

RAUPC News

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Keeping the Rules Straight on IRAs

By Michelle Lindblom

What began as a simple account arrangement to encourage retirement savings in 1974 has, through repeated rounds of legislation, become a bit of mind boggle. Layers of statutory enhancements and limitations leave IRAs surrounded with such confusion that the very people Congress wants to encourage can't keep the rules straight. So we thought it would be helpful to give a quick rundown, subject to the caveat that politics may come into play again: the Bush Administration has re-proposed a pair of tax-advantaged savings vehicles – the Lifetime Savings Account and Retirement Savings Account – which would mothball the regular and Roth IRAs described below. So stay tuned.

Traditional IRA Profile

- Tax-deductible contributions (depending on income level)
- Withdrawals begin at age 59 ½ and are mandatory by age 70 ½
- Taxes are paid on earnings when withdrawn
- Funds can be used to purchase a variety of investments
- Available to anyone due to lack of income restriction
- Withdrawals before age 59 ½ are subject to a 10% penalty (subject to exceptions)

A traditional IRA is defined as an IRA that is not a Roth IRA or a SIMPLE IRA. You can set up and make contributions to a traditional IRA if you (or, if you file a joint return, your spouse) received taxable compensation during the year and

you are not age 70 ½ by the end of the year. You can have a traditional IRA regardless if you are covered by any other retirement plan.

The maximum contribution that one can make to a traditional IRA is the lesser of \$3,000 (\$3,500 if you reach age 50 before the end of 2004) or your taxable compensation for the year. If you are covered by an employer-provided retirement plan, your deduction for contributions to a traditional IRA will be reduced if your modified adjusted gross income (AGI) is between:

- \$65,000 and \$75,000 for a married filing joint return or qualifying widow(er);
- \$45,000 and \$55,000 for a single individual or head of household; or
- \$0 and \$10,000 for a married individual filing separately.

Roth IRA Profile

- Contributions are not tax deductible
- No mandatory distribution age
- All earning and principal are nontaxable if rules and regulations are followed
- Funds can be used to purchase a variety of investments
- Income restrictions (discussed below)
- Principal contributions can be withdrawn any time without penalty (subject to some minimal conditions)

Generally, you can contribute to a Roth IRA if you have taxable compensation and your modified AGI is less than:

- \$160,000 for married filing joint or qualifying widow(er);
- \$10,000 for married filing separately and you lived with your spouse at any time during the year; and
- \$110,000 for single, head of household, or married filing separately and you did not live with your spouse at any time during the year.

If your modified AGI is above these amounts, the contribution limit is gradually reduced. A 6% excise tax is applied to any excess contribution.

The contribution limit for Roth IRAs depends on whether contributions are made only to Roth IRAs or to a traditional IRA as well. If contributions are made only to Roth IRAs, the contribution limit generally is the lesser of \$3,000 (\$3,500 if you



Washington Estate Tax Update

By Jay Hanson

In 2001, the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") changed the federal estate tax exemption amounts, thereby allowing greater amounts of estate assets to pass free of federal estate tax at death. Because Washington State did not amend its statutes to take into account the change of the estate tax exemption amounts at the federal level a *de facto* Washington State estate tax was effectively created. The difference between the federal estate tax exemption amount (\$1,500,000 in 2005) and the Washington State estate tax exemption amount (\$950,000 in 2005) created a gap (\$550,000 in 2005) which was subject to Washington State estate tax even when no federal estate tax was due to the federal government. The tax on this gap amount could be as high as \$64,400 in 2005, and rising to \$99,600 in 2006. Several requests were made of the Washington State legislature to amend Washington State law to fix this problem. Such requests were routinely dismissed. A class-action lawsuit then ensued challenging the validity of the imposition of the Washington State estate tax.

The Washington State Supreme Court ruled on February 3, 2005, in the case *Estate of Hemphill v. State of Washington*, that the imposition of the Washington State estate tax was invalid. The Court further ruled that Washington State must refund estate taxes collected since January 1, 2002. Therefore, if an estate paid estate taxes to the Washington State Department of Revenue since January 1, 2002, a refund may be due. The State is expected to issue refunds in excess of \$150 million. Additionally, if an estate plan has not been updated since the enactment of EGTRRA in 2001, the estate plan should be reviewed to determine if the language in the estate planning documents is consistent with the changes to the tax laws. A review is also recommended to determine if

the estate planning documents adequately address the goals of the distribution of estate assets at death.

If you have any questions regarding the impact of the invalidation of the Washington State estate tax or would like to discuss any other estate planning matters, please contact our office directly.

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A Trustee's Duty to Inform

By Jay Hanson

A question which often arises after the establishment (or subsequent administration) of a trust is whether a trustee has a duty to inform the trust's beneficiaries of the existence of the trust, its underlying assets or the aspects of the trust's management. The short and simple answer to this question is: yes, generally. The duty to inform a beneficiary of the existence of a trust rests in the age-old maxim that a trust beneficiary is the equitable owner of the trust property; the trustee is the mere representative whose function is to attend to the safety and management of the trust property. It is important that both the trust's settlor and trustee know that the trustee holds trust property for the exclusive benefit of a trust beneficiary. Every action taken by a trustee should be for the benefit of the trust's beneficiaries.

Under Washington law, a trustee owes a trust beneficiary the highest degree of good faith, care, loyalty and integrity. These duties generally prevent a trustee from keeping the trust's beneficiaries ignorant of the trust, the trust's property and the details of the trust's administration. A trustee's duties to a trust beneficiary include the *duty to inform* a beneficiary of all the facts which would aid the trust's beneficiaries in protecting their interests in the trust. Failure to do so is potentially a breach of the trustee's duty to the trust's beneficiaries. The reason the law imposes a duty to inform is that if a trust beneficiary does not know of the existence



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Individual taxpayers may elect to deduct either state and local income taxes or state and local general sales taxes as an itemized deduction on their federal income tax returns for 2004 and 2005.

Deduction of State and Local General Sales Tax

By Rainie McLaughlin

Prior to 1987, taxpayers were allowed a deduction for both their state and local income taxes paid and the amount of state and local general sales taxes paid. Both amounts were deducted as itemized deductions. Taxpayers could either claim the actual amount of sales taxes paid or use the amount from the IRS-generated tables.

As part of the Tax Reform Act of 1986, the deduction for state and local general sales taxes was repealed for tax years after 1986.

American Jobs Creation Act Impact

Due to the American Jobs Creation Act of 2004, individual taxpayers may elect to deduct *either* state and local income taxes *or* state and local general sales taxes as an itemized deduction on their federal income tax returns for 2004 and 2005.

General Sales Taxes

For purposes of the deduction, "general sales tax" means a tax imposed at one rate with respect to the retail sale of a broad range of classes of items. To qualify as a general sales tax, a tax must meet the following two tests: (1) The tax must be a tax in respect of sales at retail. This may include a tax imposed upon persons engaged in selling tangible personal property or furnishing services at retail. Rentals qualify as sales at retail if so treated under applicable State sales tax laws. (2) The tax must be general—that is, imposed at one rate in respect of the retail sales of a broad range of classes of items. The term "items" includes both commodities and services.

Compensating Use Taxes

A compensating use tax with respect to an item shall be treated as a general sales tax. The term "compensating use tax" means, with respect to any item, a tax which is imposed on the use, storage, or consumption of such item. Use tax is complementary to a general sales tax. For example, if a resident of Washington purchases a motor vehicle in Oregon, a state with no sales tax, the state of Washington will impose a use tax, complementary to the general sales tax rate, on the retail purchase.

Deductible Amount

Taxpayers may elect to deduct the total of actual general sales taxes paid as substanti-

ated by accumulated receipts or use the amount from IRS-generated tables. Taxpayers who elect to use the tables are allowed, in addition to the table amount, to include any general sales taxes paid in the purchase or lease of a motor vehicle (including a car, motorcycle, motor home, recreational vehicle, sport utility vehicle, truck, van, and off-road vehicle), boat, airplane, and home-building materials. The tables are based on average consumption by taxpayers on a state-by-state basis and take into account filing status, number of dependants, adjusted gross income, and rates of state and local general sales tax.

Washington Residents

The Washington sales tax is imposed on each retail sale or lease in the state of tangible personal property and specified services. Generally, all sales of tangible personal property to consumers for their own use are considered retail sales. In addition, a variety of services are defined as retail activities. The following transactions are retail sales and subject to sales tax. The list is not all-inclusive.

- Construction/Installation Services:
 - Installing, repairing, cleaning, improving, constructing, and decorating real or personal property
 - Constructing and improving new or existing structures
 - Landscape maintenance
- Services:
 - Charges for lodging for periods of less than 30 consecutive days from hotels, motels, and condos
 - Physical fitness activities
 - Sporting and recreational events

The following are common exemptions from the retail sales tax:

- Groceries and Prescription Drugs – Food products for human consumption, prescription drugs, hearing aids, etc.
- Fuel
- Airfare
- Most professional services

Other Considerations

Similar to state and local income taxes, individuals cannot deduct sales taxes for purposes of the alternative minimum tax (AMT) and may lose the benefit of the write-off if they are subject to the AMT.

Who Are Employees?

By Rainie McLaughlin

As a general rule, an employer must withhold federal income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an employee. However, before one can determine how to treat payments you make for services, you must first know the business relationship that exists between you and the person performing the services. In determining whether the person providing service is an employee or an independent contractor, all information that provides evidence of the degree of control and independence must be considered.

Facts that provide evidence of the degree of control and independence fall into three categories: behavioral control, financial control, and the type of relationship of the parties.

Behavioral Control covers facts that show whether you have a right to direct and control **how** the work is done through instructions, training, or other means.

An employee is generally subject to your instructions about when, where, and how to work. The following are examples of types of instructions:

- When and where to do the work.
- What tools or equipment to use.
- What workers to hire or to assist with the work.
- Where to purchase supplies and services.
- What work must be performed by a specified individual.

An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

Financial control covers facts that show whether you have a right to control the financial and business aspects of the worker's job. This includes:

- Unreimbursed business expenses – Independent contractors are more likely to have unreimbursed expenses than are employees. Contractors typically will incur ongoing costs regardless of whether work is currently being performed.
- Services – An independent contractor generally makes his or her services available to others. They often advertise, maintain a visible business location and seek out similar engagements from others. ***This is often a critical factor: does the person providing the service provide similar services to others, or is the service relationship exclusive to you?***

- Realization of profit or loss – An independent contractor can make a profit or loss. In other words, in contrast to an employee, an independent contractor can lose money on your job.

Type of relationship includes:

- Written contracts describing the relationship the parties intended to create.
- Whether you provide the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay.
- The permanency of the relationship. If one engages a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that your intent was to create an employer-employee relationship.
- If the worker provides services that are a key aspect of your regular business activity, it is more likely that you will have the right to direct and control his or her activities.

It is critical that the employer correctly determine whether the individuals providing services are employees or independent contractors. If an employee is incorrectly classified as an independent contractor, the employer can be held liable for employment taxes, plus a penalty.

When to Issue Form 1099-MISC?

After the business relationship has been examined and correctly classified, we can determine where payments made for services should be reported.

- **Personal payments.** Do not issue a 1099-MISC for personal payments (e.g., payments to your gardener, plumber, physician, babysitter, personal accountant, etc.).
- **Trade or business.** Payments made in connection with a trade or business in excess of \$600 are reportable on Form 1099-MISC, unless the payee is a corporation.
 - An exception to this rule is when payments are made to an incorporated law firm (i.e., payments by a business to an attorney always require a 1099-MISC).



IRAs Continued from page 1

reach age 50 before the end of 2004) or your taxable compensation for the year. If contributions are made to both Roth IRAs and traditional IRAs, the contribution limit is generally the same, but is reduced by all contributions (other than employer contributions under an SEP or SIMPLE IRA plan) for the year to all non-Roth IRAs.

SIMPLE IRA Plan Profile

- Tax-favored retirement plan used by small employers and self-employed individuals
- Allows employees to reduce their compensation by a certain percentage each month and the employer contributes these funds to a SIMPLE IRA on the employee's behalf
- Employer may choose to match employee contributions

The maximum 2004 salary reduction contribution that employers can make on an employee's behalf under a SIMPLE plan is \$9,000, an increase of \$1,000 from 2003. Individuals 50 years old or more during 2004 may be able to contribute an additional \$1,500. Generally, the same distribution rules that apply to a traditional IRA apply to SIMPLE IRAs.

President Bush's fiscal year (FY) 2006 federal budget proposes a number of tax law changes including a proposed overhaul of retirement savings plans. Instead of using traditional or Roth IRAs, an individual could have the choice of two new plans:

- Retirement Savings Accounts (RSAs)
- Lifetime Savings Accounts (LSAs)

RSAs would be similar to traditional and Roth IRAs but with some important differences. An individual would be able to contribute up to \$5,000 annually. Earnings and distributions would be tax-free after age 58 and there would be no income restrictions. However, unlike traditional IRAs, a contribution to an RSA would be nondeductible.

LSAs would serve as an all-purpose savings account. The annual contribution limitation would be \$5,000 and distributions could be made at any time tax-free and with no penalty. Distributions could be used for any expense—educational, health, or otherwise. All earnings would accumulate tax-free.

If the Bush plan passes Congress, you'll need to immediately evaluate your retirement savings and investment strategies. Depending on your age and income, you'll likely need a mix of various savings vehicles to maximize your tax-advantaged savings for retirement and for ongoing financial goals.

Trustee Continued from page 2

of the trust or the details of its administration, then the beneficiary may never know if the trustee has committed a breach of the duties owed to the beneficiary. Without the requisite knowledge of the trust's existence, a beneficiary would be without remedy for a loss, and the courts without potential jurisdiction over the trust.

What information is the trustee required to convey to a trust beneficiary? In sum, the trustee has to give information which is reasonably necessary for a trust beneficiary to enforce such beneficiary's rights under the trust agreement or to prevent or redress a breach of trustee duty. This would extend to a beneficiary's right to view trust documents relating to such beneficiary's interest in the trust. Additionally, a beneficiary should be kept apprised of the management of the trust's assets, especially if the trustee intends to engage in the sale or conversion of a significant portion of the trust's assets. The failure of a trustee to properly inform trust beneficiaries of the management of trust assets potentially subjects the trustee to litigation regarding the performance of trust assets long after investment decisions have been made. Disclosure allows trust beneficiaries to monitor the performance of trust assets and address concerns over trust management in a timely manner. Two-way communication is a method to help avoid disputes between trustees and trust beneficiaries.

In sum, a trustee owes a duty of loyalty to a trust beneficiary, not to the trust's settlor. Trust beneficiaries must be kept informed of pertinent trust information so the beneficiaries can protect their rights in the trust property. Trust beneficiaries cannot enforce their rights if they do not know of the existence of the trust or the activities of the trustee. If a trust settlor is motivated to keep the trust's beneficiaries in the dark regarding the existence and/or management of a trust, there may be available alternatives to accomplish these goals. Under Washington law, a trust settlor may put in writing (in the trust agreement) that the trust beneficiaries are not to know of the existence of the trust, its underlying property or issues related to trust management. The validity of this direction has not been tested under Washington law and there is some skepticism within the legal community regarding the ability of such a direction to withstand a legal challenge. Additionally, no professional trust management firm would entertain providing trustee services if they were directed to withhold information from a trust beneficiary. If the trust settlor is truly interested in keeping trust information from the trust's beneficiaries, the settlor would be advised to establish an offshore trust. The use of an offshore trust may permit a complete withholding of trust information.

A trustee owes a duty of loyalty to a trust beneficiary, not to the trust's settlor.

What's New Around Here

By Amy Bockelman

Welcome to the new year, everyone! We'd like to update you on what's new around here. 2005 brought two new faces to the RAUPC clan: our newest employee, Derek Hayner, and our first intern ever, Matt Fox. Derek is well known to us from our Arthur Andersen days and brings with him a wealth of knowledge and experience that we plan to exploit for many years to come. He also increases the number of RAUPC dogs by two, bringing the percentage of RAUPC employees who own dogs up to 87.5%.

Having an intern is somewhat of an experiment for us, but we clearly picked the right guy for the job. Matt is not only a willing guinea pig, but also a really good personality match for our office. He is a senior at the University of Washington and will begin work on his Master's in Accounting this fall. In the meantime, we will gratefully accept his assistance through busy season and hope that we can impart some useful knowledge along with valuable real-world experience.

Other new things around here include the revamped-but-not-yet-100%-complete website. In addition to learning about our services, you can read previous RAUPC newsletters, link to other useful and/or interesting websites, or find contact info and directions to our office. In the coming months we will add some finishing touches, including a page that is purely for amusement purposes. We will update the site on a regular basis with new information such as newsletters, employee information, or new links. You may peruse our site at www.raupc.com.



Tax Events Calendar

Date	Taxpayer	Event
March 15, 2005	Corporations	Due date for domestic C or S corporations or foreign corporations with U.S. offices to file their 2004 income tax return (Form 1120 or Form 1120S). File form 7004, together with payment, to obtain an automatic six-month extension of time to file.
April 15, 2005	Individuals	Due date for individuals to file their 2004 income tax returns (Form 1040, 1040-A, or Form 1040-EZ). File form 4868 to obtain an automatic four-month extension of time to file.
April 15, 2005	Individuals	First installment of 2005 estimated tax is due (Form 1040-ES).
April 15, 2005	Partnerships	Due date for partnerships and LLCs to file their 2004 income tax returns (Form 1065). File form 8736 to obtain an automatic three-month extension of time to file.
June 15, 2005	Individuals	Second installment of 2005 estimated tax is due (Form 1040-ES).
June 15, 2005	Individuals	Due date for U.S. citizens and resident aliens living and working outside the U.S. and Puerto Rico to file income tax return (Form 1040) and pay any owed tax, interest and penalties.

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