a group its exempt status.

### **Filing News**

This year, some early filers may have to wait a few extra weeks for their refunds. The delay is due to the Alternative Minimum Tax (AMT) legislation enacted in December.

Most tax filers will not be affected by the AMT legislation. The delays in processing and refunds will be

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experienced only by those who include any of the following five forms with their 2007 individual income tax return:

- Form 8863, Education Credits.
- Form 5695, Residential Energy Credits.
- Schedule 2 (Form 1040A), Child and Dependent Care Expenses for Form 1040A Filers.
- Form 8396, Mortgage Interest Credit.
- Form 8859, District of Columbia First-Time Homebuyer Credit

If you are filing using one of the five affected forms you won't be able to send your return to the IRS for a few weeks until the IRS computers are reprogrammed for the late tax law change. The IRS expects to be ready for these returns by February 11.

Even if you are affected, it is still a good idea to start working on your tax return sooner rather than later.

Filing electronically is the best option for most taxpayers, including people impacted by the AMT changes. Whether or not your return claims an AMT related credit, filing electronically results in faster refunds and fewer errors. When you e-file combined with direct deposit you can expect your refund in as little as 10 days. Refunds from paper returns typically take four to six weeks

### Getting Ready To File

Earlier is better when it comes to working on your taxes. Taxpayers are generally encouraged to get a head start on tax preparation, especially since early

filers avoid the last minute rush and get their refunds sooner.

General recommendations would include at least these points:

1. Gather your records in advance. Make sure you have all the records you need, including W-2s and 1099s. Don't forget to save a copy for your files.
2. Get the right forms. They're available around the clock on the IRS Web site, [IRS.gov](http://IRS.gov).
3. Take your time - rushing can mean making a mistake.
4. Double-check your math and verify all Social Security numbers. These are among the most common errors found on tax returns. Taking care will reduce your chance of hearing from the IRS and speed up your refund.
5. E-filing is easy. E-filing catches math errors and provides confirmation your return has been received and gives you a faster refund.
6. Don't panic. If you have a problem or a question, ask a CPA for help or try asking the IRS. Their web site is [IRS.gov](http://IRS.gov) and their customer service number is 800-829-1040.

Even if you are filing one of five forms affected by the recent legislation, the IRS expects to be ready for your return by February 11.

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### The AMT

Remember back when you were young and poor and nothing made you madder than tales of rich people who paid nothing in income taxes? Well, you weren't alone, and that anger led to the creation of something called the alternative minimum tax, which was designed to keep the rich from living tax-free.

Fast-forward a few years. You're a bit older, somewhat better off and paying far more in taxes than you ever thought possible. So what's the last thing you expect to see when you fill out your tax return? - that you owe the alternative minimum tax. You can take some solace in the fact that thousands of taxpayers just like you have been snagged by this nasty bit of tax law in recent years. While only 19,000 people owed the AMT in 1970, millions are paying it now.

What happened? Inflation, mostly. While the "regular" tax brackets, exemptions and standard deductions are adjusted annually for inflation, the AMT brackets and exemptions are not, so many people whose income has grown with the economy enter the dreaded AMT zone each year. Especially vulnerable are people with income over \$75,000 and some large deductions, but not the exotic ones that were originally targeted by the AMT's creators. Most vulnerable are taxpayers with several children, interest deductions from second mortgages, capital gains, high state and local taxes, and incentive stock options.

### How the Tax Works

The best way to understand the AMT is to view it as a separate tax system. It has its own set of rates and its own rules for deductions, which usually are less generous than the regular rules. Because of these confusing rules, the only ways you can tell if you owe the tax are by filling out the forms (essentially doing your taxes a second time) or by being audited by the Internal Revenue Service. If it turns out you should have paid the AMT but didn't, you will owe the back taxes plus any interest or penalty that the IRS decides to dole out.

You should definitely run the numbers if your gross income is above \$75,000 and you have write-offs for personal exemptions, taxes and home-equity loan interest. Ditto if you exercised incentive stock options during the year, or if you own a business, rental properties, partnership interests or S corporation stock. If you earn more than \$100,000, run the numbers for that reason alone.

That means filling out Form 6251. In effect, you are simply adding back some tax deductions and income exclusions to your regular taxable income to arrive at your alternative minimum taxable income. Here is where the middle class gets soaked. First you have to add back your personal- and dependent-exemption deductions (\$3,400 each in 2007, \$3,300 each in 2006), then your standard deduction if you don't itemize (\$10,700 for joint filers in 2007 and \$10,300 for joint filers in 2006; \$5,350 for singles in 2007 and \$5,150 for singles in 2006). You also lose your state, local and foreign income and property-tax write-offs, as well as your home-equity loan

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interest, if the loan proceeds are not used for home improvements.

The AMT also ignores some itemized deductions, such as investment expenses and employee business expenses, and some medical and dental expenses. It also counts as income the interest from private-activity bonds, a type of tax-exempt bond issued by governments, usually to finance sports stadiums and the like.

Finally, AMT rules force you to pay taxes on the "spread" between the market price and the exercise price of incentive stock options granted by your employer. For example, if you exercised an option to buy 100 shares of stock for \$3 a share and the stock was trading at \$10, the spread would be \$7 a share, or \$700. Under the regular rules, you wouldn't pay current taxes on that amount, but under the AMT, it's considered income.

Don't give up hope. You do get a few small breaks under AMT rules that you wouldn't see under the regular tax rules. For example, while you can't deduct state, local and foreign taxes under AMT rules, you can deduct the refunds, which would be considered income under the regular tax rules. And because you're taxed on the spread on your incentive stock options, your tax basis for the shares you bought is higher under the AMT, meaning your tax bill will be lower when you sell the shares.

The AMT form has quite a few other pluses and minuses, but you can probably ignore them unless you own a business, rental properties or interests in partnerships or S corporations. If you do,

you may need a CPA to prepare at least the Form 6251 part of your return.

Finally, you get to deduct the AMT exemption — \$62,550 for 2006 joint filers; \$42,500 for unmarried persons; \$31,275 for those married filing separately. However, this exemption is reduced by 25 cents for each dollar of AMT taxable income above \$150,000 for couples (\$112,500 for singles and \$75,000 for married filing separate status), and it's not adjusted for inflation, which is one reason why more people owe the AMT every year.

After the exemption (if any) has been deducted, the result is subject to AMT rates — 26% on the first \$175,000 (\$87,500 for married couples filing separately) and 28% on the excess. Again, the AMT brackets are not adjusted for inflation, which causes much greater exposure to the tax as the years go by. If the AMT exceeds your regular tax, you have to pay the greater amount. Technically, the AMT is just the liability over and above the regular tax, and this figure is entered on page 2 of Form 1040.

Sorry, you're not finished yet.

People get pushed into the AMT zone for different reasons, and some are actually better than others. That's because you could be eligible for the so-called minimum tax credit, which allows you to claim a credit on your tax return in future years for some of the extra taxes you paid under AMT rules. So you have to fill out another document, Form 8801, to determine if you are eligible. For whatever reason, the tax rules say that exercising incentive stock options is

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one of the few things that qualifies you for the credit, so if that's the reason you ended up paying the AMT, pay special attention to this form

### 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.

You can reach me at [gregg@greggharveycpa.com](mailto:gregg@greggharveycpa.com), phone 248-650-2960, or cell 586-707-1077. You can also visit my website, [greggharveycpa.com](http://greggharveycpa.com).

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