

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 includes a good question on estimated taxes, a note about Tim Geithner's tax problems, a primer on Michigan property taxes, IRA withdrawal rule changes, and a note on credit scores.

Estimated Taxes

Question received a couple weeks ago may apply to many people:

My husband and I are young retirees and aren't eligible yet for Social Security. We don't have pensions, annuities or other defined-income sources. Our only source of income is distributions from mutual funds.

Each year, we pay estimated federal taxes on a quarterly basis. We typically make equal payments each calendar quarter calculated at 110% of last year's tax liability because of the dollar amount of our mutual-fund distributions.

But most of our mutual-fund distributions occur in November or December, as our funds declare end-of-year distributions. What options do we have concerning our estimated tax payments as a result? For example, can we vary our quarterly payments with the largest occurring in the fourth quarter of

each year? Or, can we skip quarterly payments for each of the first three quarters?

The method you're using now for paying estimated taxes -- sometimes called the "safe-harbor rule" -- will keep you out of trouble. But you have other options that might help you postpone paying taxes until after you receive the income, according to the accountants and financial planners we surveyed.

The safe-harbor rule works to your advantage if you expect a big boost in income. If you're making \$100,000 one year and the next year it's \$200,000, you use the safe-harbor rule to pay estimated tax each quarter, based on 110% of what you owed last year and settle up by April 15, the deadline for filing tax returns.

But because large gains are unlikely for most investors right now, you may want to consider using the annualization method, which is kind of like closing the books four times a year. In other words, you would have to figure out your taxes every quarter. It's more work, but you don't overpay Uncle Sam, and you'd have the benefit of cash in your pocket.

With this method, checks are mailed to Uncle Sam after three months of the year, and then after five months, eight months and 12 months. To calculate the amount of each check, you can use Form 2210 from the Internal Revenue Service. On page four of that form (Schedule A1, Part 1), you enter your adjusted gross income for each time period, along with any itemized deductions, also for each time period. Then you calculate the tax due for each period. You remit at least 90% of that amount. Checks themselves

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must be accompanied by a voucher, called Form 1040-ES. (Both forms are available at irs.gov.)

In your case, the first three payments would be relatively small; the fourth payment would be larger because your income for the final months of the year would be higher. Note: Form 2210 -- after information for all four periods is entered -- is attached to your federal tax return.

You also could have the mutual funds withhold taxes for you, but most people consider that the less attractive option, because it's more difficult to control the amount of tax withheld than it is to control the amount they pay in the form of a quarterly payment. Most people like to have more control.

Warning: If you don't pay enough as you go, you could be slapped with a penalty, plus the taxes the government says you should have paid. Also, people who are subject to state income tax need to make sure they don't run afoul of those rules.

One other thought: consider diversifying your investments. Having a large portion of your income tied to capital gains from mutual funds invested mainly in stocks is perhaps taking too much risk. It might be better to have a couple of years of income in cash reserves.

Tim Geithner's Tax Problem

Timothy Geithner, whose nomination as Treasury secretary has been delayed by his past failure to pay taxes, was repeatedly advised in writing by the International Monetary Fund that he would be responsible for any Social

Security and Medicare taxes he owed on income he earned at the IMF between 2001 and 2004.

Questions about Mr. Geithner's initial failure to pay more than \$34,000 in taxes are clouding his prospects for confirmation. The Senate Finance Committee postponed Mr. Geithner's confirmation hearing from a tentative Friday date to next Wednesday, which means President-elect Barack Obama will take office without a Treasury secretary amid the biggest financial crisis in decades.

Current and former IMF officials said the fund provided numerous warnings to U.S. employees about payroll taxes. According to IMF documents released by the Senate Finance panel, Mr. Geithner regularly received information about his tax obligations.

Mr. Geithner didn't make any Social Security or Medicare tax payments on his income during the years he worked for the IMF, though he did pay income taxes. After the Internal Revenue Service audited him in 2006 and discovered the payroll-tax errors, Mr. Geithner corrected them for 2003 and 2004. Only after Mr. Obama picked him for Treasury secretary last fall did Mr. Geithner pay the Social Security and Medicare tax he owed for 2001 and 2002.

Mr. Obama offered a vote of confidence Wednesday that echoed a defense offered by transition officials a day earlier: Mr. Geithner made a mistake common to people who work for international institutions.

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It's possible some of Mr. Geithner's problems stemmed from bad advice. In 2004, an accountant advised Mr. Geithner in writing that he did not owe employment taxes. An accountant who reviewed Mr. Geithner's 2001 tax return also didn't inform Mr. Geithner he owed taxes, according to an Obama aide familiar with the situation.

As an international body, the IMF doesn't withhold taxes for U.S. citizens, and employees are responsible for paying their taxes. The IMF pays employees additional tax allowances to cover federal and state income taxes, and the employer's portion of payroll taxes.

Mr. Geithner prepared his own federal-tax returns during the first two years he worked at the IMF, 2001 and 2002, according to the Senate Finance Committee report.

An IMF booklet on taxes, which Mr. Geithner told the Senate panel he received, instructed employees that "you pay the employee's share of U.S. Social Security taxes."

Mr. Geithner's quarterly tax-allowance payments also included a statement of what the money was to be used for, and had an entry for "SE tax" -- meaning "self-employment" taxes. In a wrinkle in U.S. tax law, U.S. citizens at the IMF pay Social Security and Medicare taxes as if they were self-employed. Current and former IMF officials said that U.S. officials widely understood "SE tax" to mean payroll taxes.

Mr. Geithner "filled out, signed and submitted an annual tax allowance request worksheet with the IMF that

states, 'I wish to apply for tax allowance of U.S. federal and state income taxes and the difference between the "self-employed" and "employed" obligation of the U.S. Social Security tax which I will pay on my Fund income,'" the Finance Committee reported.

Tax professionals noted that even trained preparers sometimes miss the subtleties involved in taxation of employees of international organizations.

The IRS in late 2006 launched a settlement initiative aimed at noncompliant employees of foreign embassies, as well as international organizations such as the IMF. At the time, the IRS said as many as half of affected employees were out of compliance with tax rules in one way or another.

Michigan Property Tax Basics

How Property Taxes are Calculated -

To understand how taxes are calculated, a look back at Michigan's history is in order.

Taxable Value vs. Assessed Value

Until 1994, property in Michigan was assessed at half its market value for tax purposes. This is known as a property's assessed value (AV).

In 1994, Michigan voters passed Proposal A, which changed the State's constitution. Proposal A shifted some of the tax burden off of property and onto the sales tax, which rose from (4) to (6) cents on every dollar spent.

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The result of this proposal was the development of a new way of calculating property taxes using what's known as a property's taxable value (TV). A property's taxable value is determined using one of the equations (whichever one is less) below:

(Last year's taxable value) - (losses) + (5%) + (additions); or
(Last year's taxable value) - (losses) + (the rate of inflation) + (additions)

Under Proposal A, the growth of a property's taxable value is limited or "capped" with annual increases of not more than the lesser of five percent (5%) or the Consumers Price Index (CPI), which is set by the Michigan State Tax Commission.

The taxable value cannot be greater than a property's assessed value. However, when a piece of property is sold or a title is transferred, the property's taxable value becomes equal to the amount of its assessed value for the tax year following the year in which the sale or transfer took place. This is called "uncapping" a property's taxable value. After this has taken place, the lesser of five percent (5%) or the CPI applies to future increases in taxable value, until there is another sale or transfer of ownership of the property.

Property Assessment

Even though taxes are based on taxable value, the assessed value is still calculated each year so that property values can be uniformly assessed at 50 percent of market value, as required by the Michigan Constitution.

Most Assessor's Offices annually assesses each property within the city using mass appraisal techniques. This involves studies and analysis of the local real estate market.

Assessors also considers new construction, improvements to property (such as installing fencing or new pavement), and demolition of structures when calculating additions and/or losses to property values.

What's a Mill?

The property tax rate in Michigan is referred to as a millage, and it's figured in mills. One mill is equal to 1/1,000 of a dollar.

More simply, for every \$1,000 in taxable value, a property owner will pay \$1 in property tax.

Figuring Your Taxes

Property owners can calculate their tax bill by multiplying their taxable value by the millage rate.

For example, if the City's millage rate is 10 mills, property taxed on a home with a taxable value of \$50,000 would be \$500. The mathematical equation below illustrates how this is figured:

$$10 \div 1000 \times \$50,000 = \$500$$

Administration Fee

In addition to levying property taxes, many cities levy a relative low, such as one percent (1%), administration fee based on the amount of property tax paid. This helps cover the costs to

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determine and defend annual assessments.

To figure the amount due in administration fees on a home with a taxable value of \$50,000, see the example below:

\$500 property taxes x 0.01 = \$5.00

Total Taxes Due: In the example above, the administration fee of \$5 added to \$500 in property tax would equal a total of \$505 owed.

Skipping Required Withdrawals

A new tax law will allow retirees to skip required withdrawals from individual retirement accounts and related accounts this year. The change -- signed into law by President Bush last month -- is intended to give beaten-down nest eggs time to rebound from the brutal bear market.

But the new law may also create confusion, particularly for those just starting to take required withdrawals.

Here are answers to questions about the new law:

How do the existing rules governing IRA withdrawals work?

Normally, IRA owners over age 70½ must withdraw money each year. For your first withdrawal, however, the deadline is extended until April 1 of the year after you turn 70½. People who turned 70½ in 2007, for example, had until April 1, 2008, to take their first required distribution.

In a typical year, to calculate how much to withdraw, you look at your account balance as of the previous Dec. 31 -- and then divide that figure by your remaining life expectancy. (Life-expectancy tables can be found in Internal Revenue Service Publication 590.) Most people who inherit IRAs or 401(k)s can spread withdrawals over their own life expectancies.

These requirements also apply to 401(k)s and some other employer-sponsored plans, but not to defined-benefit pension plans or Roth IRAs. (If you are still working, you aren't required to take distributions from your current employer's retirement plan.)

What impact will the new law have?

The new law suspends required distributions in 2009. This gives those who can afford to leave their nest eggs alone a better chance of recovering some of the investment losses they sustained last year.

You'll have more dollars working for you in the event of a stock-market rebound.

If you don't need to pull money out of retirement accounts for living expenses, the new law will also delay the tax you would have owed on your 2009 distribution.

Unless Congress decides to extend the moratorium, those over age 70½ -- along with those who have inherited IRAs or 401(k)s -- will be forced to resume taking withdrawals in 2010.

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If I turned 70½ in 2008 and had planned to take my first withdrawal by the April 1, 2009, deadline, does the new law permit me to skip it?

No. The law suspends distributions only for 2009. Although first-timers are allowed to delay 2008's distribution until April 1, 2009, the withdrawal still counts toward your obligation for 2008, Mr. Slott says. So, if you turned 70½ last year and decided to wait until close to April 1 of this year to make your first withdrawal, that deadline still applies. To calculate this distribution, you would use your account balance as of Dec. 31, 2007.

What if I turn 70½ this year?

This gets a bit more complicated. In effect, you will have until Dec. 31, 2010 to take your first withdrawal -- even though the IRS will consider that withdrawal to be your second distribution. Here's how it works:

Under the usual rules, people who reach age 70½ in 2009 -- and who wait until early 2010 to take their first withdrawal -- would have to take two distributions in 2010: one for 2009 (their first distribution) and one for 2010 (their second distribution). That second distribution would have to be taken by Dec. 31, 2010. Of course, the new law suspends distributions for 2009. Thus, first-timers -- anyone who turns 70½ in 2009 -- won't be required to make a withdrawal in 2009, or in the first three months of 2010. In short, such individuals simply can skip that "first" distribution.

But Uncle Sam will still want you to take the "second" distribution -- the one for 2010 -- even though, as far as your retirement savings are concerned, it's your first withdrawal. Again, you would have until Dec. 31, 2010, to take that "second" distribution.

Can I still donate money from my IRA to charity without paying income taxes first?

Yes. In October, lawmakers resurrected a tax break available to those who make donations directly from their IRAs to charity in 2008 and 2009. Under the law, individuals age 70½ or older can donate as much as \$100,000 from an IRA to a public charity. No taxes are due on the withdrawal, and the donation counts toward a person's required annual withdrawal. This year, of course -- with mandatory distributions suspended -- the tactic loses a bit of its luster. But those who wish to make a direct donation from an IRA can still do so -- income-tax free.

Can I convert some or all of my IRA to a Roth IRA in 2009?

Yes, provided your adjusted gross income is \$100,000 or less, you'll be eligible to make such a move.

Typically, those taking mandatory distributions from a traditional IRA aren't allowed to turn around and deposit that money into a Roth IRA. You can take your required payment and then convert all or part of the IRA balance if you wish. But in 2009, any withdrawals can be used to fund a Roth.

Credit Scores

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It used to be that a 720 credit score or higher would get you the best interest rates. With lenders suddenly focused on credit risk, that isn't necessarily the case anymore.

To lock in the best interest rate on a 30-year fixed-rate home mortgage, it now takes a 760 or above, according to data from Fair Isaac, developers of the FICO score. For a 15-year home-equity loan a 740 FICO score is sufficient to lock in the lowest interest rate now. And borrowers will need a 720 for the best interest rate on a 36-month auto loan.

Your credit, or FICO, score is a three-digit number, ranging from 300 to 850 that lenders use to try and gauge what you are going to be like as a borrower. Fair Isaac generates the score based on your credit report from one of the three credit-reporting agencies: Equifax, Experian or closely held TransUnion Corp. The FICO score is used by more than 90% of lenders.

But despite higher standards from lenders, the average credit score has stayed relatively flat at 690. This leaves a whole swath of good customers scrambling to boost their scores.

There are still some tactics consumers can employ to boost their credit scores in an otherwise tough environment.

Look at your usage. Lenders recently have done two major things to crimp customer credit ratings: Cut back on credit limits and close dormant accounts. Even if consumers aren't maxing out their cards -- and they shouldn't -- having a high credit limit helps with the amounts-owed portion of the credit

score. The higher your limit and the more responsibly you use it, the higher your score.

In the past, customers could call up their lenders and ask for their limits to be reinstated, or even increased. But many financial institutions are being less generous as they fight to offset huge losses.

If that doesn't work, replace that credit line with a new credit card. Your credit score will take a temporary hit after applying for a new line of credit. But in the long run, having a higher credit limit should lift your score.

Pay on time, every time. Thirty-five percent of the FICO credit score is payment history, so paying off at least the minimum balance on time is crucial. The newest version of Fair Isaac's score, FICO 08, is set to unroll in 2009, and is even more sensitive to payment history.

Keep accounts open and active. Rather than closing unused lines of credit, keep them open. Call up the issuer to make sure the account isn't closed due to inactivity. If you are worried about overspending on the card, put it in a safe place in your home, to avoid the temptation of racking up unnecessary charges.

Piggyback, if eligible. One of the original provisions of FICO 08 was eliminating authorized user accounts, such as children or spouses, to cards. Due to uproar from consumers and the credit-reporting firms, that isn't the case any longer, a victory for benevolent borrowers trying to help loved ones establish a credit history.

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Order a copy of your credit report. Twenty-five percent of credit reports have an error that could result in a lower credit score, according to a 2004 study from the U.S. Public Interest Research Group.

You're legally entitled to one free from each of the credit reporting firms through annualcreditreport.com. Fair Isaac and the three credit reporting agencies charge for consumers to see their FICO credit score, but your credit report, the blueprint for your credit score, is free.

If you are applying for a loan from a specific lender, ask which of the three FICO scores (the Equifax, Experian or TransUnion scores) they will use. They aren't required to tell you, but it could save you the hassle of having to order all three scores.

If you are curious what your credit score is, but don't want to shell out the cash, there are several credit-score simulators available on Credit.com, CreditKarma.com as well as Bankrate.com. Although these are only simulators, they might help give a general sense of where your credit rating stands.

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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