

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 number of tax notes, a Question of The Month regarding retirement plans, followed by an article about IRS audit reconsiderations and an unusual case of a charitable deduction.

Tax Notes and Updates

Estate Tax Reform

Estate tax reform is at least a year away but the outlines of a bill are already clear because both of the presidential candidates believe the estate tax should not be permanently repealed. This is a position that is also favored by Democratic leaders in Congress.

The main points still to be negotiated are the top estate tax rate and the exemption amount. That will make estate planning much easier between now and when Congress finally takes action.

McCain and Obama share common ground. Both of them oppose keeping current law, under which the tax ends in 2010 but returns the following year with an exemption of \$1 million and a 55% maximum tax rate.

Contrast that with the levels scheduled

to go into effect for 2009: A \$3.5-million exemption amount and 45% maximum rate.

Lawmakers and estate planning professionals agree that this situation is untenable, and that Congress has to pass estate tax reform legislation by the end of next year.

And they're close on the exemption. Obama would keep it at \$3.5 million. McCain favors \$5 million. The key difference is where they would set the top rate: McCain would cut the maximum tax rate to 15%, while Obama would set it at 45%. Figure on a rate closer to 45%, since Democrats will keep hold of Congress in 2009.

Both candidates support making the exemption portable for spouses. Such a change would greatly simplify estate planning for surviving spouses by eliminating the need for taxpayers to set up trusts in their wills solely to save on estate taxes. Couples also wouldn't be forced to re-title assets to equalize estates.

Thus, when the first spouse dies, the unused exemption would simply pass through to the survivor and be available for use when that spouse dies. With portability, Obama's proposal would effectively allow for a \$7-million estate tax exemption for couples and McCain's plan would make it \$10 million.

Currently, if a spouse dies without having fully used his or her exemption, the remaining exemption is wasted.

A number of other issues would remain for lawmakers to resolve: The tax break

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for estate taxes paid to states. States are pushing Congress to convert the current-law deduction back to a credit, which existed prior to 2005.

But Congress will balk at doing so because the change would lose too much revenue.

The Gift Tax

The lifetime gift tax exemption is \$1 million, significantly less than the estate tax exemption. So, tax writers are mulling combining the two again. That change would allow taxpayers to make larger lifetime gifts tax free to heirs.

Lawmakers will take action to prevent rules from taking effect in 2010 that require heirs to use the decedent's income tax basis when figuring gain or loss on sales of inherited assets. Instead, tax writers will act to keep the current rules that set the tax basis for inherited assets as their value on the date of the owner's death.

Lawmakers realize that being forced to value assets under a carryover basis rule would create a tax planning nightmare for heirs.

Business Tax Breaks In The Stimulus Law

Time to claim the business tax breaks in the stimulus law is growing short. Firms need to plan now in order to maximize the available tax benefits.

The bulk of the relief expires at the end of 2008, and Congress will not extend it. So make sure that your business will be able to act in time to take full advantage.

Start with bonus depreciation.

Companies can write off 50% of the cost of new assets placed in service in 2008.

The remaining 50% of the cost is recovered via depreciation under the normal rules. Used assets do not qualify for this break. Most assets are eligible - those that are depreciated over 20 years or less.

That includes machinery, equipment, land improvements and farm buildings, even leasehold improvements that are made to the interior of commercial realty.

Businesses can expense up to \$250,000 of assets that are placed in use during the 2008 tax year, nearly twice the previous ceiling. The full \$250,000 can be claimed until \$800,000 of assets are put in use in the 2008 tax year. Firms that are squeezed by this cap still can use 50% bonus depreciation. For fiscal year companies, the higher limit applies only to assets placed in service in the 2008/2009 fiscal year.

So for firms on a July to June year, only assets in use after June 30, 2008 qualify.

2008 is also a good time to buy a car for business. The maximum write-off in the first year is \$10,960, nearly \$8,000 more than in 2007. The limit is higher for new SUVs with loaded weights over 6,000 pounds. For ones in use by Dec. 31, \$25,000 of the cost can be expensed, half of the remaining balance can be claimed as bonus depreciation, then 20% of what's left can be taken as regular depreciation.

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On a \$50,000 new heavy SUV put in use this year, \$40,000 can be written off, assuming 100% business use. Used heavy SUVs do not get bonus depreciation.

And for pickup trucks put in use in the 2008 tax year with loaded vehicle weights over 6,000 pounds, the entire cost can be expensed if two requirements are met: Their truck beds must be at least six feet long and must be separate from the cab.

Loan Forgiveness For Law Students

The IRS reverses itself on loan forgiveness programs for law students.

Such assistance is tax free when it is granted under law school programs to reduce the outstanding debt of graduates who take low paying public service jobs, such as public defenders or prosecutors. Earlier, IRS said lawyers couldn't get relief because the law applied only to doctors, nurses and teachers (Rev. Rul. 2008-34).

Soldiers Who Terminate Auto Leases

Good news for soldiers who terminate auto leases when they are deployed: They don't owe income tax on the forgiven debt or on early termination fees waived by car leasing companies, the IRS privately rules. By law, lessors are barred from charging the fee if the soldier voiding the lease is deployed for at least 180 days.

Other Tax Relief For Soldiers

Bush's OK of tax relief for soldiers starts the clock on several tax breaks:

Disabled retired veterans get some tax relief when their retirement pay is reclassified as tax free disability benefits. Refund claims for reclassifications that were made after Dec. 31, 2000 can be filed with the IRS before June 18, 2009.

Small firms get a 20% credit on makeup wages paid to called-up reservists after June 17, 2008 and before Jan. 1, 2010. The top credit is \$4,000 per worker. Only companies employing an average of fewer than 50 workers a year can qualify.

Military death gratuities are eligible to be rolled over into Roth IRAs or Coverdell education savings accounts. Rollovers of sums for death from injuries after October 6, 2001 and before June 17, 2008 must be made by June 17, 2009.

And flex plan balances can be paid to workers called to active duty. Payouts can begin after June 17 if the plan is amended to allow such distributions. This allows reservists to avoid forfeiting unused amounts in their health flex plans. But there's nothing in the law that requires companies to permit the withdrawals.

IRS Reclassification Of Your Contractors

If the IRS reclassifies your contractors as employees after an audit. You can get relief on the extra Social Security taxes and withholding that you owe to the Revenue Service, as a recent private letter ruling points out.

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Reduced penalties apply when the misclassification is unintentional. Income tax withholding is only 1.5% of wages, which is far below the normal level. And the tax rate for the employees' share of FICA tax is 1.53% instead of 7.65%. These percentages are doubled if 1099 forms were not filed for the workers.

There is no relief for the employers' share of FICA. That rate remains 7.65%. And no interest is due on the reduced penalties for income tax withholding and the employees' share of FICA tax. Interest is owed on the firm's share of FICA.

Special Withholding Rules For Severance Pay

Special withholding rules apply to severance pay, the Service says. Severance pay is treated as a payment of supplemental wages, so firms get a choice: They can withhold a flat 25% of each payment or they can aggregate severance pay with any regular wages and compute withholding on the total (Rev. Rul. 2008-29).

Late Filed S-Corp Elections

The Service continues to accept excuses for late-filed S elections.

Normally, firms that want to be S companies have to file Form 2553 with the Revenue Service no more than 2½ months after the tax year has started. But IRS will approve a late election if the corporation can show reasonable cause, such as relying on a tax pro to file the election and later finding it wasn't sent in. Ditto for late-filed elections to

treat a trust as a permitted S company shareholder.

And IRS will excuse inadvertent terminations of S status. One example: An S firm made distributions to shareholders disproportionate to their ownership, causing the corporation to have two classes of stock, a no-no for S companies. IRS let the firm make remedial payments to shareholders to resolve the slipup.

Buying Back Stock Given To Charity

Quickly buying back stock given to charity won't taint a charitable write-off, as long as the charity isn't obligated to sell back the shares, the IRS says in a private ruling. It had OK'd a gift of closely held stock to a donor-advised fund, which had a policy of selling such stock. The fund quickly sold the stock to a trust that the donor had set up for his wife. Although the donor was aware beforehand that the fund intended to sell the stock right away, he still avoids paying tax on the stock's appreciation because he couldn't force the fund to sell the shares. It doesn't matter that the donor's own trust ended up repurchasing the stock.

Deducting Expected Customer Returns

An accrual method company can't deduct expected returns from customers, the Tax Court says to a firm that sells remanufactured automotive parts.

Customers are allowed to return the used parts for a store credit, but the firm doesn't know when or if they will. The court said that the company is required

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to include the full sales price in its gross receipts (Bigler, TC Memo. 2008-133).

Corporate Directors

Even a brief stint as a CEO nixes later status as an outside director for tax purposes. An outside director who filled in for a CEO who quit is considered to be a former corporate officer and thus does not qualify as an outside director in determining if compensation is performance based. Performance-based pay is exempt from the \$1-million cap on deductible compensation (Rev. Rul. 2008-32).

Election of Simplified R&D Credit

Elections of the simplified R&D credit cannot be made on amended returns, IRS says in new regulations. The election must be made on an original tax return. Companies that have consistently increased their spending on R&D from year to year usually will benefit from using the simplified R&D credit. The credit is equal to 12% of the difference between the current year's research costs and half of the average of research costs for the prior three years. If the business has not been in existence for the requisite three years, the credit is 6% of the current year's R&D expenses.

New Mileage Rate

The IRS drives up the standard mileage rate for business usage. The rate will be 58.5¢ per mile for the final six months of this year, an 8¢ hike. With fuel prices at record highs, the Service decided to act in midyear. The mileage rate that will

apply for next year will be officially announced in the fall.

The mileage rate for medical and moving expenses also increases by 8¢ to 27¢ a mile. But the rate used for when driving for charity stays at 14¢ a mile. This rate is set by law, so only Congress can change it. Lawmakers have no plans to do so. Congress last raised this rate in 2005 and 2006 for Katrina-related driving.

Note that firms needn't pay the higher rate in reimbursing workers for using their own vehicles. Many employers will continue to pay 50.5¢ per mile.

Employees who itemize deductions can take the shortfall as a business expense on Form 2106 but only to the extent that the total tops 2% of adjusted gross income. Thus, a lot of workers will get no benefit if their employers stick with the old rate.

Changes To Preparer Laws

IRS gives preparers a break on the new tighter reporting standards. Required disclosures need to be made only to clients, not to the Service, IRS says in proposed rules. The rules flesh out a 2007 law that requires preparers to disclose when a position that's taken on a tax return has a less than 50% chance of being correct. Tax pros had complained that making disclosures to the Service would mean tattling on clients. The rules also caution preparers to keep documents that substantiate any such disclosures. That way, when IRS agents come calling, the preparer can show that he or she has the records to rebut an IRS penalty.

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Congress will provide more relief this year or next by requiring disclosure only in situations where there is a less than 40% chance that the position taken will be upheld by the Service. That's the same standard that taxpayers must meet.

Gym Fees For Travelers

Watch out if you reimburse traveling employees for gym fees they incur. The payments are taxable and hit with payroll taxes, IRS officials say. The cost of using a health club while away on business is a personal expense because the facility is not located on the business premises of the employer.

Medicare Providers Owing Back Taxes

Medicare providers owing back taxes will soon be under the gun. In October, IRS will begin to slap levies on Medicare payments to hospitals, doctors, nursing homes, hospices and others in arrears on income and payroll taxes. A recent report by Congress' watchdog agency, the Government Accountability Office, says more than 27,000 Medicare providers receive payments but stiff the taxman.

Tax Positions Of Presidential Candidates

Return to the presidential candidates' tax positions for just a moment. Look where else they share common ground: Corporate tax rate cuts.

Obama now looks more amenable to reducing corporate taxes, after hiring

advisers who advocate cutting the 35% top rate to 30.5% while scrapping other tax breaks. To Obama, it's a way of creating a simpler and fairer corporate tax system. McCain proposes to slash the top rate to 25% to help U.S. firms compete with foreign ones.

Would a Democratic Congress go along? There's at least a fair chance: House Ways and Means Chairman Charles Rangel (D-NY) favors a corporate tax cut that's paired with tax hikes, such as ending the deduction for domestic production and LIFO inventory valuation. That would help some companies and hurt others. So no matter who wins the election, a corporate rate cut is not out of the question.

Question of The Month – Retirement Plans

Question -

I am employed through a University, and max out my 403(b), but I also generate some income through an LLC. Even with maxing out my 403(b), if I set up a Solo 401(k) through my LLC, am I correct to assume I can contribute up to \$15,500 + 20% of my gross income from my LLC to the Solo 401(k)?

Answer -

If you max out your salary deferrals through work, then the Solo 401k won't get you anything over a SEP. That's because your salary deferrals from all your sources of income are limited to \$15,500 in 2008.

So if you contribute \$15,500 into your employer's 403b plan through salary deferrals, then the amount you could

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contribute into your Solo 401k plan would be 20% of net self-employment earnings - which is the same amount you could contribute to a SEP.

Solo 401k's make the most sense for self-employed people who don't have access to a 401k plan or 403b plan through another employer.

There are retirement plans out there that allow you to put away significantly more money than the amount you can contribute into a SEP or Solo 401k.

SEPs and Solo 401k's are known as Defined Contribution Plans. The amount of money you have when you retire is a function of the money you contribute over the years.

With a Defined Benefit (DB) plan, the amount of money you can contribute into the plan each year is a function of how much you'll need to have when you retire to maintain your current standard of living. The amount you can contribute into a DB plan generally exceeds the amount you can contribute into a defined contribution plan by a wide margin.

Defined Benefits plans are the actuarial opposite of Defined Contribution Plans.

With a Defined Contribution plan, you determine what percent of your income you are going to contribute (up to the IRS maximum contribution limit), pick your investments, and hope for the best. Whatever your money grows to is what you will have available for retirement.

With a Defined Benefit plan, you determine what income you want to have at a certain retirement age and make

your contributions to reach that number (up to the IRS maximum contribution limit.)

Generally, the shorter your time frame until retirement, and the more conservative your investment return assumptions, the more money you can put away. As a result, these plans generally work best if you are in your late 40's or older.

If you add insurance to these type of plans (because initially they have a very low assumed rate of return), you can put away substantially more money. You can Google 412(i) plans to see what I mean.

However, as the policy performs, you will need to put less money away. By the same token, if the market tanks or your investments tank, you can put away more money as well.

One thing to keep in mind is that SEP-IRA plans can be deceptively expensive. There may be a better, mid-range alternative.

If you have employees, a SEP-IRA can be a terribly costly way to gain a tax deduction and save for retirement. Let me illustrate. Suppose you earn \$230,000 or more. You want to put in the max \$46,000 into the SEP-IRA. You have two employees, one earning \$45,000 a year and the other earning \$35,000 a year. Into the SEP-IRA, you'll be putting into the SEP-IRA for one \$9,000 and for the other \$7,000.

Using a cross-testing 401k you could likely cut that \$16,000 a year cost in required contributions for your staff to

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just \$4,000. It depends on factors such as age and so forth, but as you can see, the savings could be \$12,000 a year.

IRS Audit Reconsideration

The Case –

A taxpayer had her 2004 return audited. Audit was "handled" by an out of town relative. A copy of the 4549 was obtained, and adjustments for \$89,000 to COGS, along with other smaller amounts were noted. Taxpayer doesn't know what was done on audit, and never signed anything. Audit letter shows SE income of \$60,000. Is it possible to have this audit reopened and try to fight at least some of these adjustments?

Analysis -

It is very, very hard to get an audit reconsideration. You must be able to clearly establish that you do have all of the documents required to change the original assessment, otherwise you will be told to file a claim after the tax has been paid in full. This is from speaking to an experienced Revenue Agent, who has turned down many such requests.

One thing to do in this situation is to get Publication 3598. One of the requirements for an audit recon is that the information that you submit must not have been considered previously in the audit. That is where IRS finds the greatest weaknesses when reviewing an audit recon.

Another suggestion is that you take the information that you have and plug it into the return (as corrected by the audit) and see if it changes the audit results in

any meaningful way. If it does not, then it may not be worth going through the process.

Another thing about audit recon is that it is normally submitted through a collection person. They do not have a sufficient grasp of the audit process to know what will and what will not fly

Finally, if the taxpayer cannot pay in full all at once, they still have two years from the date the account was paid in full to file a claim.

Extreme Makeover

There are several websites for families who have received new homes in the extreme makeover series, and they all ask for donations for various purposes including paying expenses so the families can remain in the homes.

None of those sites say anything about whether the donations are tax deductible as charitable contributions or not.

Such donations are probably not charitable donations because the organization is not a qualified charitable organization. As with all donations a receipt should be given and you should look at that receipt for indications that the organization is qualified.

Even if not deductible that way, one would think there would be enough of an advertising factor for local businesses to claim it as an advertising expense, but each situation should be examined on its merits before claiming a deduction of any sort. A safe decision would appear to be to deduct only the cost of the

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For More Information

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