

TAX NOTES & PERSPECTIVES

TAX CHANGES BENEFIT CONSUMERS AND SMALL BUSINESSES IN 2009/2010

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There are a number of new provisions designed to aid taxpayers in a recessionary economy. Some are credits, others affect itemized deductions, and still others impact retirement accounts.

First-Time Home Buyer Credit

The maximum credit for individuals buying their first home has been increased to \$8,000. The increased credit applies to purchases between January 1, 2009 and December 1, 2009. Unlike the 2008 credit, there is no requirement to repay the 2009 credit. A parent interested in assisting a child with the purchase of their first home could make **an annual exclusion gift** (see related articles on Pages 2 and 4) to help with the down payment. Additionally, a parent can co-sign on the loan without jeopardizing the child's ability to take the credit.

American Opportunity Credit (AOTC)

The AOTC replaces the Hope Scholarship Credit for 2009 and 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 2009 and 2010. The maximum credit you can claim in 2009 and 2010 combined is \$1,500. Examples of property that may qualify include: insulation materials, exterior windows, skylights and doors, natural gas furnace, central air conditioner, water heaters, high-efficiency heat pumps, metal roofs and asphalt roofs. The property must meet certain energy efficiency standards to qualify.

Sales Tax Paid On New Car Purchase

Sales tax paid on the cost of each new vehicle (up to \$49,500 per vehicle) purchased on or after February 17, 2009 through December 31, 2009 may be deducted on your 2009 tax return. The additional deduction is available to taxpayers claiming the standard deduction, as well as itemizers claiming the state income tax deduction. The deduction begins phasing out when income reaches \$125,000 for single filers and \$250,000 for joint filers.

No Required Minimum Distributions For 2009

The required minimum distribution from your individual retirement plan or defined contribution plan is eliminated for 2009. This is a one year reprieve for 2009; the required minimum distribution returns in 2010.

Roth IRA Conversion

Income limits are eliminated after 2009 for conversions of Traditional IRAs to Roth IRAs. The amount converted is subject to tax as if it were being distributed, but not subject to the 10% early withdrawal penalty. For 2010 conversions, one-half of the income recognized upon conversion is included in income in 2011 and the other half in 2012. A taxpayer may elect to recognize the income in 2010. If your traditional IRA has decreased in value, it may be a good time to convert to a Roth IRA.

NOL Carryback Period Extended for Small Businesses

Small businesses with a net operating loss (NOL) in 2008 may elect to offset this loss against income earned in up to five prior years. Typically, an NOL can only be carried back for two years. Utilizing the NOL generates a refund of taxes paid in prior years.

TAX REMINDERS AND STRATEGIES

REMINDERS

- 'Kiddie Tax' is a series of tax rules designed to keep parents from passing along taxable income to their children so that it can be taxed at the child's lower tax rate. Under the 'Kiddie Tax' rules, if the child has unearned income over a certain level, the income is taxed at the parent's rate, not the child's. The 'Kiddie Tax' can potentially apply until the year during which a child turns 24. Significant changes to these rules occurred in 2008; the rules remain the same in 2009 and beyond.
- In 2009, the federal estate tax exemption increased to \$3,500,000 per individual. Please note that the lifetime gift tax exemption remains at \$1,000,000 per individual and the Washington State estate tax exemption remains at \$2,000,000 per individual. These differences in exemptions may require modification to your estate plan.
- The gift tax annual exclusion increased to \$13,000 in 2009, up from \$12,000 in 2008. This higher amount should be incorporated into your 2009 gift tax planning.
- Small businesses that are planning significant capital expenditures should keep in mind that the enhanced Section 179 deduction of \$250,000 is only available through December 31, 2009.

- 50% bonus depreciation is available through 2009 for certain qualified property.

TAX STRATEGIES

Realizing Capital Losses

Now may be a good time to revamp your investment portfolio. You can sell appreciated securities at a gain and then offset those gains by selling poor performing securities at a loss. You can also deduct up to \$3,000 of additional capital losses against all sources of income (interest, dividends, etc.). Generate even more losses and you can carry over the rest to offset future gains – even if the capital gains rate increases. Capital losses can be carried forward indefinitely.

Worthless Stock

A capital loss deduction is allowed for a security after it becomes *completely* worthless. Consider selling securities with minimal value and recognizing the loss without waiting for them to become completely worthless.

Non-business Bad Debt

A short-term capital loss is realized for a non-business debt in the year the debt becomes worthless. Writing off a loan from a family member is generally a gift - unless you can show a bona fide loan existed.

OBAMA ADMINISTRATION TAX PROPOSALS FOR 2010 AND FUTURE YEARS

Tax changes proposed by the Obama administration could impact high income individuals in particular, as well as other taxpayers and businesses. The tax legislation that may eventually be approved by the House and Senate may look very differently, but we feel it is important from a planning perspective to know the administration's current proposals.

High Income Individuals (beginning 2011)

- Increase the highest income tax rate from 35% to 39.6%.
- Increase the long-term capital gain and qualified dividend tax rate to 20% (from 15%) for married taxpayers with income over \$250,000 and single taxpayers with income over \$200,000. Taxpayers with income below these thresholds would still be subject to a maximum 15% tax rate on long-term capital gain and qualified dividend income.
- Reinstate the limitation on itemized deductions. The limitation is reduced for 2009 and eliminated for 2010. In 2011, itemized deductions would be reduced by 3% of the amount by which adjusted gross income exceeds a floor amount, but not by more than 80%.
- An additional proposal would further limit a taxpayer's itemized deductions to 28% for taxpayers in the 36% and 39.6% tax brackets. Currently, this would apply to taxpayers with

taxable income over \$171,500 for single filers and \$208,850 for joint filers.

- Reinstate the limitation on personal exemptions.

Other Possible Tax Changes for Individuals

- Retain the Alternative Minimum Tax (AMT), but index the exemption amount annually.
- Extend the new American Opportunity Credit (see page 1) beyond 2010. This new credit has a higher maximum credit amount, higher phase-out limits, and is partially refundable.
- Extend the deduction of state and local sales taxes through 2010.

Proposed Changes for Businesses

- Extend the Net Operating Loss carryback period for more taxpayers.
- Disallow the LIFO inventory accounting method for tax years beginning in 2012. Users of the LIFO method would have to write up their inventory to FIFO values.
- Require all corporations and partnerships that file Schedule M-3 as part of their tax return to file their return electronically for tax years beginning in 2010.

CHARITABLE GIVING IN A DOWN MARKET- CONTINUING GENEROSITY IN TOUGH ECONOMIC TIMES

Many non-profit and charitable organizations feel the 'pinch' of the recession from reduced charitable giving. Donors who strategically continue their generosity in difficult economic times can continue to support their preferred organizations while often realizing tax benefits.

Donate Appreciated Publicly Traded Securities – Transfer securities directly to the charity, rather than selling them first and paying tax on the capital gain. Make sure the donated security has been held at least one year, or your charitable deduction will be limited to your cost basis.

Sell Depreciated Securities – Donate the cash from the proceeds. The charity will still receive its gift and you will get to recognize the capital loss.

Donate Retirement Assets – Individuals over 70-1/2 years of age can donate up to \$100,000 from an IRA to a qualified charity in 2009 without recognizing income on the distribution. "Qualified" charities include most public charities, but not donor-advised funds or private foundations.

Donate Motor Vehicle, Boat, or Airplane – If the value is over \$500, the deduction is limited to the smaller of its fair market value or the proceeds from the sale of the qualified vehicle by the charity. In most cases, the charity must provide you with Form 1098-C that you attach to your return in order to claim the deduction.

Limitation on Charitable Deductions – If your charitable contributions are greater than 20% of your adjusted gross income, your deduction may be limited. Contributions are limited depending on the type of property donated (cash, stocks, etc.) and the type of organization the donation is made to. If your deduction is limited, you can carry over the excess contribution to use over the next 5 years.

DOCUMENTING CHARITABLE CONTRIBUTIONS

All donors need to be aware of IRS requirements for documenting and substantiating charitable contributions. The required documentation depends on the type and amount of the gift. The following table summarizes the requirements.

	Under \$250	\$250 or more	Over \$5,000
Cash	Canceled check or bank record, or written receipt from organization.	Written acknowledgement from the organization indicating the organization's name, the date of donation, and the amount donated. In addition, a statement is needed indicating whether or not the organization provided any goods or services in return for the gift. If goods or services were provided, a good faith estimate of the value is required.	Same requirements as for cash gifts of \$250 or more.
Non Cash (For every gift of non-cash property, you should also document the cost basis and your method for valuing the property.)	Receipt showing organization's name, date of donation, and description of items donated.	Written acknowledgement describing the item donated, including the charity's name and address, and the date of the gift. In addition, a statement is needed indicating whether or not the organization provided any goods or services in return for the gift. If goods or services were provided, a good faith estimate of the value is required.	Written acknowledgement as described for non-cash gifts of \$250 or more and a written appraisal by a qualified appraiser, dated not more than 60 days before the contribution is made. Organization and appraiser must sign the Form 8283 for attachment to donor's tax return.
Publicly Traded Securities	Same as above for non cash gifts	Same as above for non cash gifts	Same as above for non cash gifts, but no appraisal is required.

ESTATE PLANNING OPPORTUNITIES

In the current financial environment of depressed asset values and historically low interest rates, the following estate planning strategies should be considered.

For assets which may be temporarily depressed in value, outright gifts are now less costly. The amount of the gift will be calculated based on the lower current value, and the gifted assets will no longer be subject to tax in the donor's estate. If the assets are held in a family business or investment entity, additional valuation adjustments, such as discounts for lack of control and lack of marketability, may also apply. Congress is considering legislation which would restrict the use of valuation discounts in valuing these transfers. If you are interested in **gifting family business or investment entities**, consider making such transfers soon, prior to any law changes.

If you are interested in transferring future asset appreciation to your heirs, but are not ready to give up the full asset value, consider **a sale of the asset to your heirs using an installment note**. An installment sale effectively freezes an asset's value at its current amount, allowing any future appreciation to benefit your heirs. Locking in current low interest rates allows for an easier purchase by your heirs, with less interest flowing back to your tax-

able estate. We would be happy to discuss several variations of this technique with you, including sales to grantor trusts and use of a grantor retained annuity trust (GRAT). Please note that the President has proposed limits on the future use of GRAT's, increasing the urgency of proceeding soon if you are interested in this technique.

A **charitable lead trust** works well for a donor looking to benefit a charity for a specific time period. A charitable lead trust provides an income interest to a charity for a specific time period, with the remainder interest transferring to either the donor or another non-charitable beneficiary. Current low interest rates allow for a larger calculated charitable deduction, and a correspondingly lower gift to a non-charitable beneficiary.

Finally, for heirs experiencing difficulties in obtaining credit, low interest rates allow **parents to make loans** that are easier for their heirs to pay back. The September Applicable Federal Rate for a short-term loan (less than 3 years) is only .84%. If parents are willing to make \$13,000 (\$26,000 when both parents make gifts) annual exclusion cash gifts to their heirs, the gift can cover annual interest payments on a fairly large loan.

ESTIMATING HOW MUCH MONEY YOU NEED FOR RETIREMENT

If you are thinking of retiring, the recent decline in real estate and financial markets may have you wondering whether or not you need to postpone retirement in order to allow more time to save. Now is a good time to review your financial plan for retirement.

The Basics

Begin by determining your expected annual retirement income, including investment income, retirement benefits, and social security. Then determine your expected annual retirement spending. King & Oliason can help you put together a budget that will capture your current living expenses and adjust them for anticipated changes once you retire.

Ask your investment advisor for assistance in finding the right investment mix to generate the income you will need to cover your expenses.

Avoid Common Pitfalls

Be realistic about your life expectancy. The average life expectancy in the US was 77.9 in 2004, according to the National Center for Health Statistics. The older one gets,

the longer the life expectancy; in 2003, those age 65 could expect to live, on average, to 83.4 and people age 75 could expect to live to 86.8, according to the Center.

Don't use a static model to project your investment income. Most investment advisors have access to dynamic income forecasting models that take into account a large number of variables, including inflation and market variability.

Be realistic about your retirement spending. Make sure you consider the increase in cost of medical insurance when you are no longer covered by your employer's plan. Also, take into account the possible need for long-term care insurance. Don't automatically assume that your costs for clothing, food, and other essentials will decline. If you plan to travel more in retirement, these costs may increase.

Consider the impact of inflation. Many financial analysts think that inflation will rise due to the large amount of cash going into the economy as part of the bailout programs. Inflation erodes buying power faster for people on a fixed income. Ask your investment advisor for investments that are more resistant to inflation.

PERSPECTIVES ON THE INVESTMENT MARKET

A note from Karol and Norma: We invited three investment counselors to prepare an overview of their perspectives on the economy and the investment market. Our thanks to **Elaine Heller, CFA, Principal, Coldstream Capital Management; John Christianson, CFA, President, Highland Capital Management; Shari Burns, CFA, President, Paragon Investment Management, Inc.** for their thoughts.

Coldstream Perspective:

“With the market up more than 48% from the low on March 9th, we believe the “relief rally” has played itself out. Over the next six months we will see increased volatility, but we believe stocks will end the year higher as the economic recovery comes into better focus. The economic data is clearly improving, but government spending is the primary driver of that growth. We believe a real increase in end user demand, a necessary ingredient for a sustainable recovery, could be far off; a weak labor market, constrained credit and the continued erosion in real estate could curb longer-term economic activity. Despite these obstacles, we note that the markets generally anticipate economic recoveries six to nine months in advance, and consequently, we recommend overweighting exposure to equities.

We are bearish on long dated bonds because we think inflationary pressures will cause interest rates to rise. Long term interest rates are already off their lows, and when the economic recovery gains traction, the Federal Reserve will need to raise short term rates to counteract inflationary pressures. Bond prices react negatively to both rising interest rates and inflation.

We expect inflation in real assets and the transfer of wealth from the developed to the emerging markets to continue, and therefore recommend overweighting positions in commodities and non-dollar denominated assets, particularly emerging markets securities.”

Highland Capital Perspective:

“So, John, what’s your outlook for the market over the next six months?’ I hear this question all the time in various forms. Sure, the timeline changes, but the question is always the same. My answer: YOU’RE ASKING THE WRONG QUESTION.

Let’s be honest – I don’t (nor does anyone else) have any bullet-proof idea of what the next six months has in store. Think about it, we didn’t know we were in this recession until many months after it happened. The reality is that no one knows what the next six months – or six years – will look like. So, if predictions about the market are the wrong question, what is the correct question?

‘What can I do to ensure that no matter what happens in the economy or the market that I’ll be okay?’ Three key things:

- 1) Get a clear picture of your unique opportunities and obstacles. What keeps you up at night worrying? What helps you sleep confidently? What are your ideal outcomes? The result is clarity about where you are and a sense of comfort about where you are going.
- 2) Create a financial strategy that aligns to your life, and yours alone. No one-size-fits-all approach here. More than a financial plan, this strategy will act as a guide and filtering system for all decisions.
- 3) Ensure that you have a transformer in your life—a trusted source that will convert information into knowledge, eliminate concerns that don’t require your attention, and free you to focus your time and energy on the things that you love.”

Paragon Perspective:

“Many analysts and economists think the worst of the economic woes are behind us, but there is little agreement about the shape of the eventual recovery. We hear three distinct forecasts for the economy and corporate profits. The economy will 1) recover in the second half of 2009, but it is unclear how quickly or slowly this will progress, 2) stagnate at these low levels for a considerable time, or 3) rise modestly, helped by aggressive monetary policy and fiscal stimulus, but then slump again toward the end of 2010 as stimulus fizzles and tax increases become clear. Imbedded within these scenarios is too much inflation, continued low inflation or deflation, a dollar crisis, earnings stagnation or a fiscal budget deficit that is not under control.

After sharp declines in real economic growth from September 2008 to March 2009, Paragon expects activity to stabilize and to turn to positive growth by the end of 2009. We forecast the real GDP to rise 2-3% in 2010, inflation to stay contained in the 2-2.5% range and interest rates to rise for longer US Treasury bonds as the government continues to finance the budget deficit. Stock prices in general will follow the recovery over the next few years. Strong recoveries took place in the 1930’s and the 1970’s, two other periods in which stock prices fell more than 50%. Stock prices are already forecasting a recovery ahead of the current economic rebound. We believe this can continue over the next several years.”

[King & Oliason does not provide investment advice. The views expressed in these three perspectives are not those of King & Oliason, P.S.]



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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.

KING & OLIASON NEWS

King & Oliason continues to grow. We are pleased to welcome two tax professionals to our team in 2009.

Sarah Gangar, CPA, Tax Accountant

Sarah has a Masters degree in Taxation and a B.A. in Business Administration in Accounting from the University of Washington. She has worked in accounting for 4 years with both small and mid-sized firms in the Seattle area before joining King & Oliason.



Lee Stordahl, CPA, Tax Accountant

Lee relocated to Seattle from Austin, Texas. He graduated from Texas A&M University with a B.B.A. in Accounting and a M.S. in Finance. He worked with a nationwide accounting firm for 3 years and also has experience in private industry.

Communication with our Clients

Along with the tax organizer we send you each year, we also send **two essential letters that require your signature**. They are the Engagement Letter and the Consent Form.

- An Engagement Letter is a contract for us to provide tax services to you. The letter states the scope of the work we will perform for you.
- Written Consent : We have always taken great care to ensure the privacy of your personal information. Our privacy policy is posted via a link on the home page of our website. However, beginning in 2009, new IRS regulations put formal constraints on the disclosure of your information. We are no longer able to provide your tax information to a third party without written consent. This means that if you would like us to send a copy of your return to an investment advisor, banker, or other third party, you must provide a consent form. The consent form must be signed by you, and indicate what information we can provide and to whom it may be provided.

Young adults: If you would like us to share your tax return information with your parents, you must provide consent in a letter or in an email.

Website Note:

You may have noticed a link on our home page to the "Client Portal." For clients who need to transfer a significant amount of electronic data (such as spreadsheets, documents and PDF files) to or from King & Oliason, we have added a password protected portal to our website to securely transfer these files. Once loaded on the portal, these documents can be accessed by both the client and King & Oliason personnel. Please contact us if you would like to establish your own secure portal or have any questions.