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January 2013

"FISCAL CLIFF" LEGISLATION -- WHAT DOES IT MEAN FOR YOU?

The American Taxpayer Relief Act, passed by Congress on January 1, 2013, permanently extends a large number of tax items from the 2001 and 2003 tax acts and extends many expired tax provisions.

Individual tax changes

- A new top rate of 39.6% (up from 35%) is imposed on taxable income over $400,000 for single filers, $425,000 for heads-of-household filers, and $450,000 for married taxpayers filing jointly ($225,000 for each married spouse filing separately).
- Phase out of personal exemptions and itemized deductions is reinstated at a higher threshold of $250,000 for single taxpayers, $275,000 for heads-of-household, and $300,000 for married taxpayers filing jointly.
- The rate on capital gains and qualified dividends increase to 20% for individuals above the top income tax brackets. The 15% rate is retained for taxpayers in the middle brackets. The zero rate is retained for taxpayers in the 10% and 15% brackets.
- The exemption amount for the AMT on individuals is permanently indexed for inflation. For 2012, the exemption amounts are $78,750 for married taxpayers filing jointly and $50,600 for single filers. Relief from AMT for nonrefundable credits is retained.
- The American opportunity tax credit for qualified tuition and other expenses of higher education was extended through 2018 and the above-the-line deduction for qualified tuition and related expenses was extended through 2013.
- Deduction of state and local general sales taxes was extended through 2013.

Estate and gift tax changes

- The estate and gift tax exclusion amount is retained at $5 million indexed for inflation ($5.12 million in 2012), but the top tax rate increases from 35% to 40% effective Jan. 1, 2013. The estate tax "portability" election, under which, if an election is made, the surviving spouse's exemption amount is increased by the deceased spouse's unused exemption amount, was made permanent by the act.

Business tax changes

The act also extended many business tax credits and other provisions.

- The research credit which expired on December 31, 2011, is now extended from Jan. 1, 2012, through 2013 and modified the Sec. 41 credit for increasing research and development activities, which expired at the end of 2011.
- Section 179 - The $139,000 expense allowance under Sec. 179 was increased to $500,000 for 2012 and extended through 2013 at $500,000. The investment ceiling is $2,000,000 for 2012 and 2013.
- The additional 50% first-year bonus depreciation was also extended for one year by the act. It now generally applies to property placed in service before Jan. 1, 2014 (Jan. 1, 2015, for certain property with longer production periods).
- The work opportunity tax credit that expired on Dec. 31, 2011, is extended retroactively from Jan. 1. 2012, through Dec. 31, 2013

This is just a partial list of the changes brought on by this legislation. For more information, please call us.

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Reviewing your internal processes and controls for efficiency as well as fraud prevention practices

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PUTTING YOUR MONEY WHERE YOUR MOUTH IS: SETTING A STRONG TONE AT THE TOP

By Jessica Kinney, CPA, CFE

It is easy for management to proclaim, "there is a zero tolerance for fraud and unethical behavior," but is it as easy to cite specific examples of management's actions displaying this strong 'tone at the top'? The term 'tone at the top' is all a buzz in recent years due to many highly public fraud cases. The 'tone at the top' refers to the ethical atmosphere that is created in the workplace by the organization's leadership.

In the newspaper every day you can find examples of how management's actions or what was portrayed by management to the employees was, to put it gently, less than ideal. How often do you hear of the positive things a company's management is doing to promote an ethical environment?

Here are three critical things management can do to help promote a culture of integrity:

1. Implement an Independent Hotline for Anonymous Reporting of Unethical Behavior

2. Provide Fraud Training for Employees

3. Implement a Formal Ethics Policy

Implementing the above suggestions sends a strong message to employees that integrity and ethical behavior is a top priority and that any deviation will not be tolerated. For information on the implementation of these items including our independent hotline, Red Flag Reporting, which includes fraud training for all employees, please contact Jessica Kinney at JKinney@Shannon-CPAs.com or 253-852-8500.

24/7 Fraud Hotline
For more info, email: RedFlag@Shannon-CPAs.com

USE TAX: AUDIT TRAP OR MISUNDERSTOOD EQUALIZER?

By David Volkert, Senior Accountant

It's important to know that the Use Tax and the Sales Tax are the identical twins separated at birth of taxation. Created at the same time, the 'genetic' makeup of these taxes is identical but their separate paths in life have given them distinct functional differences. Referred to as a compensating tax, the Use Tax basically taxes anything the Sales Tax would have been paid on, but was not. If you purchased an item without paying sales tax but would have had the item been purchased at retail from an in-state seller, you owe Use Tax. It's an equalizing tax that ensures all taxpayers pay their fair share of Washington State taxes.

But it's also an audit trap. Given the popularity of online shopping, it's improbable that a taxpayer doesn't owe any use tax and the Department of Revenue knows this and can use it to its advantage. By not reporting any Use Tax, taxpayers put up an audit flag that's easy to spot and under audit, easy to assess taxes and penalties.

Some key examples of where Use Tax liability arises are:

- **Purchasing property outside of the state and bringing it into the state.**

This is an easy one to understand. Because the Use Tax is a compensating tax, cars, computers, furniture, office supplies, etc., are all subject to the Use Tax.

- **Purchasing property for resale and using it for internal purposes.**

It is assumed that when an item is purchased for wholesale that the purchaser is not the end user of the item. When the purchaser becomes the end user by using the product, use tax is due. For example, an electronics retailer owes Use Tax on the computers it uses if they were purchased at wholesale.

- **Purchasing property at garage sales and charity auctions.**

Just because a seller isn't required to collect Sales Tax it doesn't absolve you of your Use Tax liability. Items purchased from garage sales or charity auctions all generate use tax liability even though the seller is not required to charge you the Sales Tax. The sellers' exemption from collecting the sales tax is only on the collection of the tax, not on the tax itself.

- **Converting inventory from being held for resale to sales samples.**

By taking an item held for resale and giving it away effectively converts item from being held to resale to a product consumed by the taxpayer's marketing activities. Use Tax is due because the taxpayer has become the consumer of the product.

HOW TO PROTECT YOUR BUSINESS AGAINST FRAUD

An unfortunate aspect of the economic conditions of the last few years, is the escalating prevalence of fraud within small and mid-sized businesses. In a recent study by Price Waterhouse Coopers, they found that over three-quarters of businesses reported some type of fraud, and that 88% of U.S. based businesses who reported fraud recorded corresponding declines in revenue. In this seminar we will discuss some simple controls and policies that you can implement to help you mitigate some of your risk.

Join us on Jan. 17 from 7:30-9:30 am at:

Burien City Hall and Library
400 SW 152nd St, Suite 300
Burien, WA 98166

Learn more about protecting your company. For more information, please visit:
http://www.shannon-cpas.com/news-events/

NONDEDUCTIBLE CONTRIBUTIONS TO TRADITIONAL IRAS

Many people think IRAs come in two flavors. Traditional IRAs, as they're known, often hold pretax dollars. They offer tax deferral, but you'll owe income tax on withdrawals. Alternatively, Roth IRAs are funded with aftertax dollars. Earnings inside the account are tax-free, as they are with traditional IRAs, and withdrawals also are tax-free if you are at least 59½ years old and have had a Roth IRA for at least 5 years.

In some cases, however, you might find that you cannot make a deductible contribution to a traditional IRA or a nondeductible contribution to a Roth IRA. If so, you should consider contributing aftertax dollars to a traditional IRA, even though such contributions are not deductible.

Example 1: Paul and Lois Matthews, both age 55, work at jobs where they participate in a retirement plan. Their combined income this year is over $250,000. Neither spouse qualifies for a deductible contribution to a traditional IRA because couples filing a 2012 joint tax return can't make deductible contributions if they have modified adjusted gross income (MAGI) of $112,000 or more, and if both spouses are covered by an employer's retirement plan.

This couple can't make Roth IRA contributions, either. For 2012, a couple filing jointly can't contribute to a Roth IRA if their MAGI is $183,000 or more.

However, both Paul and Lois can make full aftertax contributions to a traditional IRA for 2012. Such contributions have no income limits. Because they are both over 50, Paul and Lois can each contribute up to $6,000 to a traditional IRA this year. They'll get no deductions for their contributions, but they will enjoy other tax benefits.

Multiple benefits

After contributing nondeductible money to a traditional IRA, all investment earnings are tax-deferred until money is withdrawn. In addition, individuals will owe less tax on Roth IRA conversions and traditional IRA withdrawals.

Example 2: Paul Matthews has no traditional IRA. For 2012, he makes a $6,000 nondeductible contribution to his first traditional IRA. Once the account is open, he converts this IRA to a Roth IRA; there are no income limits on Roth IRA conversions.

If Paul's traditional IRA is worth $6,000, then all of the money is aftertax. Thus, Paul owes no tax on the conversion.

He can do this year after year, building up a Roth IRA for eventual tax-free distributions. A quirk in the tax code places no income limits on Roth IRA conversions, even though there are income limits for Roth IRA contributions. As explained in the next example, though, contributing aftertax dollars to a traditional IRA and then converting to a Roth IRA may generate a tax obligation.

Example 3: Lois Matthews has a traditional IRA. For 2012, she makes a $6,000 nondeductible contribution to a new traditional IRA. Lois keeps making such contributions for the next several years.

By 2017, Lois has a total of $100,000 in her traditional IRAs. Of that amount, $30,000 is aftertax money and $70,000 is pretax. Lois decides to convert $20,000 to a Roth IRA. Because her traditional IRA money is 30% aftertax, the conversion is only 70% taxable: on a $20,000 conversion, Lois will report $14,000 (70% of $20,000) in taxable income. That will be the result no matter which traditional IRA Lois taps for the conversion.

If Lois decides to withdraw funds from her traditional IRA for spending money then, instead of for a Roth IRA conversion, the tax treatment would be the same. Lois would report taxable income equal to 70% of the withdrawal and a 30% tax-free return of aftertax money.

TRUSTED ADVICE

Roth IRA conversion

- You can convert money held in a traditional IRA to a Roth IRA by receiving a distribution. For a conversion, you must contribute up to the same amount to a Roth IRA within 60 days.
- You also can convert by directing the trustee of your traditional IRA to transfer funds to the trustee of the Roth IRA.
- Alternatively, you can direct the trustee of your traditional IRA to transfer money to a Roth IRA. Such conversions with the same trustee can be made by redesignating the traditional IRA as a Roth IRA, rather than by opening a new account.
- You must include in your gross income the amount of any distributions from your traditional IRA that you would have had to include if you had not converted the money to a Roth IRA.

Effective 1/1/13

Washington State minimum wage increased to $9.19 per hour

HOW LONG SHOULD YOU KEEP RECORDS?

Individual taxpayers and business owners must deal with an enormous amount of record keeping. Data arrives regularly, electronically and on paper. Keeping track can be a challenge.

Just as challenging, you must decide which records to keep and for how long.

If you just keep everything, you will have increased storage responsibilities and a more difficult time locating the information you need. Moreover, the longer you retain records, the greater the chance that someone might access them and use them improperly.

So how long should you keep records? The short answer is it depends. Some records can be destroyed after a short time, but others must be kept indefinitely, depending on the nature of the transactions they describe.

Timetable for tax records

Generally, you must keep tax records that support the income, deductible expenses, and credits you report on a tax return. In addition, you should keep copies of the records you file. The basic rule is you should keep these records until the limitation period runs out for the return the record is related to. The limitation period is the period in which you can amend a return to claim a credit or refund, or the IRS can address additional tax.

Generally, the limitation period for a return is three years after you file the return. If you file your return before its due date, it Is treated as filed on the due date for these purposes.

Exceptions exist:

- If you mistakenly did not report income that you should have, and the shortfall is more than 25% of the gross income shown on your return, you should keep records for six years, rather than three.
- If you filed an amended return to claim a credit or refund, you should keep records for (a) three years from the date you filed your original return or (b) two years from the date you paid the tax, whichever is later.
- After you have filed a claim for a loss from worthless securities or a bad debt deduction, keep the relevant records for seven years.
- If you have employees, you also should keep all employment tax records for at least four years after the date the tax became due or has been paid, whichever is later.

Caution: If you did not file a tax return -- or, even worse, filed a fraudulent return -- the limitation period never runs out. Keep tax records for those years indefinitely.

Beyond the limit

Even if you haven't amended a tax return, you may have to hold onto some records for an extended time period. That's true of records connected to assets such as securities or real estate. Until you dispose of such assets in a taxable transaction, you should keep records that support your claimed gain or loss as well as any depreciation, amortization, or depletion deductions you've taken. If you have received property in a tax-free exchange, you should keep the records that relate to the property you relinquished and to the property you acquired until the limitation period expires for the year in which the new property is sold in a taxable disposal.

In addition, you should keep records of nondeductible contributions to retirement accounts indefinitely. Those contributions will allow you to avoid some tax on future withdrawals and on Roth IRA conversions. You also should retain home-improvement records as long as you own a house because those outlays could reduce the tax you'll owe when you sell.

Filing for the future

The IRS permits businesses, sole proprietors, and individual taxpayers to store tax documents electronically. Besides documents that originate electronically, the IRS rules also permit taxpayers to convert paper documents to electronic images and maintain only the electronic files. This allows for the paper documents to be destroyed.

For businesses, the IRS electronic record retention rules require electronic files to provide enough information to justify entries made on tax returns, so the tax liability can be determined. Those records must be detailed enough to explain transactions and identify any underlying source documents. Companies must make electronic records available to the IRS upon request and provide the IRS with any help needed to access the information contained in those records.

If your company uses an electronic storage system for its records, you should be sure that the system can index, store, preserve, retrieve, and reproduce the electronic data. Make sure the system provides reasonable controls for integrity, accuracy, and reliability of your data. For your own security, you'll want a system that's designed to prevent and detect any unauthorized revision or deletion of your data.

Beyond taxes, other vital business documents must be retained for extended time periods. The requirements usually are set by state law. However, legal documents such as contracts, leases, and binding agreements probably should be retained in hard copy form.

INVESTING ON THE NEW FRONTIER

The conventional wisdom holds that this century has been disappointing for stock market investors. Through the first quarter of 2012, the benchmark S&P 500 Index showed a return just over 4% per year, for the prior 10 years. That was less than half the long-term average; for the 40 years from 1972–2011, the broad U.S. stock market has returned nearly 10% a year to investors.

Still, this century has rewarded some investors who put their money into stocks from emerging markets. According to Morningstar, its diversified emerging markets category of mutual funds gained nearly 13% a year for those 10 years. These funds invested largely in Chinese and Brazilian stocks. Indeed, Morningstar's Latin American stock category of funds led all others with annualized returns over 17% for those 10 years, mainly because of their focus on Brazil.

Growth spurt

Why did Chinese and Brazilian companies, among others, reward investors, while American, Japanese, and European stocks generally lagged? In a word, growth. Some developing nations enjoyed rapid economic growth as they adopted market-oriented economies, and companies based in those countries posted significant profits.

Emerging markets investments may continue to outperform others...or they may not. History is filled with examples of investments that soared for a period of time and then came back to earth. Moreover, growth from current levels may be harder to attain than that from the starting point of 10 years earlier.

Meanwhile, some investors are seeking the next round of emerging markets—countries that now are in a position similar to that of China or Brazil at the turn of the century. Such countries are known as frontier markets, to differentiate them from more familiar emerging markets. Advocates of frontier market investments assert that investors will profit from these markets in the next decade, just as shareholders benefitted from emerging markets in the last 10 years.

Defining the terms

The globe has become divided into three types of markets. The industrialized nations of the world attract most capital from investors. Emerging markets, as previously noted, have taken steps on the path to economic development. Frontier markets (which are not in either of the other two categories) have farther to go before they offer a broad range of companies in which to invest and an efficient stock market for trading shares.

Investors can choose among many countries that are neither developed nor emerging. Nevertheless, not all of these nations are considered frontier markets. Generally, sophisticated investors seeking promising frontier markets look for an assortment of publicly traded companies, liquid trading opportunities, reporting requirements for public companies, established property rights, and a rule of law that extends to sizable companies. With such features in place—which are by no means present in all parts of the world— shareholders of public companies may have realistic hopes of pocketing profits.

The countries that meet the criteria for being a frontier market tend to be largely rural, with a low technology base yet some signs of market capitalism. Often, they offer human capital in the form of young and willing workers.

Appealing aspects

If countries can be classed as frontier markets, they may provide opportunities for investors. Because they are starting from a smaller base, frontier markets may grow faster than developed nations and emerging markets in the future.

Such growth could help create an expanding middle class, leading to more demand for high quality goods and services. That demand, in turn, may generate profits and higher stock prices. In addition, some frontier markets have ample natural resources, which they can profitably export to other countries. A recent report from Citigroup listed Bangladesh, Iraq, Mongolia, Nigeria, Sri Lanka, and Vietnam among frontier markets projected to report superior economic growth over the next several decades.

Moreover, major financial institutions typically do not devote extensive resources to following the companies in frontier markets. That may create opportunities to find well priced frontier market stocks with excellent growth potential.

Already, some funds offer investors access to frontier markets. These include exchange-traded funds and mutual funds designed to track a frontier markets index.

If you are interested in the concept of frontier markets, be aware that such investments are likely to be volatile. Any portfolio allocation should be modest.

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