

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 begins with a review of the recently passed Federal stimulus legislation. Following that is a note on the recent dramatic Fed interest rate cuts, IRS DIF scores, and a series of notes on income tax subjects.

The Stimulus Package – H.R. 5140

Much of the information in this article is the result of a discussion I recently had with the IRS Liaison officer. This year's "rebate" is really an advance, almost the same as the 2001 "Rate Reduction Credit".

Lawmakers have given their final seal of approval to a \$170 billion plan intended to spark the slowing economy. The plan's centerpiece: tax rebates.

But questions remain about how the program will work, and officials at the Treasury Department and IRS are scurrying to work out the details.

In the meantime, here are some answers based on currently available government information and experts' analysis.

Do I qualify for a rebate and how much can I expect?

One-time rebates will be sent to at least 117 million low- and middle-income households, 20 million senior citizens living off of Social Security, and 250,000 disabled veterans.

To be eligible for a full rebate, single tax filers must have 2007 adjusted gross income (AGI) below \$75,000 and joint filers must have AGI below \$150,000.

Adjusted gross income is not your annual salary. It's equal to gross income minus "above the line deductions," which are reported on page 1 of the 1040 tax form. Above-the-line deductions include deductible IRA contributions, alimony paid and, for the self-employed, some portion of money spent on health insurance or Social Security.

Single filers with AGI below \$75,000 will get rebates of as much as \$600. Couples with AGI below \$150,000 will receive rebates of up to \$1,200.

In addition, parents will also receive \$300 rebates per dependent child; there is no cap on the number of children eligible.

An example: A couple with one child and \$100,000 in AGI will get a rebate of \$1,500 (\$1,200 + \$300). If they have two children, they will get \$1,800 (\$1,200 + \$600).

Tax filers who do not owe income taxes because of various credits and deductions but have at least \$3,000 in income - which can include Social Security and disability payments - will get \$300 rebates per person or \$600 per couple.

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I make more than the income caps. What about me?

You might get a partial rebate. It depends on how much your income exceeds the caps.

The stimulus legislation allows for a 5% phaseout rate for households above the income caps of \$75,000 for single filers and \$150,000 for joint filers.

That means that for every dollar a tax filer earns above those caps, he or she will lose 5 cents of the rebate.

Take a couple with two children. If they make less than the income cap, they will likely get an \$1,800 rebate. If they make \$15,000 more than the cap, they will see their \$1,800 rebate reduced by \$750 ($\$15,000 \times 0.05$). So instead they will receive a check for \$1,050 ($\$1,800 - \750).

A childless couple whose AGI falls below the cap will likely get a \$1,200 rebate. But if their AGI exceeds the cap by \$15,000, their rebate will be reduced by \$750. So they'd get a check for \$450.

Single filers with no kids and an income below \$75,000 will likely get a \$600 rebate. But if they made \$80,000, their rebate will be reduced by \$250 ($\$5,000 \times 0.05$). So they will get a check for \$350 ($\$600 - \250).

The point at which the rebate gets phased out entirely will vary. For example, a single filer with no kids whose income exceeds the cap by \$12,000 or more will get no rebate, because it will be reduced by an amount

equal to or greater than the \$600 ($\$12,000 \times 0.05 = \600).

Do I have to pay the rebate back?

No. And here's why.

Your rebate is a one-time tax cut - an advance on a credit you'll receive on your 2008 return.

It's based on your 2007 income initially. If it turns out that your 2008 income and number of children would have qualified you for a larger rebate than the one you received, you'll be sent the difference. If it turns out your 2008 income was lower than in 2007 and you should have gotten a lower rebate, you get to keep the difference.

If you were supposed to receive a larger payment than you did, you will get the extra money. If you received more than what you should have gotten, you will not be penalized.

What do I have to do to get one?

You must file a 1040 or 1040-EZ federal tax return for 2007.

Some people are normally not required to file a return. To get the rebate, however, they have to file a federal tax return.

When will I get a check?

Treasury Secretary Henry Paulson said that the IRS will start sending out checks in early May. It should take about 10 weeks to crank out all the checks. In all likelihood then, you'll see the money sometime between May and early July.

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That assumes, of course, that you hit the IRS deadline and file by April 15.

If you have to file for an extension, you'll still get a check but it may not come until the end of the year - probably in time for Christmas shopping

Record Keeping Note

According to the IRS articles, the taxpayers will receive a letter from the IRS listing the amount of the payment. You should keep this letter, you will need it for your 2008 tax return. The 2008 1040 will have a line item where you need to enter the amount you received.

Interest Rate Cuts

With the recent, near historic, rate cuts in mind, it might be useful to return to the mortgage primer and figure out exactly what all this news means to you, to your mortgage, to your home equity line and to your home's financial future.

Generally the 30-year fixed is not tied to short-term treasuries.

Fixed mortgage rates are tied to long-term bond yields that move based on the outlook for the economy and inflation. And as you may have noticed, the long-term outlook for the economy isn't exactly rosy right now.

The recent rate cuts do affect short-term adjustable rate mortgages, but not really as much as you might think. Why? Because this rate cut was already priced into the market, maybe not three quarter's point, but definitely a half-

point. So if you are facing a reset on your ARM, you're in much better shape today than you were just six months ago.

For example, if your rate adjusts Feb. 1st, and your ARM is pegged to the 1-year treasury, than your reset is going to be to 5.25 percent as opposed to the 7.5 percent that it would have been in August. That's going to make the payment much more manageable.

So does this cut stem the foreclosure crisis? Maybe a bit on the margins, but not really, and here's why: the bulk of the folks facing foreclosure because they can't make their monthly payments have no equity in their homes and no money to put down on a refinance.

While rates might be lower, this is a market where lenders and investors are much more aware of risk and will gravitate toward borrowers that represent less risk. So many folks will still find themselves in trouble. For people who are having trouble paying the initial rate on the loan, forget it. No help there.

As for those looking to buy a home, that is, get a new mortgage, while ARM rates may be lower, the mortgage landscape is still much different than it was just a year ago. You can't do a stated income loan anymore, and you can't do 100 percent financing. Tighter standards don't change with a rate cut.

Regarding a home equity line of credit, yes, the rates are lower now, but that does not mean we should all start using our homes as ATM's again. That was one the things that led to all the trouble. This is probably a time to pay off debt,

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not to gather more. The housing market is still in trouble, especially in our area.

Watch Out For Commercial “IRS” Web Sites

Remember that for the genuine IRS Web site be sure to use .gov. Don't be confused by internet sites that end in .com, .net, .org or other designations instead of .gov. The address of the official IRS governmental Web site is www.irs.gov.

What Is A DIF Score?

The DIF score is the most widely used method for selecting tax returns for IRS tax audit. The DIF score or the DISCRIMINATE FUNCTION system is the name the IRS calls the computer-generated score the IRS uses to select tax returns to undergo IRS audits. The majority of audited income tax returns are selected by means of DIF score.

DIF scores are generated by IRS computers. The DIF score is a statistical profile that is computed by comparing the tax numbers (income, expenses and deductions) on income tax returns with numbers generated using national statistics for taxpayers in a similar income tax bracket.

The real formula of how to compute the DIF score is not revealed by the IRS. However, contributing factors to computing the DIF score can be found on taxpayers' tax returns. An example of an item on a tax return used to compute the DIF score is a loss on a Schedule C sole proprietorship business. If these

numbers or expenses are out of line with the numbers shown on the DIF analysis, then the chances of an IRS audit increase.

Even IRS agents are never told exactly how the DIF score on a particular return was calculated. On some returns sent out for audit, they can apply their judgement and its pretty obvious what appeared to be out of line, but on others, they can't tell.

A tax attorney filed a Freedom of Information Act request to get the IRS to release how it calculates the DIF score several years ago, but he didn't win.

A Review of 2007 Tax Law Changes

Taxpayers should be aware of important changes to the tax law before they complete their 2007 federal income tax forms. Here are some changes that may affect your return.

AMT Exemption Increased for One Year. For tax-year 2007, Congress raised the alternative minimum tax exemption to \$66,250 for a married couple filing a joint return. The exemption rises to \$33,125 for a married person filing separately and to \$44,350 for singles and heads of household. While the vast majority of taxpayers can file as usual, about 13.5 million taxpayers who file any of five tax forms affected by recent tax law changes related to the AMT will have to wait until Feb. 11, 2008, to file their returns. IRS.gov has more information on this important subject, including

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downloadable copies of affected forms and questions and answers.

Extended Tax Breaks Reappear on IRS Forms. Several popular tax breaks, renewed too late to be included on 2006 forms, once again appear as separate items on various 2007 IRS forms. As a result, unlike last year, eligible taxpayers will no longer have to follow special instructions in order to claim the deduction for state and local sales taxes, the educator expense deduction and the tuition and fees deduction.

Saver's Credit. This year for the first time income limits for the saver's credit are adjusted for inflation. The saver's credit supplements other tax benefits available to low- and- moderate income taxpayers who save for retirement. Begun in 2002 as a temporary provision, the saver's credit is now a permanent part of the tax code. Use Form 8880 to claim the credit.

Mortgage Insurance Premiums May be Deductible. Some borrowers may be able to deduct mortgage insurance premiums paid on mortgages taken out or refinanced during 2007. The deduction for mortgage insurance premiums is phased out for taxpayers with adjusted gross incomes exceeding \$100,000 (\$50,000, if married filing separately). Claim this deduction on Schedule A, Line 13. Further details are in Publication 936.

New Rules for Giving to Charity. To deduct any charitable donation of money, taxpayers must have a bank record or a written communication from the recipient showing the name of the organization and the date and amount of

the contribution. Though taxpayers are already required to keep records to support their contribution deductions, this new provision is designed to provide greater certainty, both to taxpayers and the government, in determining what may be deducted as a charitable contribution. See Publication 526.

Schedule C vs. C-EZ

Want to save time and trouble when filing taxes for your small business? You may be eligible to use the abbreviated Schedule C-EZ instead of the longer Schedule C when reporting business income and expenses on your 2007 Form 1040 federal income tax return. The maximum deductible business expense threshold for filing Schedule C-EZ is \$5,000.

Schedule C-EZ, Net Profit from Business (Sole Proprietorship), is the simplified version of Schedule C, Profit or Loss from Business (Sole Proprietorship).

The Schedule C-EZ has an instruction page and a one-page form with three short parts — General Information, Figure Your Net Profit, and Information on Your Vehicle. It includes a simple worksheet for figuring the amount of deductible expenses. If that amount does not exceed \$5,000, and if your business did not have a net loss, you may be able to use the C-EZ instead of Schedule C. (Other restrictions apply; be sure to read the instructions carefully.)

The Schedule C is two pages long and is divided into five parts — Income, Expenses, Cost of Goods Sold,

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Information on Your Vehicle, and Other Expenses. The C requires more detailed information than the C-EZ. The instruction package is 10 pages long. Schedule C must be used when deductible business expenses exceed \$5,000 or when a business has a net loss.

Using Schedule C-EZ can save time and reduce paperwork burden for eligible businesses.

Valuation of Donated Goods

In years past supporting non-cash charitable contributions were a lot simpler. But the rules have changed and Goodwill and Salvation Army receipts that say 'three bags' clothing and so on are no longer acceptable

The taxpayer now has to list each piece of clothing, and state where donated, when, etc., then attach the list to the receipt. You also have to attest that the clothing was in good used condition.

If you don't want to list it, then don't put it in the tax return, or disclose it. This is an area that is under very close IRS scrutiny.

Both the Salvation Army and Goodwill have valuation tables, which you can download to Excel.

The Earned Income Credit

The EITC is for people who work, but have lower incomes. If you qualify, it could be worth up to \$4,700 this year. So you could pay less federal tax or even get a refund. That's money you can use to make a difference in your life.

Did you know that in Tax Year 2006, over 22.4million taxpayers received \$43.7 billion dollars in EITC – making the credit a great investment in the lives of those who claim it? However, the IRS estimates 20 percent to 25 percent of people who qualify for the credit do not claim it. At the same time, there are millions of Americans who have claimed the credit in error, many of whom simply don't understand the criteria.

It's easy to determine whether you qualify for the EITC. The EITC Assistant, an interactive tool available on IRS.gov, removes the guesswork from eligibility rules. Just answer a few simple questions about yourself, your children, your living situation and your income to find out if you qualify and to estimate the amount of your EITC. You will see the results of your responses right away.

The EITC is based on the amount of your earned income and whether or not there are qualifying children in your household. If you have children, they must meet the relationship, age and residency requirements. Additionally, you must file a tax return to claim the credit.

If you were employed for at least part of 2007, you may be eligible for the EITC based on these general requirements:

- 1) You earned less than \$12,590 (\$14,590 if married filing jointly) and did not have an any qualifying children
- 2) You earned less than \$33,241 (\$35,241 if married filing jointly) and have one qualifying child

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- 3) You earned less than \$37,783 (\$39,783 if married filing jointly) and have more than one qualifying child
- 4) In addition you must meet a few basic rules:
 - a) You must have a valid Social Security Number
 - b) You must have earned income from employment or from self-employment.
 - c) Your filing status cannot be married, filing separately.
 - d) You must be a U.S. citizen or resident alien all year, or a nonresident alien married to a U.S. citizen or resident alien and filing a joint return.
 - e) You cannot be a qualifying child of another person.
- 5) If you do not have a qualifying child, you must:
 - i) be age 25 but under 65 at the end of the year,
 - ii) live in the United States for more than half the year, and
 - iii) not be a qualifying child of another person

You cannot file Form 2555 or 2555-EZ (related to foreign earn income).

Members of the military can elect to include their nontaxable combat pay in earned income for the earned income credit. If you make the election, you must include in earned income all nontaxable combat pay you received. If you are filing a joint return and both you and your spouse received nontaxable combat pay, then each of you can make your own election. The amount of your nontaxable combat pay should be shown on your Form W-2 in box 12 with code Q.

For more information about the EITC, go to IRS.gov or see Publication 596, Earned Income Credit, which contains eligibility criteria and instructions for claiming the tax credit.

Filing Status

Your federal tax filing status is based on your marital and family situation. It is an important factor in determining whether you must file a return, your standard deduction and your correct amount of tax.

Your marital status on the last day of the year determines your status for the entire year. If more than one filing status applies to you, you may choose the one that gives you the lowest tax obligation.

There are five filing status options:

- 1) **Single.** Generally, if you are unmarried, divorced or legally separated according to your state law, your filing status is Single.
- 2) **Married Filing Jointly.** If you are married, you and your spouse may file a joint return. If your spouse died during the year and you did not remarry, you may still file a joint return with that spouse for the year of death.
- 3) **Married Filing Separately.** Married taxpayers may elect to file separate returns.
- 4) **Head of Household.** You generally must be unmarried and you must have paid more than half the cost of maintaining a home for you and a qualifying person.
- 5) **Qualifying Widow(er) with Dependent Child.** If your spouse died

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during 2005 or 2006, you have a qualifying child and meet certain other conditions; you may be able to choose this filing status.

Getting a Copy Of A Tax Return

There are two easy and convenient options for obtaining copies of your federal tax return information — tax return transcripts and tax account transcripts — by phone or by mail.

A tax return transcript shows most line items from the tax return (Form 1040, 1040A or 1040EZ) as it was originally filed, including any accompanying forms and schedules. It does not reflect any changes you, your representative or the IRS made after the return was filed. In many cases, a return transcript will meet the requirements of lending institutions such as those offering mortgages and student loans. You should receive your tax return transcript within 10 working days from the time the IRS receives your request.

A tax account transcript shows any later adjustments either you or the IRS made after the tax return was filed. This transcript shows basic data, including marital status, type of return filed, adjusted gross income and taxable income. The IRS does not charge a fee for transcripts, which are available for the current and three prior calendar years. Allow 30 calendar days for delivery of a tax account transcript.

To request either transcript:

- 1) Phone: Call 800-829-1040 and follow the prompts in the recorded message

- 2) Mail: Complete IRS Form 4506-T, Request for Transcript of Tax Return.

If you need a photocopy of a previously processed tax return and attachments, complete Form 4506, Request for Copy of Tax Form, and mail it to the IRS address listed on the form for your area.

There is a fee of \$39.00 for each tax period requested. Copies are generally available for the current and past 6 years.

Gift Tax

If you gave any one person gifts in 2007 that are valued at more than \$12,000, you must report the total gifts to the Internal Revenue Service and may have to pay tax on the gifts. The person who receives your gift does not have to report the gift to the IRS or pay gift or income tax on its value.

Gifts include money and property, including the use of property without expecting to receive something of equal value in return. If you sell something at less than its value or make an interest-free or reduced-interest loan, you may be making a gift.

There are some exceptions to the tax rules on gifts. The following gifts generally are not taxable and do not count against the annual limit:

- 1) Tuition or Medical Expenses that you pay directly to an educational or medical institution for someone's benefit
- 2) Gifts to your Spouse
- 3) Gifts to a Political Organization for its use

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4) Gifts to Charities

If you are married, both you and your spouse can give separate gifts of up to the annual limit of \$12,000 to the same person without making a taxable gift.

Alternatively, with consent from your spouse, you can make a gift of up to \$24,000 (\$12,000 x 2) to the same person without making a taxable gift. This is commonly known as splitting gifts between spouses. Essentially, it means a gift by you or your spouse to a third person can be considered as made one-half by each of you provided there is consent by both spouses.

What If You Have Not Filed Your 2006 Return Yet?

The failure to file a federal tax return can be costly — whether you end up owing more or missing out on a refund.

There are several reasons taxpayers don't file their taxes. Perhaps you didn't know you were required to file. Maybe, you just kept putting it off and simply forgot. Whatever the reason, it's best to file your return as soon as possible. If you need help, even with a late return, the IRS is ready to assist you.

Here are some things to consider:

- 1) Failure to File penalty. If you owe taxes, a delay in filing may result in a "failure to file" penalty, also known as the "late filing" penalty, and interest charges. The longer you delay, the larger these charges grow.

- 2) Losing your Refund. There is no penalty for failure to file if you are due a refund. However, you cannot obtain a refund without filing a tax return. If you wait too long to file, you may risk losing the refund altogether. The deadline for claiming refunds is three years after the return due date. For example, the last day for claiming a refund for your 2004 tax return will be April 15, 2008.
- 3) EITC. Individuals who are entitled to the Earned Income Tax Credit must file their return to claim the credit even if they are not otherwise required to file.
- 4) Whether or not you must file a tax return will depend upon a number of factors, including your filing status, age, and gross income.

If your income was \$40,000 or less, your local Taxpayer Assistance Center may be able to assist you in preparing your prior year return. You can locate your nearest center at <http://www.irs.gov/localcontacts/index.html>. For more information on how to file a tax return for a prior year, visit the IRS Web site at IRS.gov or call the IRS Tax Help Line for Individuals at 800-829-1040.

Itemizing Your Deductions

Whether to itemize deductions on your tax return depends on how much you spent on certain expenses last year. Money paid for medical care, mortgage interest, taxes, charitable contributions, casualty losses and miscellaneous deductions can reduce your taxes. If the total amount spent on those categories is more than the standard deduction, you can usually benefit by itemizing.

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The standard deduction amounts are based on your filing status and are subject to inflation adjustments each year. For 2007, they are:

- 1) Single \$5,350
- 2) Married Filing Jointly \$10,700
- 3) Head of Household \$7,850
- 4) Married Filing Separately \$5,350

Some taxpayers have different standard deductions. The standard deduction is more for taxpayers age 65 or older and for those who are blind. It is generally less for those who can be claimed as a dependent on some other taxpayer's return.

Your itemized deductions may be limited if your adjusted gross income is more than \$156,400 or \$78,200 for Married Filing Separately. This limit applies to all itemized deductions except medical and dental expenses, casualty and theft losses, gambling losses, and investment interest.

When a married couple files separate returns and one spouse itemizes deductions, the other spouse must also itemize and cannot claim the standard deduction.

Some taxpayers are not eligible for the standard deduction. They include nonresident aliens, dual-status aliens, and individuals who file returns for periods of less than 12 months.

To itemize your deductions, use Form 1040, U.S. Individual Income Tax Return, and Schedule A, Itemized Deductions

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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