September 2013

Tax Notes and Perspectives

INSIDE THIS ISSUE:

IRS Audit Red Flags	2
Going Green: Energy Credits	2
The Affordable Care Act	3
Charitable Contribution Substantiation	3
Income Tax Planning with Trusts	4
2013 Tax Changes Impact Deductions	4
Education Tax Credits	5
King & Oliason News	6

TAX INCREASES FOR 2013

The 2012 American Taxpayer Relief Act and the 2010 Affordable Health Care Act resulted in new and increased taxes in 2013.

High Income Households

Beginning in 2013, high income households are subject to a 3.8% Medicare tax on net investment income. These households include individuals whose Modified Adjusted Gross Income (MAGI) exceeds $200,000 (single) and $250,000 (married filing joint).

Investment income includes interest, dividends, capital gains, royalties, rents, and other passive income. To calculate net investment income, investment income is reduced by certain expenses allocable to the income, such as investment advisory fees, rental and royalty expenses, and state income taxes. Tax exempt income and most retirement plan/IRA distributions are not subject to the Medicare tax.

Trusts and estates will also be subject to the 3.8% Medicare tax on net investment income. Estates and trusts will be subject to the surtax if their AGI is over a lowered threshold ($11,950) and they also have undistributed net investment income. (See related article on page 4.)

To reduce the current impact of the Medicare Tax on investment income, consider shifting some taxable bonds to tax free municipal bonds, shifting to growth stocks which pay little current income, and/or capital loss harvesting. Please consult your investment advisor before making any changes; taxes should only be one factor in your investment decisions.

Additional Medicare Tax for High Wage Earners

Starting in 2013, individuals who make more than $200,000 in wages and couples making more than $250,000 are required to pay an additional 0.9% Medicare payroll tax on earned income in excess of the base amounts. Employers are required to withhold this tax from employee wages. Self-employed individuals are also subject to this tax.

Medicare tax will be reported on the individual tax return. Any amount of the tax not withheld or paid in with estimated tax payments will be due with the return.

Limitation on Itemized Deductions for Higher-Income Taxpayers Reinstated

The overall limitation on itemized deductions is reinstated in 2013 with a starting threshold of $300,000 for joint filers and $250,000 for single filers. The total of itemized deductions is reduced by 3% of the amount above the threshold (not to exceed 80% of total allowable itemized deductions).

New Tax Rates

In 2013 there will be a new income tax bracket of 39.6% that applies to taxpayers who meet the following income thresholds: $400,000 (single), $425,000 (head of household), $450,000 (joint filers), or $225,000 (married filing separately).

Capital gains tax rates were also modified for high income taxpayers. The law establishes a new 20% rate. Additionally, the 3.8% Medicare tax on investment income may also apply, increasing the effective top capital gains rate to as high as 23.8%.

IRS AUDITS: WHAT ARE THE RED FLAGS?

Will I be audited? Every taxpayer asks themselves (or their accountant) this question from time to time. Most people rest easier when they learn that just over 1% of individual tax returns are audited each year. Even so, there are common red flags that can increase your likelihood of an IRS audit.

High Income

As income climbs, so too does the chance of an IRS audit. For those making $200,000 or more in annual income, the audit probability jumps to 3.7%; if over $1,000,000, chance of an IRS audit rises to nearly 13%.

Failing to Report all Taxable Income

The IRS receives copies of all 1099s, W-2s, and Schedules K-1 and matches them against the income reported on the tax return. When a mismatch occurs, a flag is raised. It is very important to provide complete copies of these documents to your accountant at tax time.

Large Charitable Deductions

Another red flag is when a taxpayer's charitable deductions are disproportionately large in comparison to their income.

Claiming the Home Office Deduction

Take the deduction if your circumstances meet tax code requirements; however, discuss your situation with us first, as this deduction does increase the probability of an IRS audit.

Writing off a Business Activity Loss that is Actually a Hobby

Business losses may be scrutinized to determine if the activity is carried on with a reasonable expectation of earning a profit. Absent the profit motive, the business may be considered a hobby. The IRS will disallow the net loss from a hobby. (Hobby deductions cannot exceed the gross receipts of the hobby activity).

Failing to Report a Foreign Bank Account

Offshore accounts are highly scrutinized by the IRS and are increasingly becoming audit triggers. At any time during the year, a person who has a financial interest in or signature authority over any foreign account(s) which value exceeds $10,000 must file a report of foreign bank and financial accounts (FBAR).

Engaging in Cash Transactions over $10,000

The IRS receives reports of large cash transactions from banks and others. If you engage in large cash purchases or deposits, be prepared for additional scrutiny.

Other Miscellaneous IRS Audit Triggers

- Claiming rental losses – Specific rules must be met to deduct a rental loss. This is a common area for errors.
- Deducting a large amount for business meals and entertainment as a sole proprietor - the amount must be ordinary and necessary.
- Claiming 100% business use of a vehicle – most business owners have some personal use.
- Businesses paid predominately in cash – are often audited to verify that all income is reported.
- Taking higher-than average deductions in comparison to income – is another common red flag to the IRS.

GOING GREEN: ENERGY CREDITS

Certain tax credits for solar, geothermal or residential wind turbine systems were extended through 2016. The amount of these credits is equal to 30% of the qualifying costs (including labor & installation). There is no limit to the amount of the credit. If the credit is more than the tax owed, the unused portion can be carried forward to the following year's tax return.

The home must be located in the United States but does not have to be your main home. You are allowed to take the credit on multiple homes.

The Residential Energy Efficient Property Credit applies to both solar water heaters and solar panel systems installed for use in the home. To qualify for this credit, the property must be certified by the manufacturer that it meets the requirements for the credit, in addition to meeting other criteria established by the IRS.

This credit also applies to geothermal heat pumps installed on or in connection with the home. Geothermal heat pumps use the ground or ground water as a thermal energy source to heat or cool your home. To qualify, the geothermal heat pump equipment must meet requirements of the Energy Star program in effect at the time of purchase.

(Continued on next page)

Going Green (continued from page 2)

The Residential Energy Property Credit was extended through 2013 by the American Taxpayer Relief Act of 2012. This credit is a maximum of $500 for improvements such as adding insulation, energy efficient exterior windows and energy efficient heating and air conditioning systems. The improvements must meet updated energy efficient standards set by the US Department of Energy. For more information, visit the Department of Energy website, http://www.energy.gov .

The Affordable Care Act: Mandate for Health Insurance Coverage

Mandatory health insurance coverage required by the Affordable Care Act (ACA), also known as "Obamacare," is just around the corner. Implementation of the multiple components of the ACA will occur at various dates, most likely over the next two years.

Individuals

Individuals must have health insurance beginning in 2014, unless they are exempt. Exempt individuals include Americans age 65 and older who are covered by Medicare and those for whom coverage would be unaffordable. Individuals who experience short coverage gaps (less than three consecutive months), have religious objections, or meet a few other non-financial exceptions are also exempt.

If an individual is not exempt and does not have insurance either through their employer's plan, in the individual market, or through an insurance exchange, they will owe penalties when they file their 2014 tax return. In 2014, the annual penalty will be $95 per adult and $47.50 per child, up to a family maximum of $285, or 1 percent of family income, whichever is greater. These penalties increase significantly in 2015 and 2016.

Effective October 1, 2013, employers subject to the Fair Labor Standards Act are required to provide notice regarding the Health Insurance Marketplace to their employees. The Marketplace (also referred to as the Exchange) offers "one-stop shopping" to find and compare private health insurance options.

Large Employers

Under the ACA, a large employer (one with over 50 full-time equivalent employees) must provide health insurance to their employees. Implementation of this mandate is under discussion; for now, it has been postponed until 2015.

Charitable Contribution Substantiation

For contributions of $250 or more, you must have an acknowledgement letter provided by the donee before you file your return that contains the following information:

- Date and amount of the contribution,
- A specific description of non-cash property contributed,
- A statement certifying whether you received any goods or services in exchange for the contribution, or a description and good faith estimate of the value of the goods or services received.

We often see acknowledgement letters containing verbiage which is not adequate to substantiate a charitable deduction. Common examples of inadequate language include:

- "Your contribution is deductible to the full extent of the law."
- "The organization is a 501 (c)(3) non-profit organization."

The desired wording is: "No goods or services were provided to you in exchange for your contribution."

In the case of a contribution of securities, the securities must be specifically identified by the name of the issuer and the number of shares, and the letter should indicate that the securities are publicly traded (e.g., by providing the ticket symbol). It is not sufficient for the letter to state that 'various securities' were contributed.

Income tax planning with trusts: the benefits of distributing funds to beneficiaries vs. retaining funds in the trust

As mentioned on the first page, the 3.8% Medicare tax on net investment income applies to trusts once net undistributed taxable income reaches the top marginal tax rate. In 2013, the top marginal income tax rate is 39.6%, which applies when the net undistributed taxable income exceeds $11,950. This means that a trust could pay federal income tax of 43.4% (39.6% + 3.8%) on its undistributed net investment income that exceeds $11,950.

Trust income is taxed to either the trust or to the trust beneficiaries. If income is accumulated in the trust, then the income is taxed to the trust. However, if income is distributed, then the trust receives an income distribution deduction, and the beneficiaries report the taxable income. The top marginal income tax rate doesn't apply to an individual until taxable income exceeds $400,000. The Medicare tax does not apply to individuals until an individual's modified adjusted income exceeds $200,000 ($250,000 for a married couple).

A Trustee may want to consider distributing income to a beneficiary, if the beneficiary is in a lower tax bracket than the trust.

Typically, a trust must distribute income to beneficiaries in order for it to be taxed at their rates. A trust may elect to treat some or all of the distributions made in the first 65 days of the following tax year as if they were made in the preceding tax year. If not enough distributions were made in the preceding tax year to carry out all of the trust's distributable net income, the Trustee should consider making this tax election.

As always, non-income tax issues need to be considered by the Trustee before making any distributions. For example, distributions may impact estate taxes owed by the income beneficiaries and will impact the amount of property received by the remainder beneficiaries. Please contact your King & Oliason account team with your questions on these issues.

Other 2013 changes impact deductions

Home Office Deduction

Strict qualification and record-keeping requirements must be met to claim this deduction. However, taxpayers can now elect a "safe harbor" which allows a deduction of $5 per square foot of qualifying space, up to 300 square feet (maximum: $1,500). This reduces the record-keeping and cost allocation burdens. The safe harbor can be elected in one year and actual costs may be used in another year. The deduction can still only be claimed for the part of the home used exclusively on a regular basis for business purposes.

Bonus Depreciation

Congress extended 50% bonus depreciation through 2013. Therefore, a taxpayer can deduct 50% of the cost basis of newly acquired property placed in service prior to January 1, 2014.

Capital Asset Expensing (Section 179 Deduction)

Congress extended this deduction through 2013. For property placed in service in 2013, taxpayers can deduct up to $500,000. This amount is reduced dollar for dollar for property placed in service totaling $2,000,000 or more.

Sales Tax Deduction

The sales tax deduction was extended through 2013. Generally, the deduction is pursuant to IRS tables. Sales taxes on motor vehicles, planes, boats, homes, and substantial home renovations can be deducted in addition to the table amount. In lieu of the table, actual sales taxes paid can be deducted, if substantiated by receipts showing the tax paid. A credit card receipt is not adequate substantiation unless it shows the specific amount of sales tax paid.

PLANNING POINT: While it may seem likely that Bonus Depreciation, Section 179, and the sales tax deduction will be extended, no assurance can be given. If you are planning a major business purchase or a personal purchase of a car, boat, etc., in 2014, it may be beneficial to accelerate that purchase into 2013.

Education tax credits

Education tax credits can reduce the amount of income tax owed, and thereby offset some of the costs of higher education. The two credits are the American Opportunity Credit and the Lifetime Learning Credit.

American Opportunity Credit

The 2012 Taxpayer Relief Act includes a 5-year extension (through 2017) of the American Opportunity Credit for college costs. For the 2013 tax year, you may be able to claim an American Opportunity Credit of up to $2,500 for qualified education expenses paid for each eligible student.

- Qualified expenses include tuition, required enrollment fees, and course materials that the student needs for a course of study. Expenses that do not qualify include amounts paid for insurance, medical expenses, room and board, transportation or personal expenses.
- An eligible student includes either yourself, your spouse, or a dependent for whom you claim an exemption on your tax return. A student is eligible only if they have not completed the first four years of postsecondary education (graduate school does not qualify) and must be pursuing a program leading to a degree or other recognized education credential.
- The student must be enrolled at least half time for at least one academic period that begins during the tax year and must not have been convicted of a felony for possessing or distributing a controlled substance.

The full credit is available to single individuals whose modified adjusted gross income is $80,000 or less, or $160,000 or less for married couples filing a joint return. The credit is phased out for taxpayers with incomes above these levels.

PLANNING POINT: If a parent's income exceeds the phase out levels, there is the possibility that the child can claim this credit. Please contact your King & Oliason account team to explore this option.

Lifetime Learning Credit

You may be able to claim a Lifetime Learning Credit of up to $2,000 for qualified education expenses paid for all students enrolled in eligible educational institutions. The full credit is available to single individuals whose modified gross income is $53,000 or less, or $107,000 or less for married couples filing a joint return.

For qualified taxpayers, there is no limit on the number of years the Lifetime Learning Credit can be claimed for each student. However, a taxpayer cannot claim both the American Opportunity Credit and Lifetime Learning Credit for the same student in one year.

The Lifetime Learning Credit may be particularly helpful to graduate students, students who are only taking one course and those who are not pursuing a degree.

Generally you can claim the Lifetime Learning Credit if you pay qualified education expenses for either yourself, your spouse or a dependent for whom you claim an exemption on your tax return. If you pay qualified education expenses for more than one student in the same year, you can choose to take credits on a per-student, per-year basis. This means that, for example, you can claim the American Opportunity Credit for one student and the Lifetime Learning Credit for another student in the same year.

KING & OLIASON

Professional Limited Liability Company

CERTIFIED PUBLIC ACCOUNTANTS

514 2nd Avenue W
Seattle, WA 98119

PHONE
206 285-7242
FAX
206 285-7426

info@kingoliason.com

Our Mission:

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

Visit our website
www.kingoliason.com
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

In March, King & Oliason recognized four employees for their 20 years of service. "Their contributions to the success of the firm are immeasurable," said Norma Oliason.

From left to right:
Barb Dowd
Donita Pittis
Maria Tomchick
Colleen Loughran

King & Oliason is pleased to introduce our new staff.

Standing, left to right: Kyle Swarthout, CPA ,Tax Accountant; Joe Beauregard, CPA, Tax Manager ***Seated, left to right:*** Malaika O'Rourke, CPA, Tax Accountant; Aaron Peterson and Katherine Wentz, Tax Accountants

Kyle Swarthout received his B.B.A. in Accounting from the University of Oklahoma. His experience includes work in both public and private accounting. He relocated from Denver, CO to Seattle in 2012.

Joe Beauregard has a B.S.F.S. in International Economics from Georgetown University and an M.B.A. from The University of Chicago. He has extensive experience in public and private tax accounting, including working in Europe for a national firm, as well as with a national investment management company.

Malaika O'Rourke has a B.B.A. in Finance from the University of Wisconsin-Madison and a Master in Business Taxation from the University of Southern California. Malaika is a certified public accountant in the state of California. After spending five years working for a national accounting firm, she worked in the tax departments of a national retailer and global technology company.

Aaron Peterson has a B.S. in Accounting from Central Washington University. Prior to his work with local public accounting firms, Aaron worked in the construction industry.

Katherine Wentz received a B.A. in Communications, with a minor in French, from Western Washington University and a M.B.A. with an emphasis in Accounting at Seattle University. She worked part-time at King & Oliason before joining the firm full-time in 2013.