September 2010

Tax Notes and Perspectives

KING & OLIASON

INSIDE THIS ISSUE:

2010 Health Care Act

The recently passed Health Reform legislation includes many changes that may impact you, your family members, and your business. Selected issues with tax implications include:

Additional Medicare Taxes on Higher Income Individuals Beginning in 2013

Employees will be required to pay an additional 0.9% on wages above $200,000 ($250,000 for joint returns). Self-employed persons will also pay an additional 0.9% on earnings over those thresholds.

Additionally, taxpayers with adjusted gross income over $200,000 ($250,000 for joint returns) will be subject to a 3.8% surtax on net investment income. Net investment income includes interest, dividends, royalties, rents, and gains from the sale of investment property.

Tax-free Health Insurance Covers Young Adults under age 27

Effective 3/30/10, the amount your employer pays for health insurance coverage of your children under age 27 can be excluded from taxable income. If you are self-employed, the amount you pay for health insurance coverage of your children under age 27 is deductible. This applies even if your children can no longer be claimed as dependents.

Phase-in of Changes

Beginning in 2011:

- Only insulin and prescribed medicines can be paid out of a Flexible Spending Account, Health Savings Account, Archer Medical Savings Account, or a Health Reimbursement Account. Over-the counter medicines can no longer be paid for out of these accounts.
- Employers will be required to disclose the value of health insurance coverage provided on employee W-2s.

In 2012:

- Businesses that pay more than $600 to corporate providers of services or merchandise will have to provide them with a tax form, most likely a Form 1099-MISC.

In 2013:

- The itemized deduction threshold for medical expenses will be raised from 7.5% to 10% of adjusted gross income (AGI) . The AGI floor for individuals age 65 or older and their spouses will remain unchanged at 7.5% through 2016.

Starting in 2014:

- U.S. citizens and legal residents will be required to have health insurance, or pay a penalty based on household income and number of uninsured people in the household. The maximum penalty per household is $285 for 2014, $975 for 2015, and $2,085 for 2016. Those who can't afford health insurance are exempted from the penalty.

Health Insurance Credit for Small Businesses

Small employers that provide health insurance for their employees may qualify for a tax credit, beginning in 2010 and running through 2013. A small employer employs no more than 25 full-time employees, pays annual wages that average (*continued on page 3*)

The impact of expiring tax cuts on income and estate tax planning

The 2001 and 2003 tax cuts are scheduled to expire after 2010. This directly impacts income and estate tax planning in the remaining months of this year.

Income Tax Planning

If Congress doesn't intervene and change the law, income and capital gains taxes will increase in 2011. The top ordinary tax rate will increase from 35% to 39.6%, while the top capital gains rate will increase from 15% to 20%. No phase out of itemized deductions or exemptions applies in 2010. Next year, phase outs of up to 80% will be restored.

The Obama administration has proposed retaining current tax rates for individuals with gross income under $200,000 ($250,000 for married couples), resulting in the higher rates and phase outs applying only to higher income taxpayers in 2011 and subsequent years.

Given these increases in tax rates for 2011 and future years, you may want to consider recognizing capital gains or other income in 2010, while rates are still low and deductions are not phased out.

Estate Tax Planning

Subject to potential Congressional action, federal estate and generation skipping transfer (GST) taxes have been repealed for 2010. As publicized by the recent passing of George Steinbrenner, the result could be an added boon to heirs of wealthy individuals who die this year.

Also in 2010, the provision for stepping up an asset's tax basis to fair market value at date of death has been replaced by a modified carryover basis, which allows for only a partial step up in basis.

In 2011, these transfer taxes will revert to their pre-2001 levels. The estate and GST exemptions will again be based on a $1 million amount (down from $3.5 million in 2009), and the top tax rate will return to 55% (up from 45% in 2009). Stepped up tax basis of assets at death will be restored.

The gift tax (with a $1 million lifetime exemption) remains in place, although the top rate increases from 35% in 2010 to 55% in 2011. The Washington state estate tax, with a $2 million exemption and rates ranging from 10% to 19% will not change.

Due to these wide variations in exemptions and rates, it is possible that Congress may retroactively restore the 2009 exemptions and rates to the beginning of 2010 and all subsequent years. At the time this newsletter went to press, no legislation had passed.

Taxpayers often use formulas based on current tax exemptions in their wills to determine the funding of trusts and transfers to various heirs. To prevent any unexpected changes in funding which would take place in the absence of an estate or GST tax, Washington state passed legislation earlier this year which generally assumes that 2009 federal exemption levels remain in place for 2010.

However, these legislative changes may not meet the needs of all taxpayers. You should consider having your wills reviewed to ensure that assets will be distributed according to your expectations. Also, for clients with trusts which are not exempt from GST tax or for those wishing to make large transfers to their grandchildren, unique planning may be possible in the absence of a GST tax in 2010.

Please contact us to discuss how these changes may impact your own planning

Proposed legislation may impact GRATs

A Grantor Retained Annuity Trust (GRAT) is a trust created by a person (the grantor) who has the right to receive fixed annual payments over the trust term. Any assets remaining in the trust at the end of the term transfer to the designated beneficiaries free of federal gift or estate tax.

For a GRAT to be successful, the grantor must outlive the term of the trust (currently a minimum of two years) and the assets in the trust must appreciate at a rate higher than a hurdle rate prescribed by IRS regulations.

If you have been considering a GRAT, now is the time to act for a number of reasons. Congress is expected to pass legislation this year that would require a 10 year minimum GRAT term, increasing the risk that the grantor won't survive the trust term. Many assets currently have historically low values, increasing the potential for appreciation during the trust term; and finally, the current hurdle rate is very low (2.4% for trusts established in September 2010).

All of these factors combined make this a particularly opportunistic time to establish a GRAT if you want to transfer an appreciating asset to a beneficiary free of gift and estate taxes.

2010 Health Care Act (cont'd)

no more than $50,000, and pays at least 50% of the health insurance premiums for the employees who are enrolled in the plan. The credit is generally 35% of the health insurance amounts paid by the employer, but the credit phases out as business size and average wages increase. No credit is allowed for amounts paid on behalf of partners, sole proprietors, 2% shareholders of an S Corporation, 5% owners of the employer, or dependents of these individuals.

In 2014 and later, eligible small employers who purchase coverage through a state-run insurance exchange will be eligible for a tax credit for two years of up to 50% of their contribution.

The HIRE act: Impacts employers, businesses, and individuals

Employer Credits

The HIRE Act exempts **employers** from paying the employers' 6.2% share of the Social Security payroll tax on the 2010 wages of each newly hired qualified employee. Qualified employees are individuals who for the last 60 days have been unemployed or employed for 40 hours or less.

In addition, the HIRE Act provides for an employer credit of up to $1,000 for each qualified unemployed worker retained for at least 52 weeks.

Section 179 Deduction

The HIRE Act extends the current Section 179 deduction limit through 2010, which allows **businesses** to deduct up to $250,000 of assets purchased during the year. The allowed 179 deduction phases out once the business's purchases exceed $800,000 for the year. The Section 179 limit for the 2011 tax year is $25,000.

Foreign Account Reporting

In addition to current foreign financial account reporting, the Act requires i**ndividuals** with aggregate foreign financial assets greater than $50,000 to disclose their holdings on their individual income tax returns beginning with the 2011 tax year.

Tax Reminders

American Opportunity Tax Credit (AOTC)

The AOTC replaces the Hope Scholarship Credit for 2010. It allows up to a $2,500 credit per year for each of the first four years of the student's post-secondary education. The credit begins phasing out when income reaches $80,000 for single filers and $160,000 for joint filers.

Residential Energy Credits

A credit is available for 30% of the cost of certain energy-efficient property or improvements placed in service in 2010. The maximum credit you can claim for 2009 and 2010 combined is $1,500. The property must meet certain energy efficiency standards to qualify.

Gift Tax Exclusion

The gift tax annual exclusion remains at $13,000 for 2010.

Making Work Pay Credit

A credit of 6.2% of earned income, with a maximum credit of $400 per person ($800 for a joint return) continues in 2010. The credit begins phasing out when income reaches $75,000 for single filers and $150,000 for joint filers.

Converting a Traditional IRA to a Roth IRA: Is This Right for You?

Beginning in 2010, a taxpayer may convert all or part of a Traditional IRA into a Roth IRA, regardless of income. Previously, such conversions could only be made if adjusted gross income was $100,000 or less. The funds that are converted are included in taxable income in the year of conversion.

There is a special provision for conversions made in 2010. Half of the income from the conversion may be reported in 2011 and the other half is reported in 2012. Conversions can be made from traditional IRAs (including SEP IRAs and SIMPLE IRAs) as well as employer-sponsored plans, such as a 401(k). For conversions occurring after 2010, the funds that are converted must be reported in full in the year in which the conversion is made.

Some of the benefits of a Roth IRA include:

- there are no required minimum distributions at age 70 ½, allowing your funds to grow tax-free longer, and
- you pay no taxes on qualified withdrawals after age 59 ½.

You may want to consider a Roth conversion if any of the following apply to you:

- you expect to be in a higher tax bracket in retirement, either because you expect your income to increase or you expect tax rates to increase,
- you expect to have relatively low taxable income in 2010 or a Net Operating Loss carry forward that could offset additional income ,
- you have charitable contribution carryovers that could offset some of the additional income from the conversion.

Please note that if you plan to leave your IRA account to your heirs, post-death distributions to the beneficiaries are tax free.

The conversion is most beneficial if you are able to pay the tax with non-IRA assets, as using assets from the account to pay the tax will reduce the amount available to grow tax free and possibly trigger an early withdrawal penalty.

A Roth conversion is not for everyone. There are many factors that need to be considered. Keep in mind that you don't need to convert the entire balance, but may convert only part of it. Also, if you make a Roth conversion that turns out to be disadvantageous, you have a window of time to "undo" the conversion, protecting you against adverse market swings.

Please contact us if you would like assistance in determining if a Roth conversion would be beneficial for you.

Mandatory e-filing for 2010 returns

The IRS will require electronic filing of 2010 tax returns for many of King & Oliason's individual and trust clients. Many procedural changes will occur on our end, but you will notice changes as well.

You will continue to receive a copy of the return to keep for your records, but this copy will be in PDF (electronic) format, unless you specifically request a paper copy. As we move toward electronic filing, we urge all of our clients and their investment advisors to provide as much tax return data as possible in electronic format.

Some individuals will not qualify for e-filing for the 2010 tax season because there are certain tax forms and attachments that the IRS does not yet have the ability to process electronically. If we determine that your tax return does not qualify for e-filing, you will receive a paper filing copy of your return to sign and mail as you always have. Even if your 2010 tax return cannot be e-filed, your return will likely be transitioned to e-filing in an upcoming year, as the IRS e-file system becomes more sophisticated and inclusive.

Please watch for the additional information about this process that will arrive with your tax organizer.

Renting your home or vacation home

Owning a second home may offer you tax and other financial benefits.

Taxpayers who itemize their deductions can take out a mortgage to buy, construct, or substantially improve a second home and generally deduct mortgage interest and real estate taxes. The total amount of personal mortgage and home equity interest that a taxpayer may deduct is limited to indebtedness of $1,100,000 for married taxpayers filing jointly, or $550,000 if married filing separately. These limits apply to the combined mortgage total of both a principal residence and a second home.

If you rent your home or vacation home, there are a number of issues to consider.

- You can rent your home or vacation home for up to 14 days and not report the income as long as you use it personally for more than 14 days. As no rental income is reported, no rental expenses (except taxes and interest in certain cases) may be deducted.
- If you rent your property and use it personally for the greater of 14 days or 10% of the days rented to others, your deductible rental expenses are limited to rental income. Any excess expenses can be carried over to future years to offset future income.

Rental property can provide an economic gain while at the same time providing a taxable loss. But keep in mind that rental activities are generally considered passive, regardless of your participation level, and losses can only offset other passive income. However, if you are an active participant in the rental activity and your gross income is less than $150,000, some of the loss will be allowed against non-passive income.

The Housing Assistance Tax Act of 2008 revised the home sale capital gain exclusion rules. Individuals are no longer able to convert a rental or vacation home to a principal residence, live in it for 2 years, and take the full capital gain exclusion of $250,000 ($500,000 if married filing jointly). The new rules state that any time that your home is not used as your primary residence after January 1, 2009, the exclusion will now be limited on a pro-rata basis to the period the home was your principal residence.

Other considerations to think about before renting include:

- how rent will be collected,
- who will make repairs,
- who will maintain records of income, expenses, and security deposits,
- adequacy of insurance coverage ,
- and the legal ownership of the home, such as personally or in a limited liability company.

IRS to focus on high wealth taxpayers

The IRS recently formed the Global High Wealth Industry Group, which will focus on tax compliance of high wealth individuals and their related entities. Initial investigations will focus on auditing individual taxpayers with income or assets exceeding ten million.

These teams of IRS agents will take a unified look at the individual's personal income tax return, as well as related returns, including trusts, private foundations, partnerships & other flow-through entities. Also of particular interest are any international investments and activities that could shelter income.

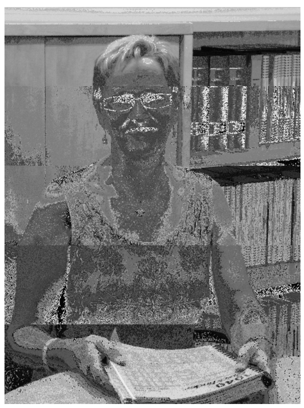
Initially, a small number of examinations will take place. Based on these results, the scope of future work to be done by these IRS wealth teams will be further defined.

King & Oliason news

King & Oliason continues to grow. We are pleased to welcome two tax professionals to our team in 2010.

Laura Griffin, CPA, Tax Accountant

Laura has a BBA in Accounting and a Masters of Accounting in Taxation from the University of Georgia. She worked at a southeastern regional accounting firm for two years before relocating from Georgia. Laura enjoys creative writing and exploring the outdoors.



Tammy Woodmansee, Tax Accountant

Tammy graduated from the University of Puget Sound in Business Administration with an emphasis in Accounting. Her more than 15 years in accounting has included audit work for a national accounting firm, work as a controller for an international finance firm, and manager of a regional tulip company. She is an accomplished sailor and cyclist.

Office Expansion

This fall, King & Oliason will expand our office space to accommodate the growth in staff we've experienced over the past few years. We're excited about the changes! When complete, you will see a new entrance on 2nd Ave West, additional space on the lower level of the building, an expanded research library and an enclosed staircase connecting our two floors. The expansion of our physical facilities will enhance our ability to provide you with the highest level of tax services.

Celebrating 20 Years

King & Oliason will celebrate our 20-year anniversary in November. Although many things have changed over the years, we remain dedicated to our core mission of providing personalized service to our clients. Each relationship is valued both professionally and personally. We continue to foster a positive work environment, which helps us retain our talented employees. This continuity is essential to our ability to provide personalized service.

As we celebrate this important milestone, we have you to thank for our success.

Karol and Norma

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To serve clients in the Pacific Northwest who value exceptional and ethical management of their complex tax situations.

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Learn more about the range of tax consulting services we offer, our people, and our firm. Use the links to access tax forms, financial information, past newsletters, and more.