

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 the recent Housing Act. Also covered: Roundup of Federal tax news, Windows Vista, and a significant victory over the IRS by an individual

Housing Act

The housing-rescue bill, also known as the Housing Assistance Act of 2008, is intended to calm the mortgage market, the real estate market, homeowners on the verge of bankruptcy and foreclosure, victims of bank failures and others whose lives are topsy-turvy this year.

But from a tax perspective, the bill is likely to cause more upset than calm. Here is a look at five areas where tax law was changed along with housing law, and the good news and bad news that goes along with each:

Tax Credit for New Homeowners

First, we have a \$7,500 credit for new homeowners that's not really a credit. It's a loan. Those who qualify to receive this credit will receive 10% of the purchase price of their home -- up to \$7,500, in the first year. Then they will repay the loan over a 15-year period, starting in the second year after the taxable year in which the house is purchased.

In other words, if you bought a home in August 2008, you start paying back 6.667% of the original credit on your 2010 tax return. This credit applies to purchases of new homes on or before April 9, 2008 and before July 1, 2009.

The good news:

This is a refundable credit. That means, even if your total tax liability is zero, you can file to get this money directly from IRS.

Although this is a loan, it's a zero-percent loan.

Bonus: If you buy the home in 2009, before July 1, 2009, you can make an election to report the purchase on your 2008 tax return and get the refund a year early.

The bad news:

Mark Luscombe, principal tax analyst for CCH, a Wolters Kluwer business, points out that people who normally don't have to file tax returns will need to start filing tax returns just to pay the credit back. That will affect seniors living on modest fixed incomes and Social Security.

If you forget to pay it back? Well, the bill doesn't include any specific penalties. But all of IRS's usual non-filing and non-payment penalties will apply. Expect IRS computers to track this and to issue notices for unfilled returns.

If you sell the house in less than 15 years, you will have to repay the rest of

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the credit immediately. This requirement is waived if the owner dies. There are special provisions when the house is sold due to divorces or other emergencies.

This is a temporary credit and may not be renewed once it expires on June 30, 2009.

The credit phases out for married folks, filing jointly, with modified adjusted gross income (MAGI) between \$150,000- \$170,000. For singles, the phase-out is at MAGI between \$75,000-\$95,000.

Who qualifies? Folks who haven't owned a principal residence for three years before buying the new home. If you've owned a vacation home or timeshare, you will still qualify.

In long-distance marriages each spouse may buy his/her own home (principal residence). They will have to split the credit between them.

New Standard Deduction Rules

We have a new standard deduction -- in addition to the old standard deduction -- for real property taxes paid. This is designed for folks whose overall itemized deductions fall below the standard deduction. Married couples, filing jointly, may now deduct qualified real property taxes paid up to \$1,000 (\$500 for singles and married filing separately).

"Qualified" refers to real property taxes you could have deducted on Schedule A if you had been able to itemize. Naturally, property taxes used on other parts of your tax return, like Schedule E,

Schedule C, Schedule F, or office in home can't be used again here.

Luscombe points out that generally when Congress gives us these extra deductions, they are "above the line" deductions, like education expenses, student-loan interest and teacher expenses.

This is effective in 2008. And there are no AGI limits to this benefit.

Vacation-Home Hit

We've been taking for granted that lovely \$250,000 (\$500,000 for couples filing jointly) personal residence capital-gains-tax exclusion for about a decade. Savvy taxpayers have played hopscotch, moving from home to vacation home to the next home, etc. and avoiding income taxes on the sale of each one. That free ride is at an end.

The personal resident exclusion is still good on your personal home. However, you'll be paying taxes on the sale of your vacation home, or rental property converted to a home. The tax will be based on the amount of days the house was not a qualified personal residence divided by the total number of days you owned it. This ratio is multiplied by the amount of gain realized on the sale of the property.

Gain resulting from depreciation taken on the property after May 6, 1997 won't be included in this computation. That gain will still be taxed separately as ordinary income.

The good news:

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This won't affect any sales you make this year since the law becomes effective on Jan. 1, 2009.

The ownership period to take into account as the numerator for nonqualified use also starts on Jan. 1, 2009.

Snowbirds, folks who typically summer in their principal residences up north and spend winter in their vacation homes in the south will have to wait until IRS writes up regulations interpreting the new law. It's not clear if their temporary absences will be considered a period of nonqualified use.

The new law defines unqualified use as:

any period after the last date the property is used as the principal residence of the taxpayer or spouse (regardless of use during that period), and

any period (not to exceed two years) that the taxpayer is temporarily absent by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances, are not taken into account.

Tighter Tracking of Payments

In a blow to eBay merchants and others accepting credit cards, debit cards, or third-party payments, your merchant bank will now be required to send a report to IRS and to you with your total annual gross payment card receipts. In other words, IRS will get your total merchant credit card gross receipts for the year.

The good news:

For merchants who had always meant to catch up on bookkeeping, you will now get a report summarizing all the money you received.

This won't be effective until Jan. 1, 2011.

There will be an exemption for business with 200 or fewer transactions generating sales of \$20,000 or less.

The bad news:

Like most bank reports that add up total deposits, it will be wrong. After all, there were credits you issued, and refunds that won't be reflected in the total gross receipts. Be sure to reduce the total income on that report by all the costs and fees you had too.

In the past, when IRS wanted to get information from banks and merchant accounts, it required going to a judge and getting a subpoena. With this new law in place, IRS can now step in and audit at any time -- with a little or no notice, depending on the urgency of the circumstances, explains Luscombe.

Miscellaneous Provisions

Some other juicy tidbits tossed our way include:

Tax exempt interest on certain mortgage bonds will no longer be an alternative minimum tax preference.

Low-income-housing credits and rehabilitation credits may now reduce AMT.

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Bonds backed by FHA are eligible for treatment as tax-exempt bonds.

Many of the provisions of this law won't become effective until next year. Some won't be effective for several years.

But the provisions for converting your vacation home to a personal residence are becoming effective soon. So, if you've got a second house you want to sell tax-free in the next year or two -- move into it before the end of this year

Taxability of Shares and Cash Distributed By Mutual Life Insurance Firms

It took seven years, but Charles Ulrich did something many people dream about, but few succeed at: He beat the IRS in a tax dispute.

Not only that, but tax experts say potentially millions of other taxpayers could benefit from his victory.

The accountant from Baxter, Minn., challenged the method the IRS has used for more than 20 years to tax shares and cash distributed by mutual life insurance firms to their policyholders when they reorganize as public companies.

A federal court recently agreed with his interpretation. This is notable because while it's not unusual for individuals to take on the agency, most of them lose.

The dispute arose when more than 30 mutual life insurance companies became publicly traded corporations in the late

1990s and earlier this decade, in a process known as "demutualization."

Mutual companies are owned by their policyholders, so the companies provided stock and cash to compensate them for the loss of their ownership interests when they went public.

All told, roughly 30 million policyholders received distributions, Ulrich estimates. MetLife Inc. provided over \$7 billion of stock to about 11 million policyholders when it went public in 2000, while Prudential distributed \$12.5 billion in stock to another 11 million.

The IRS held that the recipients hadn't paid anything for the shares and owed taxes on the full amount when the shares were sold. Cash distributions also were fully taxable, the IRS said.

That didn't sound right to Ulrich, 72, an accountant for 49 years. He began researching the issue in 2001, when he received shares from two companies, Prudential and Indianapolis Life.

Ulrich concluded that policyholders had paid for their ownership rights through their premiums so the distributions should have been tax-free.

That could make a significant difference in what a taxpayer owes. If a company distributed shares worth \$30 and a recipient subsequently sold them at \$32, under the IRS' view they would pay taxes on all \$32. Under Ulrich's interpretation, they would owe taxes only on the \$2 per share gain.

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In 2003, Ulrich publicized his views by contacting tax and insurance experts and setting up a Web site. Some people who'd paid taxes contacted Ulrich and asked him to file refund requests, which he did, for a fee. Some of those refunds were granted, he said. Tax experts say the IRS doesn't always closely scrutinize small refunds.

But the IRS wasn't pleased with Ulrich, accusing him of promoting abusive tax shelters and demanding the names of his clients, which he said he refused to provide.

It's not clear how many people could benefit from the ruling. Many of the 30 million policyholders are probably too late to seek refunds, since claims must be filed within three years of the April 15 tax deadline. That means the statute of limitations for taxes paid for 2004 ran out April 15, 2008.

The government could appeal the ruling and likely will fight future refund claims, perhaps hoping for a different outcome in a separate court, tax experts said.

Charles Miller, a spokesman for the Justice Department, said the government hasn't yet decided whether to appeal.

Still, taxpayers should request refunds if they're eligible, the tax experts said, because even if the IRS rejects the claim, doing so extends the deadline for a potential refund for two more years.

Ulrich will prepare refund requests for interested taxpayers, for a fee, and has posted additional information at his Web site, <http://www.demutualization.biz>.

But he said the principle is more important to him.

Windows Vista

In the history of the PC, the release of Windows 95 takes its place as the moment which brought PC users out of the old world of DOS and into the modern Windows-based PC world.

Windows 95 brought an important technical change - the upgrade from 16-bit to 32-bit processing. This change caused nearly every software company in the world to build new, more powerful versions of their software in order to be compatible with and take advantage of this new processing power. Microsoft supported this new operating system with their biggest and most expensive promotional campaign ever (even going so far as to be the first advertiser with approval to use music from the Rolling Stones).

It is now 13 years later and unnoticed by many, another major technological shift is underway - the change from 32-bit to 64-bit processing.

Back in 2001 (with little fanfare), Microsoft released a 64-bit version of Windows XP. And Windows Vista, from its beginning, has been available in both 32 and 64-bit versions

But even though 64-bit microprocessors have been standard in desktop and notebook PCs for several years now, the hardware manufacturers (OEMs) have continued to ship nearly all PCs with 32-bit versions of Windows (fully compatible with 64-bit microprocessors).

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This has helped users avoid even minimal compatibility disruptions, even when moving to Windows Vista.

This is now changing - fast. PC manufacturers are rapidly moving to establish Vista 64-bit as the default operating system. In fact, this change is so fast it has surprised many industry analysts and software companies.

A 32-bit operating system is limited to directly addressing no more than 4 GB of RAM. That means if a user wants to properly utilize more than 4 GB of memory, they must switch to a 64-bit version. Plus, the Windows Vista 64-bit operating system (and 64-bit applications) are specially designed to take advantage of 64-bit processing power, greatly improving the user's experience.

And so, driven by the availability of cheaper memory and a desire for Vista to run faster and smoother, we are witnessing this rapid movement to Vista 64-bit.

Changing to Vista 64-bit means you will get a better performing PC that can run more applications simultaneously, faster, and with greater stability.

While most applications will run in the 32-bit mode of Vista 64, some applications will not run properly (or at all) and some will not even install. This incompatibility is especially likely for older software that has non 64-bit drivers or other outdated hardware-specific components. If you have any problems with Vista 64 usage, you should check with the appropriate software publisher or hardware manufacturer.

The potential bad news is that consumers and businesses may be unintentionally purchasing new PCs with a Vista 64-bit operating system - and their existing software which they intend to use on the new PC is not compatible.

Federal Tax Updates

Unless tax-writers act in the next few weeks popular write-offs will not be on the forms this year.

They include the tax deductions for state sales tax, college tuition and teachers' classroom supplies. These all lapsed after 2007. Congress adjourned September 26 and won't return until after the election, after the tax forms have been sent to the printer.

Although these breaks have broad support, House and Senate taxwriters disagree about paying for them. The House wants their cost to be offset with tax increases, while the Senate favors a partial offset. This dispute will be hard to resolve quickly. Foot-dragging by Congress would disrupt the upcoming filing season.

The same thing happened with 2006 returns. Filers had to write in special codes to take the write-offs, and many folks didn't claim them. IRS wouldn't accept 1040s with these deductions until early February because it had to reprogram its computers.

In the end, all expired breaks will be extended retroactively. Among them are the minimum tax exemptions. They'll be increased over the amounts in effect for

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last year. That will prevent more filers from being thrown onto the AMT rolls.

Also tax free direct distributions of IRAs to charity. Guaranteed to be restored; 15-year write-offs for restaurant renovations and for tenant improvements; Energy credits for wind, solar and geothermal power.

The tax credit for R&D. It may even be sweetened a bit for businesses.

A group of tax increase provisions has bipartisan support in Congress:

Basis reporting by brokers. They would be required to report the tax basis of securities sold by customers, including stocks, bonds, mutual funds and options. This would apply only to securities bought after '09 so brokers have time to gear up.

Delaying the start of favorable interest allocation rules for multinationals.

And taxing more deferred compensation of investment fund managers by closing a loophole that lets them defer tax on pay stashed in offshore accounts.

All of these tax hikes will pass this year or next. If the extender bill becomes bogged down in Nov., these provisions may be dropped to speed passage.

But even if that occurs, they'll be used in the next Congress to pay for other easings.

Republicans will stymie other revenue raising proposals this year: Higher taxes on fund managers compensated with a share of the profits. They'd have to pay

tax at ordinary income rates instead of at capital gains rates.

And curbing tax breaks for big oil firms. Denying them the 6% write-off on income from domestic production. And imposing a windfall profits tax on them.

But they will be reconsidered next year. If Obama wins the election, they'll be used to help offset the cost of his tax cuts for low- and middle-incomers.

The 1040 for 2008 will sport a special line for the new property tax write-off for filers who don't itemize. This break is on top of the standard deduction and is capped at \$1,000 for married couples and \$500 for single filers.

Nonitemizers will have to check a box on new line 39c if they are taking the property tax break, and will then have to add the extra amount to their standard deduction on line 40. There will be a new worksheet in the instructions to help with the computation.

IRS provides some flexibility on penalty free IRA distributions before 59½. A makeup payout due to a broker's mistake won't trigger the 10% penalty, IRS says privately. Usually, payouts before 59½ are penalized unless the IRA owner takes a series of substantially equal annual payments. Withdrawals must continue for the longer of five years or until the recipient reaches 59½. Here, an IRA owner was using this rule to tap her two IRAs. She timely requested her annual payouts, but one was denied because the custodian lost her distribution form. Once the mess was straightened out, she received the missed payment. Though she got two payouts in

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one year, the Service says no penalty is owed because the error was not her fault.

Lack of ability to pay isn't a defense for failing to send payroll taxes to IRS, an Appeals Court says. It affirms a conviction of a nursing home operator who used taxes withheld from employees to pay creditors other than the Service.

He knew he should have paid IRS and failed to do so. The government needn't prove that he had sufficient funds to pay the taxes that were due (Easterday, 9th Cir.).

Can the IRS get at an LLC's assets for a tax debt owed by its sole owner? The agency thinks so, even if state law says creditors can't attach assets of a limited liability company to satisfy the debts of its owner. In a private ruling that's raising eyebrows among tax pros, IRS says it can levy on an owner's share of the firm's profits that are payable to him.

The issue will likely end up in court. IRS does agree it can't levy on payments firms make under contracts with the LLC.

Amounts paid to get out of an onerous lease are deductible, a court says. Under the lease, if the corporate tenant didn't purchase the property after 10 years, the rent would jump to more than three times the fair market rent. So the tenant exercised the option in the lease to buy the building and, after a court battle, paid several million dollars more than the building was worth to terminate the lease.

The payer can deduct the excess as a business expense (ABC Beverage, D.C., Mich.).

Expect IRS to appeal. In 2000, the Tax Court ruled in favor of the Service that a similar payment had to be capitalized and recovered through depreciation.

A man who didn't father his girlfriend's kids can't take them as dependents if he has not adopted them, the Tax Court says. The kids are not treated as his qualifying children because they aren't related to him, and they aren't eligible to be his qualifying relatives because they are qualifying children of their mother. Nor can he use head of household filing status (Espinoza, TC Summ. Op. 2008-112). Fortunately for him, these tax problems disappeared after he married his girlfriend.

A child of divorced parents can be a dependent of both for limited purposes, the Service says. If a noncustodial parent wants to claim the child as a dependent for health savings account purposes, he can do so, even though the custodial parent doesn't release the exemption. Similar rules also apply for employer medical plans, medical savings accounts and fringe benefits. But the Revenue Service makes clear that both spouses are not able to claim dependency exemptions for the same child.

If you're thinking of buying a hybrid to lower your bills at the pump. Some makes no longer qualify for the credit because the hybrid credit law requires the break to be phased out after a manufacturer has sold 60,000 hybrids. Credits will dry up for Hondas after this year. Originally, buyers of Civic hybrids

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got a \$2,100 credit and Accord buyers got \$1,300. That was cut in half for buyers in the first six months of 2008 and will decline to just 25% in the last six months of the year. There's still no reduction for hybrids by Chevy, Mazda, Mercury, Nissan Ford and Saturn. Credits for Toyota and Lexus models dried up after Sept. 30, 2007. Also keep in mind that the hybrid credit doesn't offset any minimum tax liability.

Hybrids aren't the only vehicles that are eligible for an income tax credit. Advanced lean-burn diesel vehicles qualify as well, according to the IRS. Two 2009 Volkswagen models, the Jetta and SportWagen, carry a \$1,300 tax credit.

And purchasers of three Mercedes-Benz clean diesel models can claim a credit... \$1,800 for the GL320 BlueTec, \$1,550 for the R320 and \$900 for the ML320. Leased cars don't qualify, but leasing firms may be willing to share the largesse.

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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