

# 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 recent IRS activity, a new mortgage law signed by President Bush, deductibility of leased autos, a discussion of different forms of organization, and an overview of the tax positions of the major presidential candidates.

### IRS Will Not Challenge Accuracy of Returns with AGI of One Dollar

The IRS, in Rev. Proc. 2008-21, stated that it will not challenge the accuracy of income tax returns listing AGI of \$1.00 solely for e-filing purposes. Taxpayers whose qualifying income consists only of Social Security benefits and who seek to take advantage of Economic Stimulus Act of 2008 payments by complying with Notice 2008-28, may enter \$1.00 in AGI to file electronically.

### IRS Says Unbundling Trustee Fees Not Necessary for 2007 Returns

Notice 2008-32 offers interim guidance for 2007 and prior year trust and estate tax returns. Fiduciaries are not required to "unbundle" the portion of a trustee's fee or executor's commission that may

include charges for a range of in-house services, including investment advice and other costs that may be subject to the 2-percent floor.

However, if a fee or commission includes fees paid by the fiduciary to a third party (e.g., investment advisers) for expenses that might be subject to the 2-percent floor under the Supreme Court's "commonly test," those third party fees are readily identifiable and must be treated separately.

The Service is asking for comments by May 27, 2008, and plans, soon afterward, to issue final regulations which will apply prospectively, presumably in time for preparing 2008 tax returns.

### Revised Form 5227 Issued for 2007 Filing

The IRS revised Form 5227, Split-Interest Trust Information Return, and instructions for use in preparing 2007 tax year returns. Changes affecting charitable remainder trusts, charitable lead trusts, and pooled income funds include:

Eliminating the requirement for charitable split-interest trusts to file Form 1041-A Trust Accumulation of Charitable Amounts.

Pages 1-6 of Form 5227 are now open to public inspection. (Page 7, related to non-charitable beneficiaries is not.) Late filing, failure to file, failure to include required information and failure to show correct information may result in new and increased penalties for the

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trust and personal liability for the trustee.

### **IRS Changes Position on Performance-Based Compensation for \$1 Million Limit**

In Rev. Rul. 2008-13, the IRS ruled that an incentive plan is not performance-based compensation because it allowed payments upon (1) involuntary termination without cause by the employer; (2) voluntary termination by the employee with good reason; or (3) voluntary retirement whether or not the performance goals are met. Thus, all payments under the plan are subject to the section 162(m) deduction limit of \$1 million, including payments made when the performance criteria have been met.

This revenue ruling and a recent private letter ruling [200804004] are contrary to two prior PLRs [199949014 and 200613012] which held that compensation was performance-based even though the payments could be made upon involuntary termination without cause or voluntary termination for good reason.

Because many employers have adopted compensation programs with provisions similar to those set forth in the prior letter rulings, the revenue ruling will not apply to qualified performance-based compensation for performance periods beginning on or before January 1, 2009, or for compensation paid pursuant to an employment contract in effect on February 21, 2008.

Employers who relied on the prior rulings will need to either (1) change their compensation programs on a prospective basis; or (2) reevaluate their tax position on the deductibility of the compensation. Employers will also need to consider the impact of these tax positions on their financial statements.

### **Supreme Court Rules to Let Workers Sue for 401(k) Losses**

The Supreme Court unanimously ruled, in *LaRue v. DeWolff*, that individual participants in a 401(k) retirement plan may sue plan administrators to reclaim losses on their investments. This reverses the Fourth Circuit's decision that individuals could not sue plans over losses pertaining to mistakes and misrepresentations. More lawsuits from financially savvy 401(k) participants are expected as a result of this recent decision.

### **President Bush Signs Mortgage Law**

President Bush recently signed into law the Mortgage Forgiveness Debt Relief Act of 2007 (H.R. 3648) which would exclude from gross income up to \$2 million (\$1 million for married filing separately) forgiven debt used to buy, build or substantially improve the principal residence of debt-ridden homeowners during 2007-2009.

The amount excluded would reduce basis, but not below zero, of the principal residence. The exclusion would apply if the discharge is directly related to a decline in the value of the residence or to the taxpayers financial condition.

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The bill also permits the surviving single spouse to qualify for the \$500,000 home sale exclusion if the sale occurs not later than 2 years after his/her spouse's death and the requirements for the \$500,000 exclusion were met immediately before the spouses death. This provision is effective for sales and exchanges after December 31, 2007. Currently the up to \$500,000 exclusion is available only if spouses file a joint return for the year of sale.

Another provision of the law is the extension through 2010 of deducting mortgage insurance premiums as interest.

### **Deductibility Of Leased Automobiles**

The rent paid on a leased automobile generally is deductible to the extent the automobile is used in the taxpayer's trade or business or for the production of income. The general rule for leased vehicles is to deduct the greater of the business percentage of the lease expense each year or the standard mileage rate.

However, to achieve approximately parity with the depreciation limitations applicable to owned vehicles, the taxpayer may also be required to include in gross income an inclusion amount for each taxable year that an automobile is leased.

The IRS annually releases a table of these amounts that apply to vehicles leased for 30 days or more. These amounts increase with the fair market value (FMV) of the vehicle and vary

with the year of the lease. The business percentage of the annual income inclusion amount is added to the lessee's gross income for each year of the lease.

### **Should You Incorporate Your Business?**

**Q:** I've been told that I should incorporate my business. But I'm not sure why or what type of corporation? It's all very confusing.

**A:** For a small business, there are three main corporations to choose from: C corporations, S corporations and Limited Liability Companies (LLCs). There are pros and cons to each kind, but the good news is that they all offer important legal protection.

Incorporating creates a "corporate shield" which protects you from legal responsibility and personal liability for business debts. So if something goes wrong in your business, your corporation is at risk, not you personally (or your personal assets.)

Unlike sole proprietorships and partnerships, corporations can last in perpetuity.

Owners of a corporation (i.e., the shareholders) can share in its profit but do not have to be involved in the day-to-day operations of the business.

A business may be taken more seriously if it has an "Inc." or "LLC" after its name.

The downsides to incorporating are relatively few.

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Creating a corporation may require that you hire a lawyer so it can be expensive.

Corporations are subject to more government regulations than sole proprietorships and partnerships.

Taxes are more complicated for corporations and usually require assistance of a lawyer or a CPA.

Usually, the question for most small businesses is not whether to incorporate, but what type of corporation to choose.

### **S versus C Corporations**

There are two basic differences between S and C corporations (S and C are subsections of the tax code.)

The first, and a major reason many small businesses are not formed as C corporations, is that C corporations are taxed twice: Once on profits, and again when profits are passed onto the shareholders.

S corporations, on the other hand, pay no corporate tax. Instead, all profits are passed on to shareholders' personal tax returns and profits and losses are reported there. Accordingly, S corporation profits are only taxed once.

The second difference has to do with size. There is a limit to how many people can own shares in an S corporation (75), but there are no such limits for C corporations. Therefore, the ability to sell shares is a major advantage of a C corporation. Stocks bought and sold on the New York Stock Exchange are shares of C corporations.

The one advantage a C corporation offers small businesses is that it can deduct 100 percent of health insurance it pays to its employees (including you). Despite that, many small businesses do not incorporate as C corporations.

### **S Corps versus LLCs**

There are two types of Limited Liability Companies. The first, called "member managed," is when owners actively run the business. The second, called "manager managed," is when managers run the business. LLCs are relatively new entities that have become popular.

First, like S and C corporations, LLCs protect their owners from personal liability for business debts. Second, LLCs are flexible. For example, S and C corporations have stringent record-keeping formalities. But LLCs require much less rigorous paperwork. Also, S corporations must distribute their profits with a percentage of stock ownership in mind, but LLCs can be more creative.

On the other hand, S corps have an advantage when it comes to taxes. Owners of an LLC are "self employed" and must pay the 15.3 percent self-employment tax (for Medicare and Social Security). S corporations only have to pay that tax on the amount of salary paid to the employee-owner; and any remaining income paid as a distribution is not subject to the self-employment tax.

### **Which is best?**

I hate to say it, but "it depends". If the self-employment tax is killing you, then

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an S corporation may be the way to go. If business formalities and record-keeping are not your strong suit, an LLC may be your best bet.

The best answer may be to speak with your lawyer and CPA about these options. It's important to get expert help because the downside of making the wrong decision is significant.

### **Definitions – Forms of Business Organization**

#### **Sole Proprietorship**

This is the simplest way for an individual or married couple to go into business. There is less regulation and there are fewer taxes, but the business owner is personally liable for all debts.

#### **General Partnership**

General partnerships are composed of two or more people who participate in the business by investing money or labor while sharing the profits or losses. Each partner is liable for debts incurred. Before entering into one, put the terms of the partnership into a formal written agreement.

#### **Limited Liability Company (LLC)**

An LLC can be either an individual or a group of partners. The advantage of forming an LLC is that participants are not personally liable for the debts of the company. A written agreement that details the following is required: provisions for management, ability to assign interests, and distribution of profits and losses.

#### **C Corporation**

Incorporating your business may have tax or financial benefits, but you also have increased licensing fees and a more complicated process. Stock ownership determines control of the company, and board of directors' meetings and annual stockholder meetings should be held. Record keeping requirements are also more extensive. If you're forming a corporation, you'll want to seek legal counsel.

#### **Who Can Take The Mortgage Deduction In This Case?**

Q - Father took out home equity loan on his house and loans the money to his son to purchase another home. Son is paying off the loan. Can the son take the interest deduction on Schedule A even though the loan is in the Father's name?

A - Absolutely not. The loan isn't secured by son's home therefore it isn't mortgage interest for him. Son also has no legal responsibility to pay the home equity loan, therefore no deduction. He fails both requirements.

The person who is legally responsible for the loan (Father) gets to take the credit.

#### **Issue With Direct Deposits Due To Name On The Account**

Can a couple when E filing a tax return, when only one of them has a checking account only in their name, have the refund direct deposited into that

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account? Or does the account need to have both names on the bank account? It's ok with the IRS, but such couples need to ask their bank. Some banks will not allow a direct deposit of a joint refund into an account that is only owned by one spouse. To be safe they should add the spouse or open a separate joint account. Some banks used to reject these deposits but now most of the banks don't check anymore -- especially the big ones.

### Presidential Candidates Positions On Taxes

The 2008 presidential election has been full of surprises and American voters have been much more engaged than in any election in recent memory.

Regardless of your party affiliation or preferred candidate (at least for the moment), it is worth spending a little time familiarizing yourself with the tax platforms of the four remaining candidates.

Following is a snapshot of the tax and economic platforms of Hillary Clinton, Mike Huckabee, John McCain, and Barack Obama (listed in alphabetic order).

#### Senator Hillary Clinton (D-NY)

Senator Clinton has historically championed a number of causes in the Senate and in New York, including indexing minimum wage increases to raises in Congressional pay.

She has also supported tax deductions for college tuition, lobbied to eliminate

the "marriage penalty" permanently, supported the extension of lower marginal rates to a larger segment of low income taxpayers and called for "refundable" child tax and adoption credits.

While generally not a champion of tax relief for large corporations, Senator Clinton has gone on record as saying the federal corporate tax rates are too high and should be lowered to allow American businesses to be more competitive on the world stage.

Clinton has also been a supporter of a variety of New York economic development initiatives, including wage credits under the Empire Zone Tax Credit Program, as well as micro-business programs and the New Jobs for New York private venture program.

With respect to larger companies, Clinton is less business-friendly. She has made it clear that she is no fan of certain tax breaks available to large corporations, including oil companies. Therefore, if elected, we can expect her to tighten or eliminate the depletion rules applicable to natural resource companies, eliminate tax deferrals on foreign operating income of U.S. companies and push the energy sector to invest in alternative energy projects or face penalties and/or higher taxes.

The Senator has also expressed frustration with the high levels of CEO salaries; therefore, more restrictive rules for deducting executive compensation under IRC Sections 162(m) (tax deductibility executive compensation limits for public companies) and 4999 (deductibility limits and excise taxes for

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“parachute” payments) will likely occur under a Hillary Clinton administration.

From an estate tax standpoint, Senator Clinton is a bit more forgiving to those individuals who accumulate significant wealth during their lifetimes. The Clinton tax platform will view estates with values less than \$7 million as eligible for full exemption from the estate tax.

In summary, if elected, Senator Clinton will likely push for tax breaks for small businesses and lower-income employees. Senator Clinton will likely shift much of the tax relief cost for the lower-income employees and small businesses to large corporations and upper-income individual taxpayers — generally those making more than \$200,000 annually — by her definition.

### **Former Governor Mike Huckabee (R-AR)**

Former Governor Huckabee has created the biggest stir on the campaign trail as a result of announcing a controversial plan that would dismantle the IRS and replace the complex federal tax system with his “Fair Tax” plan.

Under the Fair Tax plan, all federal income and payroll taxes (personal federal, corporate federal, gift, estate, capital gains, alternative minimum, Social Security, Medicare, self-employment taxes) would be eliminated and replaced with a “consumption tax,” otherwise known as a national sales tax.

The Huckabee plan is designed to simplify the complex and time-consuming tax assessment, collection

and reporting systems. Huckabee supporters estimate that up to three percent of the U.S. Gross National Product is wasted on tax compliance activities.

This plan would provide a monthly rebate or reimbursement for taxes on purchases up to the poverty line so that taxpayers aren’t taxed on basic necessities, allowing those living below the poverty line to avoid federal taxes altogether.

Taxes would be applied only to new goods, allowing tax savings by purchasing used goods. Huckabee believes the Fair Tax will promote investment, discourage American companies from moving overseas, entice foreign companies to come to the U.S. and create jobs.

The estimated federal Fair Tax rate is projected to be in excess of 20 percent of the cost of all new goods purchased in order to maintain the federal tax collections currently banked under the federal income, payroll and estate tax systems.

Critics say the Huckabee plan is fatally flawed. “To truly equal today’s federal revenue take, to be revenue-neutral, the flat tax has to be quite high — usually higher than is advertised up-front,” said Richard DeKaser, chief economist at National City Corp in Cleveland.

Analysts also see the plan as regressive — since the tax rate would be the same rate across the board, regardless of one’s income — even though the Huckabee plan does make provisions to exempt the poor.

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The Huckabee camp states that the Fair Tax will instantly make American products 12 percent to 25 percent more competitive because the cost of these goods will no longer be burdened by corporate taxes, costs of tax compliance and Social Security matching payments.

When consumers buy products now, the various federal taxes are already factored into the cost. Therefore, it is argued that consumers currently pay corporate taxes, indirectly, on top of their personal tax burden.

### **Senator John McCain (R-AZ)**

Senator McCain would seek to lower the marginal federal corporate income tax rate from the current 35 percent rate to 25 percent. A McCain administration will also attempt to require a three-fifth's majority in Congress in order to pass any new taxes.

Alternative Minimum Tax (AMT) reform for both corporations and individuals is a critical element of McCain's tax platform and he has expressed his clear intent to eliminate permanently the personal AMT. Specifics on corporate AMT reform is a little less clear, but relief will likely be a component of his plan.

He will push to make the Bush tax rate reductions and other benefits permanent, rather than have them expire after 2010.

McCain will also attempt to make the current Research & Development (R&D) Credit permanent, rather than leave taxpayers with the current uncertainty of

whether the R&D credit will be renewed from year-to-year.

Senator McCain is lobbying for a permanent ban on any new cell phone taxes and taxes on Internet activities.

Senator McCain also supports aggressive "tax expensing" of equipment and technology equipment in order to encourage capital expenditures by businesses.

The McCain administration will seek to overhaul the Social Security system and reduce the Medicare premiums for retirees — an attractive policy for AARP members.

### **Senator Barack Obama (D-IL)**

Senator Obama has stated that he will seek to repeal President Bush's tax cuts for the wealthiest Americans and use that money to pay for healthcare reform. He has not stated whether he would raise other taxes to pay for expanded services.

The majority of Senator Obama's tax platform focuses on individual tax reform, although he does provide a few corporate tax overhauls similar to Senator Clinton's.

The freshman Senator would eliminate special interest loopholes and tax breaks and crack down on international tax havens, such as those for the oil and gas industry, as well as limiting the ability of large multi-national corporations to use tax havens to defer or eliminate U.S. income taxes on foreign income.

He will also seek to institutionalize the "economic substance" doctrine firmly to

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stop companies from creating abusive tax shelters.

He has proposed to increase the amount of wage income that is taxed to provide funds for additional monthly Social Security benefits. Senator Obama has stated: "I think the best way to approach this is to adjust the cap on the payroll tax so that people like myself are paying a little bit more and people who are in need are protected." Obama's proposal will likely be structured to shield middle-income earners from paying more in payroll taxes.

Obama plans on creating a new "Making Work Pay" tax credit of up to \$500 per person and up to \$1,000 for America's working families. The tax credit will be refundable to the extent it exceeds the taxpayer's net tax liability and is projected to completely eliminate income taxes for 10 million Americans. The "Making Work Pay" tax credit will also offset some or all of a taxpayer's self-employment tax.

His plan will also create a new universal mortgage interest credit that will benefit low and middle-income homeowners.

American seniors would see the elimination of income taxes for those making less than \$50,000 per year.

With respect to estate and gift taxes, Obama has no current plans of increasing the current \$2 million exemption.

The Obama plan would also dramatically simplify tax filings by "pre-populating" federal tax forms with data such as W-2 income, interest and

dividend income, Social Security income and other readily available income and expense data, so that millions of Americans can complete their taxes "in less than five minutes" — a bold promise to say the least.

### **A Murky Crystal Ball**

This is a very tough race to handicap, so cautious tax planning is recommended. Even though a candidate wins the presidency, there is no guarantee that their tax proposals as outlined during the campaign, will actually pass Congress.

However, with possible tax increases for large corporations and high income individuals under a Democratic president, acceleration of income into 2008 may be considered by certain taxpayers once the winner is decided in November (absent delays from hanging chads or other voting issues). This will make even more sense for those in an AMT position. Careful analysis of foreign operations will also be recommended.

Capital gains acceleration may make sense under certain scenarios. Installment sale structuring will take extra care since it will be difficult to predict whether any increases in capital gains rates will only have prospective application, or whether such rate increases will also apply to gain on installment note collections from sales occurring before the change in law.

These uncertain times will require you to do careful analysis before and after the election.

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### 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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