

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 HOPE For Homeowners legislation, changes for 2009, moer bad news about unlicensed tax preparers, and the Kiddie tax.

HOPE For Homeowners

The "HOPE for Homeowners Act of 2008" creates a new program within FHA to back FHA-insured mortgages to distressed borrowers. The new mortgages offered by FHA-approved lenders will refinance abusive loans at a significant discount for homeowners facing difficulty meeting their mortgage payments.

The program is built on five principles:

Long-term Affordability. The program is built on the idea, expressed by Federal Reserve Chairman Bernanke, that creating new equity for troubled homeowners is likely to be a more effective way to avoid foreclosures. New loans will be based on a family's ability to repay the loan, ensuring affordability and sustainable homeownership.

No investor or lender bailout.

Investors and/or lenders will have to take

significant losses in order to benefit from the proceeds of the loans refinanced with government insurance. However, these losses would be less than the losses associated with foreclosure.

No windfall for borrowers. Borrowers will share their new equity and future appreciation equally with FHA. Borrowers will pay for the FHA insurance.

Voluntary Participation. This will be a voluntary program. No servicers will be compelled to participate.

Restore confidence, liquidity, and transparency. Credit markets are fearful and frozen in part because banks and other financial institutions do not know what their subprime mortgages and related securities are worth. The uncertainty is forcing lenders to hoard capital and stop the lending necessary for economic growth. This program will create certainty and get markets flowing again.

Program Administration. The new program will be overseen by a Board made up of the Secretary of HUD, the Secretary of the Treasury, and the Chairman of the Federal Deposit Insurance Corporation (FDIC). The Board will have the authority to develop standards within the framework of the legislation.

Eligible Borrowers. Only owner-occupants will be eligible for the new FHA-insured mortgage. No investors or investor properties will qualify. The Board will establish other eligibility criteria, including criteria designed to determine whether borrowers can afford their existing loans.

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New Loan Amount. The size of the new FHA-insured loan will be determined by:

The lesser of the amount the borrower can afford to repay, as determined by the current affordability requirements of FHA, taking into account the amount of income available to the family after basic expenses are paid (residual income); or,

The amount of the existing loan minus a discount established through an auction process established by the Board. The auction process will allow for bulk refinances, at a discount, of eligible loans. The federal government will not take possession of the mortgages. The Board will have flexibility to change the affordability standards to suit circumstances.

In either case, FHA will not insure more than 90% of the current value of the home. Loans must be 30-year, fixed rate loans.

Equity Sharing. In order to avoid a windfall to the borrower created by the new 90% loan-to-value FHA-insured mortgage, the borrower must share the newly-created equity and future appreciation equally with FHA. This obligation will continue until the borrower sells the home or refinances the FHA-insured mortgage. Moreover, the homeowner's access to the newly created equity will be phased-in over 5 years.

Existing Subordinate Liens. Before participating in this program, all subordinate liens must be extinguished. This will have to be done through negotiation with the first lien holder.

Qualified Safe Harbor. The legislation provides servicers with an incentive to participate in the program by offering a safe harbor against legal liability.

Funding. The Act provides for \$20 billion in credit subsidy, which is expected to insure new, affordable loans that refinance approximately \$400 billion in troubled mortgages.

Program Sunset. The program sunsets at the end of 2012. Any remaining funds, and future collections resulting from appreciation of FHA-insured mortgages made under this program, will be returned to the government.

New Foreclosure Prevention Affordable Housing Goal for Fannie Mae and Freddie Mac. In addition to the FHA option, the legislation requires the Secretary of HUD, together with the Secretary of the Treasury and the Director of OFHEO, to establish a new Foreclosure Prevention goal for Fannie Mae and Freddie Mac. The two enterprises would be required to purchase eligible loans at a discount, and write down those mortgages to help the families keep their homes. Mortgages would have to be written down according to the same criteria as loans eligible for FHA insurance under this legislation – based on ability to pay, taking residual income into account. OFHEO would be given the authority to require the enterprises to raise additional

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capital commensurate with the additional risk this new goal may pose

Unlicensed Tax Return Preparers

In a limited study of tax returns completed by unlicensed paid preparers, 17 out of 28 -- or 61% -- were prepared incorrectly, including one that showed the taxpayer owing \$4,903 more than he really did, according to a study by the Treasury Inspector General for Tax Administration (TIGTA), which provides independent oversight of IRS activities.

While most of the mistakes resulted in an underpayment of taxes or a too-big refund, sometimes it was the taxpayer, not the government, who would have paid for the mistake, according to the study in which TIGTA auditors posed as regular taxpayers and visited tax preparation offices in a single metropolitan area.

Six returns overstated the amount taxpayers owed by a total of \$7,798, with the most glaring of these showing the \$4,903 overpayment. Another return had a \$1,043 overpayment, while the others were under \$1,000. The returns prepared for the study were never filed; the auditors told the preparers they would file the returns themselves, but didn't.

Given the study's small sample size, the findings cannot be generalized to all paid preparers.

Other returns understated taxes owed and overstated refunds due, shorting the

government by a total of \$20,626. Taking the 17 returns together, all told the government would have been out \$12,828 had the returns been filed. For the study, TIGTA auditors created five different taxpayer scenarios, including single, married filing jointly and head of household, with incomes ranging from \$16,000 to \$85,000.

Overall, only 11 of the 28 returns showed the correct amount for tax owed or refund due. In 2007, the IRS processed about 83 million individual income tax returns filed by paid preparers, according to the report.

The auditors went to tax preparers at 12 commercial chains and 16 small, independently owned businesses. The report does not name practitioners and does not say in which metro area the study was conducted.

Six returns were prepared with "willful or reckless" disregard for the tax rules while another 11 simply had mistakes. For instance, one of those six preparers claimed a charitable deduction on the return, even after the auditor posing as a taxpayer said he had made no charitable contributions that year. That same preparer also added a property-tax deduction for a car -- even though the taxpayer didn't say anything or offer any documentation verifying he was eligible for that deduction, according to the report.

Those six preparers filed 973 tax returns during the past tax season, according to the report. "We have referred matters that we encountered to the IRS so that any appropriate follow-up actions can be taken," the report said.

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The study focused on unlicensed and unenrolled preparers, specifically those who were not certified public accountants, enrolled agents or tax attorneys.

"Unenrolled and unlicensed preparers are not regulated. There have been ongoing concerns from Congress and other stakeholders about the lack of required training or demonstration of ability to apply tax law correctly for these unregulated tax return preparers," said J. Russell George, the Treasury Inspector General for Tax Administration, in an email message.

Attorneys and certified public accountants are regulated by state licensing agencies and associations such as the American Bar Association and the American Institute of Certified Public Accountants. Meanwhile, enrolled agents must pass an IRS test and are essentially approved by the IRS to practice.

There are an estimated 800,000 unenrolled and unlicensed tax preparers, said Paul Cinquemani, director of government relations with the National Association of Tax Professionals, which represents tax preparers both licensed and unlicensed.

The report said the IRS does not have a database of preparers and that the IRS "acknowledges that it does not know how many paid preparers exist and cannot determine the full extent of noncompliance and incompetence among practitioners."

"Anyone -- regardless of training, experience, skill or knowledge -- is allowed to prepare federal income tax returns for others for a fee," the report said. Only two states, California and Oregon, require these preparers to register with state agencies and meet continuing-education requirements, according to the report. Currently, proposed bills in the U.S. House and Senate aim to better regulate tax-return preparers.

The report recommends that every tax preparer be assigned a single identification number to make it easier for the IRS to ascertain which preparers are causing the most errors. Currently, tax preparers can file taxes using a variety of different identifiers, including their own Social Security number, their practitioner tax ID number or their company's employer ID number. The IRS responded to TIGTA's recommendation by saying it will study the issue.

Given that taxpayers are ultimately responsible for the information filed on their return, it behooves consumers to be careful when hiring a paid preparer, whether licensed or not -- even licensed professionals may make mistakes.

Whether you go with a licensed or unlicensed preparer, it's important to assess whether there are any complaints against that person. That's easier to do when the tax preparer is licensed or registered with a state or other agency. But another option is checking your local Better Business Bureau. Also, find a practitioner who is a member in good standing of a trade or professional group.

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And, be sure to ask about education before laying down your money. "I'd say, 'Give me some evidence you've had continuing education this year,'" said Cinquemani, of the NATP. "If they could produce nothing, or wouldn't tell me anything, I'd go down to the next one," he said.

For taxpayers seeking a preparer, NATP's Web site offers a "find a professional" tool. Cinquemani said complaints against members are investigated, and tax preparers who don't meet the association's standards are "dismissed automatically." Also, try the National Association of Enrolled Agents, and the American Institute of Certified Public Accountants.

A spokesman for H&R Block said the company supports the study's recommendation to register tax preparers. "We strongly support tax professional certification," said Gene King, an H&R Block spokesman, adding that "the typical H&R Block client is seen by a preparer with eight-plus years experience and 450 hours of training." About 5% of the company's tax practitioners are Circular 230 certified, he said. Circular 230 generally refers to attorneys, certified public accountants and enrolled agents.

Jackson Hewitt said it, too, agrees with the report's recommendation, adding that it "recognizes that ongoing education of tax preparers is critical," said Kristen Sharkey, a spokeswoman. "Jackson Hewitt has implemented compliance systems and education programs that are designed to ensure high levels of competency and training," she said, adding that the company "has publicly

stated to the IRS that they welcome more uniform standards and compliance efforts to all tax preparers." Jackson Hewitt said it employs both enrolled and unenrolled preparers, but does not disclose specific numbers.

Changes For 2009

Amid the financial crises and the election-year banter that are currently inundating the airwaves, the approach of the end of the fiscal year makes COLA adjustments fairly calculable. This in turn permits a projection of the numbers that will be of interest to taxpayers in 2009, with one major reservation.

The standard deduction increases for joint filers from \$10,900 probably to \$11,400 (from \$8,000 to \$8,350 for head of household filers). The additional standard deduction for each taxpayer who is married and either over age 65 or blind rises from \$1,050 to \$1,100; for those who are unmarried, the additional amount likewise increases by \$50 to \$1,400. A dependent on another taxpayer's return may be able to claim \$950 as a standard deduction.

Personal exemptions will rise from \$3,500 to \$3,650, and the phaseout level for a joint filer will likely move from \$239,950 to \$250,200 (to \$208,500 for head of household and to \$166,800 for unmarried). Such exemptions now are only one-third of the tentative phaseout amount. Thus, every exemption should be at least \$2,433 (\$3,650 - \$1,217) when listed on the 2009 Form 1040.

Itemized deductions are reduced when the taxpayer's AGI exceeds a threshold amount, which apparently will increase

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to \$166,800 from \$159,950. Again, the phaseout is only one-third of the amount tentatively computed.

The Kiddie tax exemption seems poised to increase from \$1,800 to \$1,900, with corresponding increase in the range of kiddie qualifying income a parent may elect to include directly on his or her return to \$950 to \$9,500. A kiddie in 2009 may be able to claim a \$6,700 AMT exemption (subject to phaseouts).

The AMT remains in a state of flux. As previously reported in this column, Representative Rangel has a proposed "solution" to the annual patches the Congress has devised: repeal. The chances of that happening any time soon appear slim. Even as this is being written, both the Senate and House have passed legislation that will set the AMT exemption amounts at \$69,950 for joint filers, \$46,200 for head of household filers, and \$34,975 for unmarried filers in 2008 only; so the AMT remains murky in 2009, because the much lower unadjusted levels -- \$45,000, \$33,750, and \$22,500 respectively -- that will again be apparently applicable in 2009 are subject to the suspicion that they will again be increased but there is no assurance. That legislation for 2008 is not yet finalized, however, because the provisions are contained in larger legislations that contain other differing provisions that will require reconciliation before it can be presented for signature, but one may presume that the 2008 AMT patch will be enacted.

The reservation mentioned in the first paragraph is that the tax programs of the candidates -- and more importantly, the economic necessities of that year --

may change all or certainly parts of the current outlook. One case in point is the preliminary threshold for the highest tax bracket, which probably will be pegged at \$372,950 (\$186,475 for marrieds filing separately). If the top tax rate changes, as it does under the Obama plan, this number may also be adjusted.

The reservation is tepid because the most recent announcements for the campaign suggest that a President Obama would probably allow the 2001 and 2002 tax cuts to merely expire in accordance with their sunset provisions rather than by an accelerated repeal. If this actually occurs, the return to a top 39.6-percent rate, and a return to a 20-percent maximum capital-gains rate will not kick in until 2011

Kiddie Taxes Explained

The laws have changed a couple of times in the last few years—with the most substantial change occurring in 2006. But, unless you've given your kids a great deal of money in their custodial accounts, the new tax laws shouldn't have a huge impact on your finances or your children's. I'll start by explaining how the kiddie tax works, what has changed, and then talk about other saving strategies based on your goals.

I should point out here that as a general rule, I don't believe investment decisions should be based solely on their tax consequences. But if you do have a great deal of money to give, this is a case where the tax laws may justifiably change your approach to investing for your children.

What is the "Kiddie Tax"?

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At the heart of the issue is the fact that kids--dependent children--enjoy a special "limited standard deduction" on unearned income, or income derived from investments: interest, dividends, and capital gains. In 2008 the first \$900 of a dependent child's (below the age of 19, or 24 if a full-time student) investment income is tax-free, and the next \$900 is taxed at the child's rate, which is typically 10%. So if your kids each earned \$1,800 or less in investment-related income in 2008 and didn't have additional earned income, each would pay \$90 at most in tax (10% on the second \$900), and perhaps no tax at all if that income was in the form of long-term capital gains or qualified dividends (this is a special tax break for 2008-2010; see below). If a child earns more than \$1,800, any excess is taxed at the parent's marginal rate.

You, by contrast, would not enjoy the \$900 deduction or the low rate on the next \$900; you'd pay your normal rate for investment income (but only 15% on long-term capital gains and qualified dividends). If you were in the 25% federal tax bracket, that \$1,800 in investment income would result in \$450 in additional taxes for a short-term gain or \$270 for a long-term gain. (Hint for adults: Strive for tax efficiency in your taxable portfolios: think about stocks or funds with long-term capital gains potential; if current income is your need, seek qualified dividends.)

Obviously, it takes a fair amount of capital to generate \$1,800 in investment income. If we assume that your child's investments generate a return of 6% (all of which is interest and/or dividends; i.e., no capital gains), you'd need

\$30,000 in capital to get to the \$1,800 ceiling.

Several years ago, investment income for children 14 and older was taxed at their own rate, giving them a pretty powerful tax break. In 2006 Congress raised the age ceiling to kids under the age of 18. Now the law has changed again: For 2008, the kiddie tax is extended to dependents under the age of 19 and dependent full-time students under the age of 24. On the plus side, the income limit has increased over the years; on the minus side, many more kids are subject to the kiddie tax laws. (Note that children who provide more than half of their own support are not affected by the kiddie tax rules.)

Why did Congress do this? Because of a popular income shifting strategy that many wealthy parents were employing. People were gifting appreciated stock to their older children, who would then sell the stock and pay the lower capital gains rate. This would have been especially valuable in 2008 through 2010, when capital gains rates are zero for people in the two lowest tax brackets.

Say you had a \$12,000 stock position with a long-term gain of \$6,000 (that was a good stock!). Under the old rules, you could have given that stock to your 18-year-old (still under the gift tax ceiling), who could sell it and pay nothing on the gain. If you'd sold it yourself, you'd owe tax of \$900 (15%). That's a pretty big incentive to shift the asset to your child. Congress didn't want to forego that revenue, so they expanded the kiddie tax rules to older kids.

Does it really matter?

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Obviously, if you have substantial investment income and were hoping to use your children's low tax rates to avoid taxation, you're out of luck given the new law. But the child's tax break is still pretty valuable for parents who want to start investing for their children's future. You can open a custodial account, which you control until your child reaches the age of majority. (Note: Some states allow you to extend the age from 18 up to 21, or in some cases even as old as 25; this is probably a good idea since you can always turn the account over to your child early, but you can't postpone the transfer). The account is in your child's name and any income is reported to the child's Social Security number. (He or she will have to file a tax return; for your very young children, you can sign it.) Just be mindful of the deduction limits.

On the flipside, any assets you place in a custodial account belong to your child. When they reach the age of majority, they are free to spend those assets however they want, whether that means paying for college or buying a new car.

One other potential problem with custodial accounts is that they could negatively impact your child's chances to get financial aid. When colleges calculate financial aid eligibility, they treat custodial accounts as the child's asset (which makes sense: a custodial account belongs to the child). These assets are generally "assessed" at a rate of 20%; in other words, the college would reduce any aid awards by 20% of the custodial assets.

Now compare this with what is probably the most popular vehicle for saving for college, the 529 plan. Those are

considered the assets of the parents, and are assessed at a rate of just 5.6%. Essentially, if you're saving for college, it's probably best to open a 529 account for each of your kids. Income from 529 plans grows tax-free and, if used for qualified education expenses, withdrawals are tax-free. As long as your child goes to college, you'll never pay a dime on assets you stash in a 529 plan.

That said, you may still want to keep small custodial accounts for your children. As they get older, it might offer a vehicle for teaching them about the financial markets. And there is a reasonable tax break up to that \$1,800 ceiling. If you think you'll be able to afford college without financial aid—perhaps by aggressively saving through a 529 plan—then you'll be building nest-eggs for your kids through the custodial accounts.

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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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