

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 a rather long list of federal tax notes, followed by an article about how to go about managing vendors if you find you need to start slowing down payments.

Federal Tax Updates

Tax Gap

There's a new push to close the tax gap. Democratic leaders are keen on enacting proposals to increase tax compliance. They call it tax fairness. But the need for added revenue is a primary motive.

Such measures would create a windfall lawmakers can use to offset the cost of big tax cuts, including extending expiring breaks, AMT reform, estate tax easings and the like. A new estimate shows that boosting compliance with tax laws by just 1% would bring \$3 billion a year more to the Treasury.

The Senate's top taxwriter will lead the charge. Sen. Max Baucus (D-MT) wants to increase information reporting and clamp down on bad return preparers.

Some tax gap proposals stand a good chance of passing: Basis reporting by brokers when their customers sell securities, as a way to curb

underreporting of gains. Whatever Congress passes will apply to many types of securities - stocks, bonds, mutual funds, options, etc. Brokers will have time to get their systems ready: The reporting rule will only apply to securities bought 18 months after enactment.

Making credit card companies file 1099s on payments made to merchants. Getting the data would help the IRS determine if a seller was underreporting income.

Extending the three-year statute of limitations on IRS' ability to collect tax.

Mandating registration for unlicensed preparers. Those who aren't CPAs, lawyers or enrolled agents would have to pass a test and regularly renew eligibility, but Congress would make sure IRS had a year or more to gear up for the program.

Having the Service create a self-audit program for individual taxpayers, patterned after those now used by some states. The Service would contact taxpayers about deductions that other filers have habitually overstated, such as auto expenses and meals and entertainment. IRS would explain the rules and give them a chance to fix the mistake. In return, any penalty they owed would be reduced or waived. Congress could also require IRS to expand an existing self-audit program for firms.

Having states share more data with IRS. Although popular with lawmakers, the idea ran into trouble recently. IRS had to halt existing data sharing programs because of faulty computer firewalls.

August, 2008

Phone 248-650-2960; website greggharveycpa.com, email gregg@greggharveycpa.com

Monthly Tax and Accounting Newsletter

Gregg Harvey, CPA

Congress will wait until IRS fixes the problem.

Mandating electronic filing for individuals. Congress will resist the urge to make individuals e-file.

State and local information reporting. Those governments will fight a plan requiring them to send out 1099s on all their payments for goods and services.

And a huge boost in funding for the Service. Many lawmakers believe that the Service would need a much bigger budget to make a real dent in the tax gap. But IRS' recent track record of computer glitches and rebate processing problems will make them leery of forking over big bucks until IRS shows it can spend wisely.

HAS Updates

Making a onetime transfer from an IRA to an HSA can pay off tax-wise for folks who have made after-tax contributions to the IRA. The amount that you transfer to the HSA is deemed to come out of deductible contributions first, the IRS says. Thus, a larger portion of future payouts from the IRA will be tax free.

But there are limits. You can't transfer more than the maximum HSA pay-in for the year - \$5,800 for family coverage or \$2,900 for self-only, plus an extra \$900 if you were born before 1954. And distributions can be made only from a regular IRA or a Roth IRA, not from a SIMPLE-IRA or SEP-IRA.

Access to on-site medical clinics doesn't bar employees from having HSAs,

according to the IRS. Receipt of free or low-cost services at a clinic in the workplace is permitted, including immunizations, physicals, nonprescription pain relievers and treatment for on-the-job injuries. But comprehensive health care isn't allowed.

HSAs can be tapped to pay Medicare Part D premiums if the owner is 65 or older. But withdrawals that are used to pay the Part D premiums for a spouse will be taxed as income and hit with a 10% penalty if the account owner is under 65.

Employers can give employees debit cards to access funds in their HSAs, as long as the cards are coded to allow payment only of expenses for health care.

And HSAs can be used to pay premiums for continued health care coverage for a spouse or dependent, known as COBRA coverage. Also, accounts can be used to pay the medical premiums for a spouse or dependent who is on unemployment.

Charitable Remainder Trusts

Charitable remainder trusts can be divvied up without triggering taxes, the Service rules. If a single trust with multiple beneficiaries is split up, IRS will not deem a sale to have occurred and won't impose excise tax on gains. This is a big help to these trusts, in which one or more beneficiaries get payments for a set term or for life, with any balance remaining going to charity. The donor gets to deduct the amount that

August, 2008

Phone 248-650-2960; website greggharveycpa.com, email gregg@greggharveycpa.com

Monthly Tax and Accounting Newsletter

Gregg Harvey, CPA

is expected, using IRS tables, to go to the charity.

Dividing up a charitable trust may be necessary when married beneficiaries divorce.

And when a trust has several named beneficiaries, splitting it up into separate trusts will enable the charitable organization to get some of the expected money sooner.

Otherwise, the charity must wait until the final beneficiary dies (Rev. Rul. 2008-41).

Divorce Case – Importance of Form 8332

An ex-wife's failure to sign the divorce decree costs a non-custodial father, the Tax Court says.

A divorce court gave the ex-wife custody of their child, but let the father claim a dependency exemption for the child in odd-numbered years provided that he made timely child support payments, which he did. Although his ex refused to give him a signed Form 8332 for those years, he claimed the exemption, attaching the divorce decree to his income tax return. But because his ex-wife had not actually signed the decree, the Court said that it was not a valid substitute for Form 8332 and denied him the exemption (Lease, TC Summ. Op. 2008-73).

Teachers Paid Over 12 Months

Good news for teachers who elect to be paid over a 12-month period: That won't

trigger a penalty tax on the pay they deferred, IRS now says.

By electing to be paid over a 12-month span instead of over the shorter school year, teachers effectively defer a portion of their compensation to the following tax year. For example, a teacher who earns \$4,800 a month and is paid over the school year that begins Sept. 1, 2008 and ends June 30, 2009 will get a \$4,000 monthly check if he or she elects to be paid on a 12-month basis. The IRS won't tax the teacher in 2008 for the \$800 a month deferred from the final four months of 2008 into 2009.

Travel Tip With Tax Implications

With airlines reinstating the Saturday night stayover rule for cheap fares - Remember that an extra day tacked onto a business trip can be deductible if the total cost of the trip is lower as a result. The extra meal and lodging expenses for the nonbusiness day must be less than the cost of flying without a Saturday stay.

This is so even if the additional day is used for sightseeing, shopping and the like.

Reimbursement of the extra day's food and lodging is also tax free to employees.

Rebate Redemptions

An accrual method firm can't count rebate redemptions before they occur, the IRS privately tells a retailer.

August, 2008

Phone 248-650-2960; website greggharveycpa.com, email gregg@greggharveycpa.com

Monthly Tax and Accounting Newsletter

Gregg Harvey, CPA

Although the retailer could predict the percentage of cash rebates it would pay out from rebate offers customers turned in, IRS says it can't offset its gross sales by that amount. The rebates are deducted when paid.

IRS won't follow a contrary Tax Court case that treated the rebates as coupons and approved a deduction for estimated redemptions. So more litigation is likely. S corporations cannot deduct premiums paid on key-man insurance - policies taken out on key owners, providing funds to redeem stock at their deaths.

But the proceeds don't reduce the firm's previously taxed income account, the Service rules, because the insurance proceeds are tax free (Rev. Rul. 2008-42).

This account tracks the undistributed S firm income that owners have paid tax on.

That is good news for corporations which had accumulated profits and switched to S firm status. The policy proceeds will not trigger tax on distributions made above the amount of S firm income already taxed to the company's shareholders.

Estate Tax Value of Businesses

Can unrealized gains lower the estate tax value of businesses?

The government wants the Supreme Court to limit this valuation break. Last year, an Appeals Court said the full amount of the future capital gains tax bill could be taken into account for

valuation purposes. It said that the company's value must be reduced dollar for dollar by the tax that would be due if the assets were sold when the owner died. IRS says the valuation formula should account for the period over which the company's assets would be sold. That would give a smaller discount.

Tool Reimbursement Plans

The IRS is ramping up its examination of tool reimbursement plans.

Firms involved in aviation, agriculture and construction will be audited, expanding a probe that began with auto dealers, car repair firms and body shops. The Service decided to act after it discovered widespread marketing of these plans.

IRS believes that many tool reimbursement plans are just shams that are designed to make a portion of the workers' pay tax free and save payroll taxes for employers.

Unless employees are required to substantiate tool expenses and return any excess to their employers, payments made under the plan are taxed and hit with payroll tax.

Environmental Remediations

Environmental remediation done by polluting firms will be eyed as well.

Agents will deny deductions for these projects because, in the IRS' view, the cost is a nondeductible fine if the work is done to settle government charges of pollution. This includes

August, 2008

Phone 248-650-2960; website greggharveycpa.com, email gregg@greggharveycpa.com

Monthly Tax and Accounting Newsletter

Gregg Harvey, CPA

wildlife habitat restoration and wetlands purchases.

Social Security Numbers Provided to Outsourced Tax Prep Firms

I do not outsource any tax preparation work, but IRS will give a break to accounting firms that outsource tax preparation.

It's proposing to let accountants share clients' Social Security numbers with foreign preparers. The change will reverse a rule scheduled to go into effect on January 1, 2009. That rule would require the numbers to be wiped out or masked. Firms must still get their clients' OK and ensure that data safeguards are in place.

Start Up Expenses

Businesses no longer have to file an election to amortize start-up expenses, thanks to new regulations from IRS. Instead, firms wanting to capitalize these costs must elect to do so on Form 4562. The Service says that filers can apply this rule to costs paid after Oct. 22, 2004, even if no separate amortization election was filed.

Up to \$5,000 of start-up costs can be deducted, but this phases out dollar for dollar once total costs top \$50,000. The remaining balance is amortized over 180 months.

The same rule applies to organizing costs of partnerships and corporations. Shorter filing extensions for

partnerships, estates and trusts are coming.

Rebate Program Problems

The Revenue Service continues to be plagued by errors in issuing rebates. More than 100,000 self-employed received larger checks than warranted because the agency overlooked some losses taken by them on Schedules C or F when it estimated their incomes, according to Treasury inspectors. The good news is that they will not be required to send back any excess payments they received.

And 25,000 clergy members who are exempt from SECA didn't get rebates owed to them. IRS missed them because they weren't required to file Schedule SE.

Doling out tax rebates is preventing IRS from getting other jobs done.

Collection agents have been reassigned to help answer the flood of calls from taxpayers who are confused about the timing or the amount of their rebates. The resulting backlog of cases will cost IRS more than \$500 million in lost revenue this year alone. Also, correspondence from taxpayers about account adjustments is piling up in IRS offices because there are fewer employees to process the letters. That'll lead to more unnecessary collections and more taxpayer frustration with IRS.

New Breaks For Real Estate

August, 2008

Phone 248-650-2960; website greggharveycpa.com, email gregg@greggharveycpa.com

Monthly Tax and Accounting Newsletter

Gregg Harvey, CPA

Note the many new tax breaks for real estate lawmakers have slipped into a soon-to-be-enacted bill that provides relief from the current mortgage crisis. Taxwriters have approved tax cuts worth \$12.4 billion over 10 years, as well as tax increases to offset them.

Nonitemizers can deduct property taxes for 2008 in addition to their standard deduction. The extra write-off is capped at \$1,000 for marrieds and \$500 for singles. This break lapses after 2008.

First-time home buyers get a tax credit of up to \$7,500 for buying a main home after April 8, 2008 and before July 1, 2009.

To be eligible, purchasers must not have owned a principal residence in the U.S. in the previous three years. The credit phases out between \$150,000 and \$170,000 of AGI for married couples and \$75,000 to \$95,000 for single filers. It is refundable to the extent it exceeds the buyer's regular tax liability, but does not offset the AMT.

Home buyers in 2009 can elect to take the credit on their 2008 income tax returns.

But the credit is recaptured ratably over 15 years, without any interest, starting two years after the year the credit is claimed. Thus a first-time home buyer who claims a \$7,500 tax credit for a purchase in 2008 must pay an extra \$500 of income tax in 2010 and in later years. If the homeowner sells the residence before the credit is fully repaid, the seller is taxed that year on the lesser of the gain from the sale (if sold to

an unrelated party) or the unrecaptured balance of the credit.

The credits for low-income housing and fixing up old buildings are better, as follows.

They now can offset the AMT. This rule applies to low-income projects that are put in service after 2007 and rehabilitation expenses incurred after 2007.

Interest on more tax free bonds is exempted from the minimum tax - ones used for low-income housing and mortgages for veterans and low-incomers.

Over Stating Charitable Contributions

Grossly overvaluing a contribution to charity carries a stiff tax penalty. The fine is 40% of the additional tax attributable to the overvaluation, the Tax Court says to a group of doctors whose corporate practice was acquired by a tax-exempt hospital. Just before the acquisition, they donated their stock to the hospital and claimed a value of \$400 a share, even though their corporation was going out of business. The Court decided the true value was \$37 per share and imposed the maximum penalty on the doctors (Bergquist, 131 TC No. 1).

Advances To Closely Held Corporations

Make sure that you document advances to a closely held corporation. You may draw unnecessary IRS scrutiny otherwise, wasting money on a

August, 2008

Phone 248-650-2960; website greggharveycpa.com, email gregg@greggharveycpa.com

Monthly Tax and Accounting Newsletter

Gregg Harvey, CPA

protracted legal battle, as this couple did. The wife loaned funds to a company in which her husband was a part owner but nothing was put in writing. The firm repaid her with interest. Unfortunately, because her advances weren't documented, an IRS agent decided the payments to her were nondeductible constructive dividends to the shareowners. Fortunately, the Tax Court said that the agent was wrong and the principal repayments were not taxable dividends (Beckley, 130 TC No. 18).

Defaulting on Loans From Retirement Plans

Look out if you default on a loan from your firm's plan when you quit: You owe tax on the amount of the loan, the Tax Court says. The tax bill is determined once the period for curing the default lapses...in this case, 90 days after a payment was missed. If you are under age 59½ when you default on the loan, you also will have to pay the Service a 10% penalty (Leon, TC Summ. Op. 2008-86).

Use Care With Payroll Services

Be careful if you use a payroll service firm to pay your employees: You are on the hook if the company defaults, a district court says. One day after a business wired payroll funds to its agent, the IRS imposed a levy on the agent's bank for unpaid taxes. The business paid its employees directly and sued the Service to get its money back, claiming that the seizure was invalid. The court disagreed, saying the bank didn't hold the funds in trust for the business, so the IRS levy was proper

(DT Floormasters, D.C., Ind.). The payer's only recourse is to sue the payroll firm, which, given the firm's financial woes, probably won't help.

Congress will help employers avoid bad payroll firms by passing legislation in a year or so waiving penalties for those who use agents that register with the IRS.

Paying Someone Else's Mortgage

Paying interest on another person's home mortgage can be tax deductible. A son took out a mortgage to buy a home for his parents, who had filed for bankruptcy and couldn't get a mortgage themselves. He held title to the house. Even so, the couple made all of the mortgage payments, paid all taxes and upkeep and were the house's only occupants. So the Tax Court determined that the parents were the home's equitable owners, bearing all benefits and burdens of ownership, and OK'd their deduction of the mortgage interest (Njenge, TC Summ. Op. 2008-24). This is so even though the couple in this case wasn't liable to repay the mortgage.

Paying Vendors Late?

Are you making payments late? It can happen to good businesses in times like we are in these days.

Given the tight economic environment most organizations now find themselves in, paying your vendors late sometimes becomes a necessity. The trick is to make sure your employees don't make the matter worse by giving the vendors

August, 2008

Phone 248-650-2960; website greggharveycpa.com, email gregg@greggharveycpa.com

Monthly Tax and Accounting Newsletter

Gregg Harvey, CPA

conflicting information or shifting blame for delayed payment.

Change Payment Terms

In today's economy, a growing number of companies are facing cash-flow issues not seen for several years. When your company decides to delay payments for a specified period, say 15 or 30 days, you must also decide whether or not to communicate this decision to your vendors and if so, how the communiqué will be delivered.

The easiest way is to send a letter informing vendors that you have changed your standard payment terms. If you do send the letter, some suppliers may refuse to sell to you on open-account terms. In the long run, this is the easiest way to handle your vendors, but some companies do not take this step.

If your organization decides to communicate to your vendors by sending a letter, make sure everyone on your staff knows about your new terms.

Temporary Delay

If you're concerned that your vendors will not accept your new terms, you must then decide on one of the following courses of action:

Call your vendors and explain that you are experiencing a temporary cash-flow issue and you will need to pay 15 days (or another specified number of days) late. If you do this, you must honor your commitment.

Notify everyone on your staff of the new policy and present a consistent approach

on how your staff should handle calls from vendors looking for payment.

Designate one or two employees to handle all vendor inquiries if you decide against sending a letter and are reluctant to share this information with the staff. Make it clear to the entire staff that all inquiries are to be answered only by those you designate.

It is crucial that the vendors receive consistent information from all parties.

Reality

For situations in which cash is tight, management is often reluctant to share this information with their staffs. Why? They're concerned about scaring away valued employees who may be tempted to seek employment elsewhere. To avoid this dilemma, it is better for your company to designate only one or two employees to respond to vendor inquiries. The harsh truth is your employees already know cash is tight and by being secretive about the situation may lead them to believe it is worse than it actually is.

The other issue you need to address is that you will have some vendors who will be dissatisfied and will complain. Expect some complaints as part of the "cost" of the decision to pay late.

Beware of Duplicate Payments

And finally, be aware that you are at a greater risk for duplicate payments. When an invoice goes unpaid for 30 days, many companies will send a second invoice. Unless your company's

August, 2008

Phone 248-650-2960; website greggharveycpa.com, email gregg@greggharveycpa.com

Monthly Tax and Accounting Newsletter

Gregg Harvey, CPA

duplicate payment prevention and detection strategies are ironclad, don't be surprised if a few invoices end up getting paid twice. It is an unfortunate fact of business life that most duplicate payments are not returned, unless you actively uncover the duplicate and take steps to reclaim it.

Closing Thoughts

While delaying payments may be required from time to time, it is not the end of the world. Handled properly, vendor dissatisfaction can easily be held to a minimum.

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, phone 248-650-2960, or cell 586-707-1077. You can also visit my website, greggharveycpa.com.

August, 2008

Phone 248-650-2960; website greggharveycpa.com, email gregg@greggharveycpa.com