

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 current developments in S Corporations, MFJ versus MFS, and some tax planning ideas that are applicable through the end of this year.

Current Developments in S Corporations

This year Treasury issued final regulations that provide guidance on changes made by the American Jobs Creation Act of 2004 and the GO Zone Act to the rules governing S corporations.

There have been numerous tax law changes in the past few years, each of which has included provisions that affected S corporations. This year Treasury issued final regulations that provide guidance on changes made by the AJCA and the GO Zone Act to the rules governing S corporations. Specifically, the regulations address three S corporation issues:

The S corporation family shareholder rules;

The definition of "powers of appointment" and "potential current beneficiaries" regarding an electing small business trust (ESBT); and

The allowance of suspended losses to the former spouse of an S corporation shareholder.

A major change in the AJCA was to treat family members as one shareholder. The regulations retain the provisions of Notice 2005-91 that describe certain entities other than individuals that will be treated as members of the family. In addition, the regulations clarify that the "six-generation" test is applied on the latest of (1) the date the S election is made; (2) the earliest date an individual who is a member of the family holds S stock; or (3) October 22, 2004.

A question that arises related to an Electing Small Business Trusts (ESBT) is what provisions qualify as a power of appointment. The regulations state that the ability to add beneficiaries to an ESBT is generally a power of appointment but will be disregarded to the extent it is not exercised. Another important issue for ESBTs is who is considered a potential current beneficiary. The regulations amend the definition of "potential current beneficiary" to provide that all members of a class of unnamed charities that may receive distributions are to be treated as one potential current beneficiary.

However, each named charity is treated as a separate potential current beneficiary and thus a separate shareholder. Finally, the AJCA allowed ex-spouses to use suspended losses if the ex-spouse received the S stock under a divorce decree. The regulations explain how the suspended losses should be allocated between the two spouses. The transferor spouse will be allowed to use

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all of a suspended loss from previous years in the year the stock is transferred. Any loss that is not used in the year the stock is transferred must then be prorated between the shares owned by the transferor spouse and the transferee spouse based on their ownership at the beginning of the succeeding tax year.

Example: A owns all 100 shares of an S corporation. As of December 31, 2006, A has a zero basis in his S corporation shares. For 2006, the S corporation has \$100 in losses, which A cannot use because of the basis limitation under Sec. 1366(d)(1). On July 1, 2007, A transfers 50 shares to B, A's former spouse, pursuant to a divorce that qualifies under Sec. 1041(a). The S corporation has an \$80 loss in 2007. For 2007, the year of the transfer, A may deduct the entire \$100 suspended loss from 2006 and his share of the 2007 loss [$\$60 = (80 \times .50$ for the first half of the year) + $(80 \times .25$ for the second half of the year)] if he has sufficient basis in the S corporation stock. B can deduct her share of the 2007 loss ($\$20 = 80 \times .25$) assuming she has sufficient basis in the stock.

Should You File Married Filing Jointly or Separately?

Usually married couples will have the lowest tax liability if they file a joint income tax return, however, this is not always the case.

Married individuals can either file a joint income tax return or, if they choose, may file two separate tax returns. Filing separate tax returns is usually (but not always, as you will see) done to reduce

the tax liability. However, if finding the lowest tax liability is your main concern, there are no actual guidelines for determining which filing method you should use. If this is your goal, you need to calculate the tax liability under both scenarios to see which is better. Nonetheless, there are other factors you need to consider.

Note: Although only married taxpayers may file jointly, if the individuals are separated and living apart, they may still file a joint return. However, if a husband and wife are legally separated, they are not considered to be married, and a joint return may not be filed.

Disadvantages of Filing Jointly

At first glance, you would think that married individuals would always want to file a joint return. After all, a joint return is certainly simpler to prepare and the applicable tax rates are the lowest for married filing jointly. However, due to various individual situations, the lowest tax liability may actually result from filing separately. In addition, there may be at least two other disadvantages to filing a joint return:

A joint return precludes a deduction for alimony. Prior to a divorce, a spouse who pays taxable alimony, must file a separate return in order to be able to deduct the payments.

Although alimony is deductible by one spouse and is taxable to the other spouse, it may not be a wash if separate tax returns are filed. Assume, for example, that the payor spouse is in the 28 percent tax bracket while the payee-spouse is in the 15 percent bracket. Each dollar of

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alimony will yield post-tax income of 85 cents to the payee while the payor is entitled to a post-tax deduction of 72 cents, making for a 13-cent difference on every dollar of alimony.

A joint return means the couple is jointly and severally liable. Generally, individuals who file a joint tax return are jointly and severally liable for any income tax, penalties and interest from the return. (The exception to this is if the innocent-spouse rules apply.) The IRS may collect such amounts from either spouse. Therefore, if the individuals are divorcing and even if married filing separately results in a higher-net-tax liability, it may be worth filing separately in order to protect one or the other party.

Itemizing on Separate Returns

If a couple files separately and one spouse itemizes deductions, the other spouse should also itemize as otherwise their standard deduction is zero.

As to which spouse can claim which deduction, the answer depends mostly on whether one lives in a community property state. If qualifying expenses are paid by a spouse with separate funds, then that is the spouse who may claim the deduction for paying them. However, if the expenses were paid with community funds and the couple lives in a community property state, then usually each spouse claims half of the deduction.

Filing Separately Prevents Certain Deductions and Credits

If a married couple decides to file as married filing separately, there are

certain deductions and credits that may not be claimed. Taxpayers who are married filing separately can not claim the:

Hope Credit or the Lifetime Learning Credit,

IRS Section 32 earned income credit,

IRS Section 22 credit for the elderly and disabled, unless the spouses lived apart all year,

IRS Section 21 credit for household and dependent care expenses,

IRS Section 23 adoption assistance credit,

IRS Section 135 exclusion for any amount realized from redeeming qualified U.S. savings bonds that are used for higher education expenses, or

Deduction for any IRS Section 221 interest paid on a qualified student loan.

In addition to the above, married taxpayers who file separately:

May have a smaller IRS Section 24 child tax credit, and

May have to include in income more of any Social Security benefits (including any equivalent railroad retirement benefits).

Change of Filing Status

If married individuals file a joint return, they may not later amend their return to file married, filing separately for that

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taxable year. However, the reverse is not true. Generally, if either or both spouses file a separate return, a joint return can still be filed as long as:

No more than three years have elapsed from the due date of the return, without regard to extensions,

No notice of deficiency has been mailed to either spouse for the year. (Note that if the individual has not filed a return by the time the IRS mails a notice of deficiency, the IRS can determine the spouses' filing status as either married filing separately or as jointly. The IRS is not obligated to use the most favorable method.)

Neither spouse has sued in any court for the recovery of any part of the tax for the year, or

Neither spouse has entered into a closing agreement (see Section 7121) with respect to the tax year nor has there been a compromise of any case arising against either spouse for the tax year.

Miscellaneous, But Important

There are additional issues to be considered when determining the correct filing status for certain taxpayers:

Generally, if either spouse is a nonresident alien during a tax year, a joint tax return can not be filed. An exception to this occurs when a nonresident alien is married to a U.S. citizen or resident and, if both spouses elect, a joint return may be filed.

If the spouses have different tax years, a joint return is not allowed.

If an individual is considered to be missing due to service in a combat zone, the spouse may elect to file a joint return.

If the taxpayers are only married for part of a tax year, they may not prorate their income and use different rates for each part of the year.

In Summary: What Should You Do?

Usually married couples will have the lowest tax liability if they file a joint income tax return rather than separate returns. However, this is not always the case, and you must prepare the tax return both ways to be absolutely sure this is so. Plus, there are specific situations where it may be better to file separately due to other reasons.

To answer the question of what you as the tax preparer should do, there are two things. First, you need to understand the client's situation. Make sure that the liability for any income tax, penalties and interest resulting from the return won't be an issue. Furthermore, determine whether alimony is being paid and be sure to look at what credits the taxpayer may be entitled to claim.

Finally, you can (and, really you must) use income tax planning software that will allow you to prepare the tax return both as married, filing jointly and married, filing separately. Only then can you make the absolute best decision for your client.

After the Election – Key Tax Planning Ideas before the End of 2008

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The historic election of Barack Obama has not only ushered in a new era in American politics but has also created a late fall/early winter, busy season for accountants as substantial changes in the tax law in 2009 appear in the offing. Many taxpayers will be required to take action this year to take maximum advantage under the current system.

There is not space in this column to examine in detail all of the various strategies that advisers must consider but below I point out, in bullet-form, some of the areas I anticipate will be impacted by the changing environment, assuming the "current" proposals do not significantly change

Individuals

Increase in the highest two ordinary income-tax brackets in 2009: part of 33 percent bracket goes to 36 percent and 35 percent bracket goes to 39.6 percent

Accelerate ordinary income to 2008. Special attention must be paid to the AMT because certain 33 percent bracket taxpayers who are in the AMT and in the exemption phase-out range may find deferral a better option. Higher income taxpayers in the AMT will not be adversely affected by an acceleration this year.

Roth IRA may more be attractive than a traditional IRA contribution to a taxpayer who had a relatively bad year as they are in a lower tax bracket in 2008 and will be in a higher tax bracket in later years when distributions are taken.

Many taxpayers who have had a bad year and are in a lower tax rate for 2008

may want to roll over traditional IRAs to a Roth IRA if the AGI is \$100,000 or less.

If AGI is less than \$159,000, contribute to Roth IRA rather than traditional IRA. Make nondeductible contribution to IRA if AGI exceeds \$159,000. This can be rolled over to a Roth IRA in 2010. Use the §454(b) election to accelerate U.S. savings bond income.

Increase in capital gains and qualifying dividend tax rate: maximum rate for certain taxpayers in the highest two brackets increases from 15 percent to 20 percent

Accelerate sales of business or other sales at a gain to lock-in lower tax rate. Repurchase gain securities as there is no wash sale rule for gains.

Pay a dividend from C and S corporations to take advantage of 2008 favorable rates and to reduce earnings and profits so that fewer later distributions will be taxed at the higher rate.

Arrange for dispositions of underwater real estate ventures to pick up excess of liabilities over basis at favorable rates. Take short-term capital gains now rather than early in 2009.

Defer capital losses rather than offset current lower-taxed, long-term capital gains so they may offset higher-taxed, long-term gains in later year.

Sell partially worthless investments to recognize loss.

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Elect out of current installment sales treatment, or get out of old installment sales by selling the notes or making substantial modifications of such notes to accelerate gain.

Gift property that has declined in value to family members in lower tax brackets, including zero-percent bracket on capital gains and qualifying dividends. Transfer reduced value of remainder interest by transferring residence in a QPRT.

Investments

Tax-exempt bonds will become more valuable.

Capital gains and qualifying dividend-paying property are still advantaged over taxable interest-paying obligations. Move into second home to grandfather §121 exclusion on gains from sale of principal residence.

Defer taking minimum required distributions to late December in case two-year holiday is enacted.

Social Security (enhanced taxable wage base for those making more than \$250,000 and application of Social Security tax to pass-through income of a service S corporation)

Accelerate tax on substantially unvested property by making §83(b) election to reduce tax base.

Consider converting non-service LLCs and partnerships to S corporations to create pass-through income not subject to self-employment tax.

Business

Cash method businesses should consider accelerating income.

Accrual non-C corporation taxpayers should consider accelerating income by seeking prepayments or by discounting accounts receivable.

Defer deductions: consider not electing §179 expense, bonus depreciation, choosing straight-line depreciation over MACRS.

Redeem stock treated as a dividend to family member in a zero-percent bracket to shift basis to higher-bracket shareholders and remove earnings and profits.

Make dividend distributions and loan back to C corporations and S corporations with C earnings and profits.

Use Incentive Stock Options that are not subject to Social Security tax but can produce capital gain income rather than ordinary income; they are more useful in a higher ordinary tax rate and enhanced Social Security tax structure.

One intriguing proposal is the zero-tax bracket for gains derived from the sale of a start-up or small business; the bracket is apparently independent of the tax profile of the seller but based on the character of the business. No working definition of “small” or “start-up” has yet emerged. This could encourage a wind-down of existing business to create a start-up situation or to splinter existing businesses to meet the threshold for small businesses and to multiply the

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number of potential gains subject to this favorable tax treatment.

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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