

CHOOSING THE RIGHT 401(K)

Many companies offer employees a choice between two 401(k) plans. The version with which you're probably most familiar is now considered a "traditional" 401(k). As before, you can choose to defer some salary and defer the income tax as well. You'll also defer the tax on any investment earnings. However, when you withdraw tax-deferred earnings and tax-deferred investment income, you'll owe income tax. You'll probably owe a 10% penalty on withdrawals before age 59½, too. Another option you may have is a Roth 401(k). With this account, you're not deferring income tax, so you're contributing after-tax dollars. Again, you won't owe tax on any investment income inside the plan. After you've had a Roth 401(k) for five years and after age 59½, all withdrawals are tax-free.

Aside from those key differences, the two 401(k) options are similar. You can contribute up to \$16,500 of income this year. If you are 50 or older in 2011, you can contribute an extra \$5,500, for a maximum total contribution of \$22,000. With either the \$16,500 or the \$22,000 cap, you can divide your contribution

between the two plans in any way you choose, or you can put all the money into one type of 401(k).

Making the choice

Generally, you are better off contributing to a Roth 401(k) when you are in a low tax bracket. **Example 1:** Jacob Benson is in the 15% tax bracket. If



Jacob defers tax by contributing to a traditional 401(k) this year, he will get little benefit from the tax deferral because he will defer few tax dollars. Jacob eventually may pay tax at a higher rate when he takes money out. Therefore, Jacob chooses the Roth 401(k), where he will pay relatively little tax on the money he contributes while arranging for possibly tax-free withdrawals in the future.

With the same reasoning, workers in a high tax bracket may be better off

in a traditional 401(k).

Example 2: Diane Evans is in the 35% tax bracket. Diane will get a substantial benefit from tax deferral this year so she chooses the traditional 401(k). Diane hopes to be in a lower tax bracket after she retires. If that is the case, Diane may be able to convert

her traditional 401(k) funds to a Roth IRA and pay less tax she would pay by contributing after-tax dollars to a Roth 401(k) now. Diane might choose to convert her traditional 401(k) to a Roth IRA after she retires because all withdrawals will be tax-free five years after the conversion, as long as Diane is at least age 59½. In addition, Roth IRA owners never have to take required minimum distributions.

Not so simple

At first glance, you might think this is a simple matter. You can look at your income tax return from last year and see the taxable income you reported, adjust for any increase or decrease in anticipated income from this year, and then go online to see the tax tables for 2011. If you'll be in the

10% or the 15% bracket, you might lean towards the Roth 401(k); in the 33% or 35% bracket, a traditional 401(k) may be appealing. In between (25% or 28% brackets), you could straddle the fence, contributing some to a traditional 401(k) for immediate tax relief and some to a Roth

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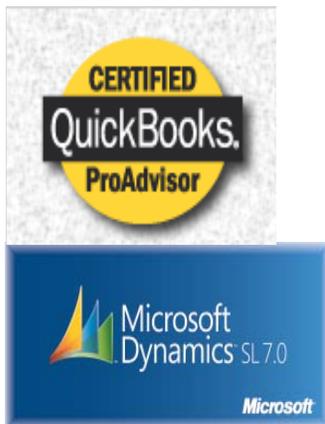
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News from the inside...

We are pleased to announce that Roger A. Jones, CPA, is now a partner. Roger joined Shannon & Associates in 2009 starting the firm's financial institution niche. Roger has spent over 20 years in public accounting and private industry as a financial institution expert. Roger focuses his work with modern-day financial services companies that include credit unions, mortgage lenders, community banks, international money transmitters and other non-traditional lenders. While not working, Roger enjoys spending time with his wife, Ellen, their 6 kids and the family dog, Sunny. Not one to age gracefully, Roger continues to enjoy certain "board sports" that include snowboarding, windsurfing, wakeboarding and long-boarding. In addition, you will occasionally find Roger participating in weekend motorcross events with his family throughout Washington and Oregon. A resident of Woodinville, he has also been known to enjoy a special glass of vintage Washington wine while attending outdoor concerts at Chateau St. Michelle or following a round of golf at Bear Creek Country Club.

We are pleased to welcome Laura Koenig, CPA, to our firm. Laura is a senior manager, and the first tax return she prepared was for the year 1987. She has more than 23 years experience in public accounting. Laura is married to a University Place firefighter and they have an 11-year-old daughter. When not working, she enjoys gardening and cooking. Some other facts about Laura is that she avidly plays World of Warcraft with people across the country where she is known as Sonyachrushr, a short red-headed dwarf.

We are pleased to welcome Ferdinand Aonan, CPA, to our firm. Ferdi is a senior accountant with nearly 6 years experience in public accounting. His experience includes audits, reviews and compilations of financial statements for profits and NPO's and special projects relating to internal controls. He also specializes in audits of employee benefit plans. When not working, Ferdi enjoys spending time and taking care of his little sister, 2 nephews and 1 niece who range from ages 4-13. He loves watching UFC with friends and supporting the Phillippine boxing hero, Manny Pacquiao. Some other facts about Ferdi, he is an Ophiuchus who is left handed and he loves sushi.

Jeans for Charity

If you come into our office on a Friday, you may notice a lot of denim! This is because each Friday each of our staff who wears jeans donates \$2 to our "wear jeans for charity" fund. The firm will match the staff donations collected between now and December. The funds will be shared between two charities chosen by our staff, Pediatric Interim Care Center (www.PICC.NET) in Kent and Children's Therapy Center (www.CTC.ORG).

DOES YOUR BUSINESS HAVE “NEXUS” ISSUES?

A business that sells to customers in many states may be exposed to a variety of multistate tax issues. “Nexus” is a concept that is increasingly becoming a hot-button issue for companies with a multistate presence.

As many states grapple with budget deficits, nexus is gaining momentum as a means by which a state or other jurisdiction may claim that a particular activity of a company is subject to tax. Activities of a company in a given state where the business has a presence may be considered sufficient — from the taxing state’s perspective — to cause a strong enough connection to impose any one or more of a number of taxes.

Businesses operating in a variety of states should consult with their tax professional as to whether taxes or other levies may be triggered in each state in which it operates. Not every state has each of the following taxes. For instance, many states do not impose an income tax and a franchise tax.

Sales and Use Tax

Generally, under federal law, a state must have “substantial nexus” to a seller in order to require the collection of sales and use taxes imposed on buyers upon the sale of goods or merchandise in its state. Over the years, “substantial nexus” has been defined generally as a company’s having a *physical presence* in the state, as determined by one or more of a number of factors, including the presence of a salesperson or a contractor or a location

within the state.

You should determine whether any of your business’s activities creates substantial nexus with each state in which it does business. In your analysis: Consider the activities that you are engaged in that may rise to the level of nexus; Determine which states consider the activities a sufficient connection; and Prepare for the possible exposure to uncollected tax by conducting an analysis regarding those states where substantial nexus exists. An added complication to the nexus concept is that, even if your out-of-state business activities do not result in exposure to one type of tax, it does not necessarily mean that those activities aren’t sufficient for the state to impose other taxes.

Income Tax

Generally, a higher level of business activity than what constitutes nexus for sales tax must be present in a given state for it to also impose an income tax. As a general rule, if an out-of-state business engages in any of the following activities, it is generally considered to have sufficient state income-tax nexus:

- Derives income from sources within the state;
- Owns or leases property in the state; or
- Employs personnel who engage in activities that go beyond those protected under federal interstate commerce laws.

Merely selling into a state should not be enough to cause nexus for income-tax

purposes. Under federal law, a state may not impose a tax on out-of-state taxpayers based on or measured by *net income* where the only activity connecting it to the state is the solicitation of orders for sales of *tangible personal property*—as long as such orders are approved and shipped from outside the state trying to impose the tax. Generally, tangible personal property is an asset that can be touched or moved. Examples include furniture, jewelry, clothing, artwork, or household goods.

As a result, businesses must be vigilant against the potential exposure to income tax as it relates to a business’s solicitation for the sale of *intangible* property (such as goodwill, trade secrets, patents, trademarks, or copyrights), real estate, or services.

Franchise Tax

A business’s protection under federal law against the imposition of a given state’s income tax does not necessarily insulate it from franchise tax. Franchise tax is typically imposed based on non-income factors, such as net worth or apportioned capital. Generally, franchise tax is exacted on a business entity for the *privilege* of doing business in the state. If a business has substantial nexus for sales- and use-tax purposes, it may well have exposure to a state’s franchise tax.

Gross Receipts or Other Business Taxes

The concept of basing tax on non-income factors is a growing trend. Many states have passed laws that base the imposition of such a tax

on measuring *gross receipts* generated from the seller from:

- The sale of products or services within the state;
- The value of a business’s transactions within the state;
- or some other modified base.

Such so-called gross-receipts taxes imposed on sellers are separate from sales and use tax imposed on buyers — even though the same sales receipts give rise to both tax liabilities.

A Review Is Needed

Many states have expanded their tax reach by imposing a variety of taxes based both on income and non-income factors. Business taxpayers should carefully consider their potential exposure to any one or more of the taxes discussed in this article in each state in which it does business. Need assistance determining your multistate tax obligations? Let us help.

Thank you for your referrals!

We appreciate the confidence you have in our services to refer to us other individuals and businesses!

401(k) for possible tax-free cash flow in the future. However, the calculation of your real tax rate for 401(k) purposes is far from simple. That's because of all the income-based tax breaks in the Internal Revenue Code, going from a traditional 401(k) to a Roth 401(k) will raise your income and may increase your vulnerability to losing tax benefits. You also might move into a higher tax bracket. Conversely, going from a Roth 401(k) or no 401(k) at all to a traditional 401(k) will lower your income

and may provide other tax savings on your return.

Example 3: Previously, we had seen that Jacob Benson is in the 15% bracket. Assume that Jacob is married and reported \$60,000 in taxable income on the joint tax return that he and his wife filed for 2010. That was because Jacob deferred \$15,000 of his salary in 2010. If he puts that \$15,000 into a Roth 401(k) for 2011, the Bensons' taxable income will go from \$60,000 last year to \$75,000 this year. That will move them over the \$69,000 cap

for the 15% tax bracket and into the 25% bracket. What's more, increasing taxable income by switching from a traditional 401(k) to a Roth 401(k) generally will increase your adjusted gross income (AGI) and your modified adjusted gross income (MAGI) as well. With a higher AGI and MAGI, you may lose tax benefits, such as the student loan interest deduction, the child tax credit, the passive loss deduction for real estate losses, and so on. Losing tax benefits will drive up the immediate cost of

switching from a traditional 401(k) to a Roth 401(k). On the other hand, moving into a traditional 401(k) will lower your AGI and MAGI, providing additional tax benefits.

As you can imagine, determining the tax implications of choosing between a traditional 401(k) and a Roth 401(k) can be complicated. Our office can go over your tax return to help you determine the true tax cost so that you can make a well-informed decision.

IRS EXTENDS DELAY OF HEALTH CARE REPORTING REQUIREMENT FOR SMALL BUSINESSES

Last year's health care reform legislation, the Patient Protection and Affordable Care Act (the "Act"), requires certain information reporting by employers relating to employer-sponsored health care insurance coverage for tax years beginning on or after January 1, 2011. The Act generally requires that the aggregate cost of the applicable employer-sponsored health care insurance coverage must be reported to employees on Form W-2.

Previous guidance issued last October made the new reporting requirement optional for *all* employers for the 2011 Form W-2 (which will typically be provided to employees in January 2012). The IRS has now issued interim guidance further extending the Act's optional health care insurance coverage information reporting requirements for *small employers* through at least 2012 (or until further guidance is issued by the IRS, if later). It should come as welcomed relief, as small employers won't be required to report the cost of health insurance coverage on any forms required to be provided to employees until January 2014 — at the earliest.

Under the Act, a small employer is considered one who files fewer than 250 Forms W-2. Accompanying guidance is provided for larger employers who are subject to the information reporting requirements for the 2012 Form W-2 (and to those who choose to voluntarily comply with the reporting requirements in either 2011 or 2012).

The complete guidance can be found in IRS Notice 2011-28 (which can be accessed at www.irs.gov). Let us know if we can be of further assistance relating to the Act's information reporting requirements.

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EASING THE BURDEN OF ESTATE TAX

The new tax law relieves many taxpayers from concerns about federal estate tax for the next two years. What's more, the law clarifies the treatment of estates of the people who died last year.

New rules

For 2011 and 2012, the federal estate tax exemption is set at \$5 million. That's a significant increase over the \$3.5 million exemption for deaths in 2009 and a huge jump from the \$1 million exemption that would have taken effect if a new law had not been passed. Excess assets are now taxed at 35%, down from 45% in 2009. As before, bequests to charities and to surviving spouses who are American citizens are not subject to estate tax, regardless of the amount. Perhaps most important, the new law includes "portability" of the estate tax exemption between spouses. Any exemption amount not used by the first spouse to die can be used by the estate of the surviving spouse in addition to their own allowed exemption.

Example: George Wilson has a \$5 million net worth and his wife, May, has \$3 million of assets. In a traditional plan, George's will calls for his assets to be left in trust for May and their children up to the amount of the federal estate tax exemption with the balance of George's estate going to May. This arrangement enables George's estate to maximize his estate tax exemption. However, this plan also moves \$5 million out of May's easy reach.

In an alternate plan, George might leave all of his assets to May, which would be a tax-free bequest. George could then name either a trust or their children as

secondary beneficiaries. At George's death, May could disclaim (relinquish) some or all of the inheritance to the backup beneficiary, depending on how much she needs.

This type of disclaimer strategy, though, relies upon the ability of the surviving spouse to make an astute decision. If the survivor fails to do so, the plan might go awry. In this example, if May neglects to disclaim any assets and subsequently dies with an \$8 million estate, assuming a \$5 million estate tax exemption and a 35% estate tax, the estate could owe more than \$1 million in tax on the excess \$3 million.

Under the new rules, married couples can avoid such dilemmas. George, with a \$5 million estate, can leave as much as he wants to May and as much as he wants to his children. Any unused tax exemption will go to May.

Say that George leaves \$2 million to his children and \$3 million to May, and May subsequently dies with \$6 million in a year that the federal estate tax exemption is \$5 million. Because George used only \$2 million of his exemption with the bequest to their children, the \$3 million that wasn't used passes to May's estate. This brings the total exemption for May up to \$8 million at her death. Even though May dies with \$6 million, her estate has an \$8 million exemption to offset any estate tax due. In essence, the new law provides married couples with a total estate tax

exemption of \$10 million and reduces the need for complicated estate tax strategies.

Clarity for 2010 estates

Throughout 2010, the federal estate tax was not in effect. Many people expected this tax to be reinstated retroactively. Thus, there was a great deal of uncertainty for the estates of people who died last year. The new tax law sets the rules for federal estate tax in 2011 and 2012. In addition, it gives 2010 estates the choice of using the 2011 law or the law as it applied during 2010.

- **The 2011 law.** Decedents have a \$5 million federal estate tax exemption.

Excess assets are taxed at 35%.

Inherited assets have the date-of-death value as their basis, although

executors can choose to use the value of estate assets exactly six months after death. As a result, heirs generally do not owe capital gains tax on the appreciation of the assets during the decedent's lifetime.

- **The 2010 law.** As mentioned, estates owe no federal estate tax for deaths last year. There may be a capital gains tax, though, when heirs sell appreciated assets. Assets passed at death retain the decedent's basis, plus a step-up in basis of no more than \$1.3 million, or \$4.3 million for assets placed to a surviving spouse, allocated by the executor of the estate among the decedent's properties.

The bottom line is that estates under \$5 million need not worry about federal estate tax. They can use the 2011 rules and avoid paying estate tax while minimizing future capital gains tax.

Executors of estates over \$5 million face a more difficult choice. They can use the 2011 rules and pay 35% tax on amounts over \$5 million, \$350,000 on a \$6 million estate, for example. Alternatively, they can choose the 2010 rules and avoid federal estate tax. If they choose the 2010 rules, executors will have to track the decedent's basis in all the assets passed on to beneficiaries who might owe tax on future sales. Our office can help executors of 2010 estates make the choice that is better for heirs.

Triple play

Just as the new law sets the federal estate tax exemption for 2011 and 2012 at \$5 million, it also raises the federal gift tax exemption to \$5 million during those two years, up from \$1 million in 2010. Excess lifetime gifts will be taxed at 35%. The same \$5 million exemption and 35% rate also are set for the generation-skipping transfer tax in 2011 and 2012. Therefore, wealthy taxpayers will find planning easier now that all three taxes have the same exemption amount and tax rate, at least for this year and next.

Altogether, few taxpayers will have to face federal estate, gift, or generation-skipping transfer tax because of the expanded exemption amounts. However, state taxes might be a concern so you should consider them in your estate planning.

Give us a call if we can help with your estate planning needs.



EXPANDED 1099 REPORTING REQUIREMENTS REPEALED

Despite numerous uncertainties, many states and the federal government are moving forward with implementing aspects of the Patient Protection and Affordable Care Act of 2010 (the “health care reform law”). However, certain provisions of the health care reform law are undergoing closer scrutiny and some have either been repealed or their effective dates have been delayed. One such affected provision is that relating to the scheduled expanded income reporting requirements to the IRS through Form 1099. Recently, the Comprehensive 1099

Taxpayer Protection and Repayment of Exchange Subsidy Overpayment Acts of 2011 (the “Act”) was signed into law. This Act repeals the requirement contained in the health care reform law that payments of \$600 or more made to corporations that relate to amounts paid for any type of goods or services be reported to the IRS.

Background

Businesses have long had to issue a Form 1099-MISC to each individual service provider who is paid \$600 or more during the year in the course of business. Reportable payments include compensation paid to individuals for both goods and services. Some

exceptions applied.

Expanded Reporting

The health care reform law, however, greatly expanded this mandated reporting requirement by removing the exception for most payments to corporations. This change was to become effective starting in 2012. Thus, the existing requirement that business taxpayers report payments of nonemployee compensation, interest, rents, royalties, etc., totaling \$600 or more was expanded to include payments made to corporations, other than tax-exempt corporations. These new reporting requirements promised to burden businesses with

substantial additional recordkeeping – as well as potential increased costs. Now, there’s relief: These new Form 1099 rules have been repealed by the Act. Basically, the reporting requirements revert to the rules in effect prior to the 2010 changes. (The requirement that rental property owners report certain payments to service providers on Form 1099 starting in 2011 also has been repealed. This provision was originally included in the Small Business Jobs Act of 2010.)

Please contact us if you have any further questions relating to the repeal of the health care reform law’s 1099 reporting requirements.

BE SURE ABOUT BENEFICIARIES

The new tax law greatly reduces exposure to federal estate tax for most individuals and families. However, the new law does not remove the need for all estate planning. You’ll need a thoughtful estate plan to ensure that your assets go to the desired recipients with a minimum of time, expense, and contention.

Your estate plan should begin with a will that was drafted by an experienced attorney. Whenever there is a major change in the law—such as for this year—you should review your will to make sure it still expresses your wishes. The same is true after major life events: births, deaths, marriage, and divorce.

Beyond your will

You also should be aware

that some assets generally do not pass under your will. Instead, they will go to a beneficiary you name. That’s true for employer-sponsored retirement plans, individual retirement accounts (IRAs), life insurance policies, and annuities. Some investment accounts and savings accounts also belong to this group if they are transfer-on-death or payable-on-death accounts.

To see how this might work, suppose that Dan Smith creates an IRA when he begins his working career. He names his sister, Beth, as the beneficiary. Many years later, Dan has a substantial amount in his IRA, as well as other assets. When Dan creates a will as part of his estate plan, he states that all of his assets should go to his nephew,

who is supporting a family on a modest income. Dan does not include his sister in his will because Beth has substantial assets of her own.

However, Dan has neglected to change his IRA beneficiary, in this scenario. At his death, his IRA will pass to Beth, who is still the designated beneficiary. For Dan’s IRA assets, his will is disregarded.

Supreme Court’s view

If you think the Dan Smith example is unlikely, consider this real-life story. An employee at a major U.S. corporation was divorced. In the divorce agreement, the employee’s wife relinquished all claims to his company benefits. The employee, however, did not change the beneficiary designation on his account in the company’s savings

and investment plan. The employee died several years later, with about \$400,000 in this plan. The company paid all the money to the ex-wife, who was still the designated beneficiary. The deceased employee’s estate sued the company, and, in 2009, the U.S. Supreme Court unanimously ruled for the company (*Kennedy v. Plan Administrator for DuPont*). The employee’s failure to revisit his beneficiary selections thwarted his estate plan.

Check and keep checking

You should create a will and revisit it periodically. The same is true for your beneficiary selections. Check them at regular intervals to make sure that the people you have named are still the ones you’d like to inherit those assets.

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