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RAUPC News

Inside this issue:

1 Newsletters are Back

1 Changing Residency to Avoid the WA Estate Tax?

2 A Primer on "Like-Kind Exchanges"

3 The Legislative Front

4 Trustees Take Heed

5 The Domestic Partnership Registry Comes to Washington

10 Tax Events Calendar

Newsletters are Back

And Other News

By Amy Bockelman

RAUPC has been growing, bringing some changes around the office. In January 2007 **Brandi Fruik** joined us as a staff person. Brandi graduated from the University of Washington, immediately passed all sections of the CPA exam, and has shown a remarkable ability to adapt to all the quirks that go along with working at RAUPC.

Another University of Washington grad, **Matt Goodwin** was hired as our second staff person this January. Matt was our intern during the 2007 spring tax season, and despite what we put him through last year he was willing to come to work with us full time. Thanks, Matt!

Also new this year is our part-time receptionist/administrative assistant, **Rachel Faircloth**. You will get to know Rachel as she works the front desk in the afternoons and shares many of my duties. Rachel has already been an enormous help and will be a great asset to us as we head into busy season.

I am now shuttling between two desks. The fastest way to reach me is via **my new direct dial number, 206.357.3036**, though I can still be reached at the main number. Please note that we have also changed some of our voice mail prompts and settings to reflect some of our recent changes. The good news is that this gives you a better chance of reaching a live person when you dial the main number. But if you get the voice mail system, rest assured that if you leave a message we will respond as soon as possible. As always, you can find our contact info on the website, www.raupc.com.

Sadly, sometime in 2007 we lost our second fish, Fernando Deux. Our latest fish is another Betta, a female whom we have named Floaty. Flo seems content and is thriving under our sometimes neglectful care.

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Changing Residency to Avoid the WA Estate Tax?

A Back of the Estate Tax Return Calculation[1]

By Jay Hanson

The Washington State estate tax has in all likelihood become a fixture on the tax planning landscape for Washington State residents and non-residents alike. The passage of Initiative 920 last fall, which affirmed the retention of the tax, likely solidified the political and popular support of this tax for some time to come. The Washington State estate tax is imposed in different ways depending upon an individual's Washington State residency status at the time of death. The estates of Washington State residents are taxed on interests in tangible personal property and real estate located within Washington State, as well as interests in intangible personal property[2] regardless of the property's location at the time of death. The estates of Washington State non-

***Estate Tax* Continued on page 6**

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A Primer on "Like-Kind Exchanges"

By Bob Underhill

Section 1031 is one of the oldest sections of the Internal Revenue Code (1924), originally aimed at agricultural interests in the early part of the last century. Grounded in a fundamental concept underpinning much of the tax code, Section 1031 aims to tax economic gain when there is "wherewithal to pay." Where one property is exchanged for another, with little or no cash changing hands, the section defers the tax until the replacement property is eventually sold. The deferral is accomplished via a substitution of basis—the basis of the old property attaches to the new. Consequently, when the replacement property is sold, the taxable gain will include the gain deferred in the 1031 exchange.

Years ago, the statute was used heavily by farmers and ranchers—one exchanging acreage or farm equipment with another. As business and economy grew more complicated through the

years, "direct" exchanges became something of a rare occurrence. The law evolved to allow three- (or four-) corner exchanges through use of an intermediary—a facilitator who takes title to property owned by an exchange party, sells it for cash, uses the cash to acquire replacement property identified by the exchange party, and transfers ownership of the new property to the exchange party to close the loop. In a three- or four-corner exchange, only one of the parties need be seeking Section 1031 treatment. This contrivance was necessary to keep the statute from slipping into near obsolescence, reflecting the rather rare circumstance in modern society where two taxpayers will each own property of like kind and near in value that the other so happens to want.

A question we get a lot is whether one's home, vacation home, yacht or other personal use property can be exchanged "like kind" for another. The answer is "no"—Section 1031 requires that the both the old property and the replacement property be held for investment or the production of income in a trade or business. That rules out personal use property, although until 1997 a somewhat similar rule existed for the sale of a principal residence—if a taxpayer's primary home was sold, any gain was deferred as long as the proceeds were fully invested in a replacement residence. The new rule excludes up to $250,000 of gain on the sale of a principal residence ($500,000 on a joint return), irrespective of the amount reinvested.

There are two other limitations on property that may be exchanged. Inventory or stock in trade cannot be exchanged like kind; nor may shares of stock (how wonderful would that be?), securities or partnership interests.

For the exchange to qualify, the property given up and property received in the exchange must be "like kind." If the property is real estate, like kind is very liberally construed. Any real estate is considered like kind to any other real estate—agricultural for urban; improved for unimproved; a factory for retail space or an apartment building. A leasehold exceeding 30 years is also considered an interest in real estate. For tangible property, however, the term has a far more literal interpretation—"like kind" means like in use and character. Consequently, a bull is not like kind with a cow; a truck is not like kind with a passenger automobile; an extruding machine is not like kind with a drill press. Also, non-US situs property is, by definition, not like kind.

The taxpayer's interest in the exchange property cannot be held through a partnership or other entity (for entity-owned assets, the entity itself must be the exchange partner). For example, a taxpayer who owns a 50% interest in a real estate partnership cannot exchange that interest for other real estate. The reason is that a partnership interest is not like kind with real estate (even if the partnership owns only real estate assets). The partnership in question must dissolve, or the taxpayer take a distribution of his or her interest in the real estate asset (i.e., go "on deed" as an undivided tenant in common), and thereafter proceed with the exchange.

There are time periods prescribed in the statute for identifying the replacement property (45 days from the sale of the relinquished property) and closing on its purchase (180 days). These timeframes are calendar days (weekends and holidays count) and are strictly enforced (even the most heartfelt excuses for missing them are repudiated by the courts). A taxpayer may "identify" up to three potential replacement properties without regard to their value; or more than three properties as long as their total value does not exceed 200% of the property sold; or any number of properties regardless of value provided that 95% of the fair market value of those properties is eventually acquired.

***Like Kind* Continued on page 8**

The Legislative Front

By Bob Underhill

2007 was a relatively quiet year legislatively, and 2008 (an election year) would normally be the same. However, the new economic stimulus bill has been stealing headlines with the much-touted rebate checks due arrive to most US households beginning in May. For our clients, that portion of the bill is a non-event. But the small business expensing provision and bonus depreciation (discussed later) could have significant impact.

With the economy cratering in an election year, politicians of both stripes needed to show at least the appearance of doing something about it. And to that end, nothing beats the impact and simplicity of doling out cash. That gives both parties political cover, but most economists doubt it will have anywhere near the intended impact. The House normally adheres to "pay-as-you-go" (PAYGO) rules, meaning that any tax relief bill must be "paid for" through a tax increase somewhere else in the system. That rule was obviously suspended this time around given the need for political expediency, meaning that all the rebate checks will be funded by an increase in the deficit (more borrowing). The new House Ways and Means Chair Charlie Rangel commented that:

> "This stimulus package will send critical relief to millions of lower- and middle-income families whose economic situation dictates that they have no choice but to spend the rebate check and purchase goods and services to spur our economy."

We doubt it. Taxpayers can use the money to pay off charge cards, which does nothing to stimulate the economy. Or they can save it. Or if they spend it, there's a good chance they'll buy gas or hit the consumer electronics store. In either case, they'll end up with goods produced elsewhere.

The business incentives only last for one year (tax years beginning in 2008), but could well be lucrative enough to stimulate business investment that would otherwise be deferred to later years in the face of a weakening business outlook. The new law doubles the amount of immediate expensing of capital equipment purchases by small businesses to $250,000 for 2008 (phased out if total property purchased and placed in service exceeds $800,000). Qualifying property is "tangible personal property" (i.e., not plants or buildings), used in a trade or business and which is otherwise depreciable. (Section 179 of the Tax Code)

In addition to the expensing provisions, Congress temporarily revived the Bonus Depreciation rules (last used after September 11 and for property in the New York "Liberty Zone" and Hurricane Katrina "Gulf Opportunity Zone"). Bonus depreciation allows businesses to take additional first-year depreciation of 50% of the cost of qualifying property. The original use of the property must be ***new*** with the taxpayer, and the property must be placed in service in 2008 (and there cannot have been a binding contract to acquire the property prior to 2008). Qualifying property generally constitutes property with a depreciable life of 20 years or less; off-the-shelf computer software; and certain leasehold improvements.

The impact of both of these provisions is that they reduce the after-tax cost of qualifying capital improvements, in that capital recovery deductions are dramatically accelerated. By sunsetting the incentives at the end of 2008, Congress hopes to encourage rapid capital spending by business to help thwart the slowing economy.

A few items that made it into law in 2007 are worth noting. We'll also talk about other proposals that have been bandied about, and a few areas of the tax law that Congress really needs to fix.

- In late 2007 the President signed into law yet another AMT patch. Nothing new here other than another increase to the AMT exemption amount, which was designed to prevent an estimated 25 million more Americans from falling into the AMT. Repeal of the AMT or a permanent fix is possible for 2009, but the price tag is enormous. Consequently, how to pay for the lost tax revenue (i.e., whose tax bill goes up) is the political dilemma. Most of the sting of the AMT could be eliminated by simply removing state and local taxes as an AMT adjustment item (state income tax and sales and property taxes are not deductible under the AMT system). Another potential "cure" (you won't like it) relates to the fact that taxpayers pay the higher of the regular tax or the AMT. So raising the regular tax would have the effect of pulling more people out of AMT (we said you wouldn't like it).
- Small business expensing of certain capital expenditures (which would have reverted to $25,000 a year) was extended and increased to $112,000. The deduction is phased out to the extent qualifying property additions exceed $500,000 for the year (thus effectively targeting the provision to small businesses). However, for 2008 capital expenditures, the special rule in the stimulus bill applies.
- Further simplifications were made to the tax rules affecting Subchapter S corporations.
- A married couple who jointly own an unincorporated business (proprietorship, partnership

Legislative **Continued on page 8**

Trustees Take Heed—
Investment Advisory Fees are not so Unique After All

By Jay Hanson

The United States Supreme Court, in delivering a setback to taxpayers, has settled a longstanding disagreement regarding the character of the deductibility of investment advisory fees incurred by a trust in regards to the financial management of trust assets. The Court, in a unanimous decision, ruled in favor of the IRS, holding that investment advisory fees incurred by a trust are subject to the 2% floor for miscellaneous itemized deductions. Generally, individual taxpayers may subtract from their income certain miscellaneous itemized deductions but only to the extent that such deductions exceed 2% of an individual's adjusted gross income (commonly referred to as the "2% floor"). Investment advisory fees, when incurred by an individual, are subject to this 2% floor. However, expenses incurred by a trust which are unlikely to be incurred by an individual are not subject to the 2% floor and are generally fully deductible against trust income. Examples of fully deductible expenses include fiduciary expenses, accounting fees and legal fees incurred by a trust in regards to the management of trust assets. Because of this difference in treatment, a trust can claim a full deduction for certain expenses which would otherwise be subject to the 2% floor if those same expenses were claimed by an individual taxpayer. The question before the Court was whether investment advisory fees, when incurred by a trust, are so unique to trust management as to permit the trust to take a full deduction for the payment of such fees.

For the last 15 years there has been disagreement among lower federal courts concerning the characterization of the deductibility of investment advisory fees by a trust. One lower court ruled that investment advisory fees incurred by a trust were unique in a trust management context and permitted a full deduction of the fees. The lower court's reasoning underpinning this ruling was that a trustee was required to invest trust assets in a professional manner under state law; therefore, a trustee was effectively compelled to seek the professional management of the trust's assets. The fact that the trustee was required to invest trust assets in a professional manner differed markedly from an individual who was free to choose whether or not to professionally manage the same type of investments. The fees associated with the investment of trust assets in this context were to be characterized as unique to the trust, and correspondingly, fully deductible. However, several other lower federal courts ruled that investment advisory fees were not distinguishable if incurred by a trust regardless of whether the trustee was required for any reason to professionally invest a trust's assets. These lower federal courts subjected a trust's investment advisory fees to the 2% floor. The disagreements on this issue led to various interpretations regarding a trust's characterization of the deductibility of investment advisory fees. Not surprisingly, the IRS took the position that investment advisory fees were to be subject to the 2% floor, thus putting trustees in the crosshairs of the disagreement between the lower federal courts. All of this confusion eventually prompted the Supreme Court to step into the fray and settle this issue once and for all.

The Court's recent ruling will now require all trustees to subject investment advisory fees associated with the investment of trust assets to the 2% floor. Trustee's fees, which typically wrap both the fiduciary's trust management fee with an investment advisory fee, will now need to be segregated to determine the portion of the fee attributable to investment advisory services. On an ongoing basis trustees will need to report a trust's investment advisory fees as a separate line item detail for tax accounting purposes. It is worth noting that this ruling has no impact on the limitation of deductions in regards to tax-exempt income, as deductions will still need to be reduced to account for tax-exempt income. Additionally, tax practitioners may need to be more attentive in terms of determining the characterization of deductible fees incurred by a trust. The litmus test for the characterization of trust deductions now becomes whether an expense at the trust level is really of a type which would not be incurred by an individual.

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The Domestic Partnership Registry Comes to Washington State

By Jay Hanson

Effective July 22, 2007, all same-sex partners and different sex couples with at least one partner aged 62 or older are permitted to register as domestic partners in Washington State. This law extends to registered domestic partners some Washington State level rights previously extended only to married persons. Individuals seeking to enter into a domestic partnership must:

- Share a common residence;
- Be at least 18 years of age;
- Not be married to, nor be in a state registered domestic partnership with, someone other than the person with whom they are entering into a domestic partnership;
- Be capable of consenting to the domestic partnership;
- Not be a close family relative; and
- Be members of the same sex, or, if in a different-sex couple relationship, one of the partners must be at least 62 years of age or older.

Registering as domestic partners is a legally binding act and should be examined closely to determine what specific implications may be involved by registering.

In order to register both partners must sign a “Declaration of State Registered Domestic Partnership” form, have their signatures notarized, and deliver the form and associated application fee to the Office of the Secretary of State for Washington State. The registration cost is $50. Paper registration is the only current form of registration; online registration is likely to be available soon.

Certain powers and rights granted to married persons in Washington State will now be extended to registered domestic partners. Some of these powers and rights include but are not limited to:

- Health care facility visitation rights;
- Ability to grant informed consent for health care purposes for a partner who is not competent;
- Ability to obtain health care information without a partner’s prior authorization;
- Right to control the disposition of a partner’s remains;
- Ability to make anatomical gifts;
- Authorize a partner’s autopsy and receive copies of autopsy reports and records;
- Inheritance rights when a partner dies without a will;
- Ability to administer a partner’s estate if a partner died without a will or if the named representative is unable or unwilling to serve; and
- Seek damages in wrongful death actions.

While the domestic partnership registry extends certain powers and rights to registered domestic partners it does not go as far as to offer all of the same rights currently afforded to married couples. Specifically, the domestic partnership registry does not permit:

- The ability to file federal tax returns as married filing jointly;
- The extension of spousal support;
- Community property characterizations;
- Health insurance coverage and other retirement benefits (exemptions do exist for Washington State employees); and
- Federal rights and protections afforded to married couples.

Domestic partnerships can be terminated by either party, or both parties, filing a notice of termination with the Office of the Secretary of State. The termination notice must be signed and notarized by at least one party to the partnership. The effective date of the termination is 90 days after the notice is properly filed. Additionally, domestic partnerships are automatically terminated if either or both of the parties enter into a marriage which is recognized as valid in Washington State.

Registering as domestic partners is a legally binding act and should be examined closely to determine what specific implications may be involved by registering. A domestic partnership does not extend the same rights as marriage but it is anticipated that this law will expand the rights of domestic partners over time. Domestic partners are still well advised to review their estate planning documents, title to real and personal property, registration of bank and brokerage accounts, and family law issues to ensure those matters are in line with each partner’s expectations regarding their union.

For more information on the domestic partnership registry please see the Office of the Secretary of State’s website (www.secstate.wa.gov) or contact our office for further information.

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Estate Tax Continued from page 1

residents are taxed only on interests in tangible personal property and real estate located within Washington State at the time of death. Interests in intangible personal property are not subject to taxation even if such interests are located within Washington State.

For Washington State purposes the value of an estate for determining the amount of tax to be imposed is defined by using federal guidelines with some minor adjustments made for the ownership of farming and timber interests. This basically means the Washington State estate tax is imposed when the value of an estate exceeds $2,000,000. Washington State permits many of the same deductions and deferrals available for determining the federal estate tax; therefore, a marital deduction is generally available to help defer the imposition of the tax until the death of a surviving spouse when an individual was married at the time of death. If the marital deduction is utilized the estate tax must be paid on the value of the surviving spouse's gross estate (including the value of property passed free of tax via the marital deduction) upon the death of the surviving spouse. For single individuals the tax is imposed at their death with no opportunity for deferral. Regardless of an individual's residency or marital status, the Washington State estate tax is imposed at rates ranging from 14% on estates valued over $2,000,000 and then rises up to 19% on estates valued in excess of $9,000,000. The combination of both federal and Washington State estate taxes can lead to the imposition of taxes in excess of 50% of an estate's total valuation.

An additional feature of the Washington State estate tax is that it is completely unaffected by changes to federal estate tax laws. Currently, the federal estate tax exemption amount is scheduled to rise from its current threshold of $2,000,000 to $3,500,000 in 2009. However, this rise in the federal exemption amount will have no impact on the Washington State exemption amount. Therefore, estates valued in excess of $2,000,000 will be subject to Washington State estate taxation irrespective of the taxability of the estate for federal estate tax purposes. The imposition of a state-level excise tax as high as 19% has prompted many of our clients to inquire what we can do to assist them in alleviating the burden the Washington State estate tax may impose on their families at death. A question which soon follows is whether one should consider moving from Washington State to avoid the imposition of the estate tax. This question seems to be asked more in the winter than in the summer, but the question has prompted us to ask whether overall tax savings can truly be achieved by moving out of Washington State. In this manner could an individual structure his or her affairs in a manner sufficient to alleviate the imposition of the Washington State estate tax after establishing residency outside of Washington State?[3]

It may at first seem straightforward to make the assertion that moving out of Washington State to avoid a 19% excise tax will ultimately reap a tax windfall. However, moving from Washington State is not without cost. Factors such as the payment of income taxes to another state, the imposition of the alternative minimum tax, the time value of money, lost investment opportunities on funds used to pay income taxes, and other factors caused us to pause and put this assertion to the test. Our inquiry began with a basic question: does the establishment of residency outside of Washington State provide a meaningful opportunity to minimize the imposition of taxes over a significant period of time? To address this question we sought to compare two hypothetical high-net-worth individuals—one a Washington State resident and the other Washington non-resident residing in a high-income-tax state. Our goal was to establish which individual paid more taxes after a 10-year period culminating in the death of each individual.

As a baseline we started with our two high-net-worth individuals in 2007, each having a total net worth of $25,000,000. One individual is a Washington State resident with all property located within the state ("Wash"). The other individual is a California resident with all property located outside of Washington State ("Cal"). For our hypothetical example we attributed each individual with $750,000 of income in 2007, which breaks down as follows:

$50,000 of ordinary interest
$50,000 of ordinary dividends
$150,000 of qualified dividends
$100,000 of long-term capital gains
$400,000 of rental income

For purposes of our inquiry each individual's income was projected to increase by

[1] This article is designed to address the economic impacts of establishing residency outside of Washington State for purposes of alleviating the burden of the Washington State estate tax. This article does not address the many facets of planning necessary to structure one's estate planning and financial affairs to best minimize the impact of both the federal and Washington State estate tax systems. Please see our article entitled "Don't Die in Washington" in our November 2006 newsletter for more information addressing the planning opportunities (and pitfalls) available for minimizing the effects of the federal and Washington State estate tax systems.

[2] Examples of intangible personal property include stocks, bonds, bank accounts, retirement accounts, and partnership and limited liability company interests.

[3] Living Outside Washington State: After moving from Washington State a former resident may end up in a position of still owning tangible personal property and/or real estate within Washington State. To alleviate the imposition of Washington State estate tax, a non-resident can structure the ownership of such property in a manner to reduce the imposition of the tax. For example, a non-resident owning tangible personal property and/or real estate located within Washington State should structure the ownership of such property in a manner so that such assets are deemed to be intangible personal property *not* subject to Washington State estate taxation. These assets should generally be transferred and held in an entity such as a corporation, limited liability company or partnership.

Estate Tax Continued on page 7

Washington State is one of seven states without an income tax, making it a very attractive address for individuals with large taxable incomes.

***Estate Tax* Continued from page 6**

5% each year and the value of each individual's net worth was also projected to increase by 5% each year. The net worth of each individual was increased by the income received each year and then reduced by the amount of taxes paid. For simplicity, no reduction in net worth or income was made for any expenditure other than for the payment of state and federal income taxes.[4] Each individual was attributed a standard deduction and the only itemized deduction taken was for the payment of state income taxes. Based on these parameters we projected each individual's income and corresponding tax obligations based from 2007 through 2016.[5]

The obvious tax benefit of Washington State residency is that Washington State has no income tax. The absence of a state level tax on income has a substantial tax benefit and the savings reaped by its absence cannot be underestimated. Washington State is one of seven states without an income tax, making it a very attractive address for individuals with large taxable incomes. Based on our projections, Wash easily came out ahead each year in terms of paying the least amount of total income taxes. Cal not only ended up paying federal and state income taxes, but ended up paying alternative minimum tax which was attributable to the itemized deduction generated by the payment of state income taxes. In 2007, Wash paid federal taxes of approximately $180,000 compared to Cal, who paid approximately $165,000 in federal income tax, $8,500 in alternative minimum tax and nearly $65,000 in California income tax. In 2007 Wash came out nearly $59,000 ahead of Cal in terms of overall tax savings.

Not surprisingly, over the period from 2007 to 2016 Wash paid substantially less in income taxes than Cal. The average annual tax savings during this period for Wash was $67,700, reaping total tax savings of over $677,000. These results indicate that Washington State residency is a substantial tax savings factor on an annual basis and its cumulative effect should not go unnoticed. In addition to the income taxes saved by Wash on an annual basis, the net worth of Wash rose faster than that of Cal due to the amount of taxes saved on a cumulative basis. The increase in the net worth by taxes saved compounded with a 5% growth rate on that net worth produced a large increase in Wash's net worth over the 10-year inquiry period. Over this 10-year period, Wash saw an increase in total net worth in excess of $880,000 over that of Cal . At the end of the projection period Wash's net worth totaled $49,307,000 and Cal's totaled $48,425,000. The payment of state income taxes certainly had a substantial negative impact on the growth of net worth over time. If estate taxes were not at issue the decision would be very clear: living in a state without an income tax is a net worth enhancement factor over a period of time. However, the imposition of an estate tax at death in lieu of an income tax could very well offset any tax savings reaped during lifetime.

Based on our final net worth calculations detailed above we then calculated the impact of the payment of federal and state estate taxes in 2016. Cal ended up with a total gross estate of $48,425,000 which yielded a federal estate tax payment totaling $20,891,000. Wash ended up with a gross estate totaling $49,307,000 which yielded a federal estate tax payment after a deduction for state estate taxes paid of $17,365,000. However, the Washington State estate tax payment weighed in at $8,718,000 producing a total estate tax bill of $26,083,000. Cal's net estate remaining after the payment of estate taxes was $27,533,000, resulting in 43.1% of the estate paid in estate taxes. Wash's net estate remaining after the payment of estate taxes was $23,224,000, resulting in 52.9% of the estate paid in estate taxes. Wash's death resulted in the payment of $8,700,000 more in estate taxes, representing a 9.8% larger tax payment than that of Cal. In addition Wash's total estate remaining after the payment of taxes was $4,300,000 smaller than that of Cal.

The outcome of these results produced a clear answer for us: death as a Washington State resident is an expensive proposition! Even with the annual savings reaped from not paying income taxes over a 10-year period, death as a Washington State resident is extremely costly in terms of the payment of state level estate taxes. In fact, the income taxes saved over time actually inflate the size of the gross estate which then subjects even more of the estate to taxation. What is one to do about this situation? Now that we know that dying as a Washington State resident may be expensive in terms of the payment of estate taxes, what should a person concerned about these taxes do? Moving residency is hardly an easy fix to any problem and moving residency for purposes of tax savings may not be worth it in terms of social, familial and other personal reasons. Each individual will need to as-

***Estate Tax* Continued on page 8**

[4] Differences in income and changes in net worth would obviously be present in a "real world" example due to differences in investment styles, rates of return on investments, expenditures made for living expenses, and other discretionary payments and other variables. For purposes of this article we kept the models tested as simple as possible and to keep a basic level of parity between the Washington Resident and the California Resident. Therefore, for tax purposes, each individual was given a standard deduction and no itemized deductions other than the payment of state income taxes were made. Any deduction for state sales taxes was deemed too small to make any meaningful impact on the financial modeling.

[5] The federal estate tax is scheduled to be repealed in 2010 only to come back in 2011 with the exemptions in place as they were in 2001 (*i.e.,* a $1,000,000 estate tax exemption and a credit for state estate taxes paid). For purposes of this article we assumed an estate tax exemption amount of $2,000,000 as it stands in 2007. It is anyone one's guess what the federal government will do in terms of raising, lowering or freezing the current exemption. With this in mind we chose to use the current exemption amount.

Estate Tax Continued from page 7

sess the merits of tax savings, family wealth preservation, charitable intentions and other estate planning goals when it comes to a decision regarding the establishment of residency outside of Washington State.

There are many arguments advocating for and against the imposition of the federal and Washington State estate tax systems. Changes to the federal estate tax system in 2001 may have lowered the federal take in terms of estate taxes paid, but the burden of this reduction ultimately fell to the states. Washington State, like many other states, reacted to the reduction in federal revenues associated with the collection of the federal estate tax by imposing its own state-level estate tax. While the merits of the estate tax are debatable, the effects of the imposition of essentially a 19% flat tax on large estates may not. As Washington families with moderate to substantial net worth begin to see the erosion the estate tax has on their net worth, many of these families may finally succumb to the allure of a warmer climate. Relocation to addresses in California, Arizona, or better yet Nevada, which has no income or estate tax, may become even more compelling. If Washington families do relocate to avoid the imposition of the Washington State estate tax, the State ends up on the losing end of the deal as it misses the opportunity to tax the build-up in wealth attributable to the State not imposing an income tax. The leadership in Olympia will need to grapple with weighing the merits of a tax with very high top-end rates which may well have the effect of driving the very taxpayers it hopes to pay the tax away from the State's reach.

Like Kind Continued from page 2

It is also possible (although highly rule-bound) to do so-called "reverse exchanges"—for example, in situations where it is necessary to receive the exchange property before a buyer is found for the "outbound" property.

For the gain to be fully deferred, the replacement property must be of equal or greater value. If it is of lesser value, by definition, there will be other non-qualifying property received back to equalize the exchange values (typically cash or a reduction in liabilities). Non-like-kind property is called "boot." In such a case, gain is triggered in an amount equal to the lesser of the overall gain or the value of the boot received. However, one property may be exchanged for several properties, and vice versa. The time periods mentioned above can present challenges if, for example, the replacement property is under construction or development (and those expenditures are needed to "cover" the value of the property given up).

To qualify for the tax deferral, the sale proceeds must be held by a "qualified intermediary" (QI) between the sale of the relinquished property and the purchase of the replacement property. A QI must remain completely independent and cannot have been the taxpayer's agent in the last two years. A CPA, attorney or other agent cannot act as a QI for their clients.

Most businesses have engaged in like-kind exchanges without even knowing it: a used truck (probably fully depreciated) is traded in for a new one. But most modern-day exchanges need to involve professional assistance. The rules get pretty tricky if there is debt involved; if the property given up was acquired from a related party or if the exchange partner is a related party; or in cases of non-simultaneous exchanges if either property is income-producing.

Legislative Continued from page 3

or LLC) and file a joint return no longer need to file as a partnership on Form 1065 (this has previously been available by administrative rule to couples who own a business as community property). However, if there are any other owners in the business—even one's children—the rule is not available.

- And the Congressional tax clinker of all time? The "kiddie tax"—where unearned income of a child is taxed at the parents' tax rate—was made worse in a rather perverse way. The age limit (defining "child") was raised from age 18 to 19 ***and to students under age 24.*** As recently as 2006, the age was 14. What this means is that college students will no longer be able to fund their education by selling off appreciated investments at their own (presumably lower) tax bracket. So gifting stock to children to use later for college education (which most would feel is a prudent thing to do) was blunted by Congress. The answer is 529 plans. Only cash, not stock, may be gifted to such plans. But the income and appreciation is tax free if the funds are withdrawn to pay for college education.

- Other measures are targeted to lower-income taxpayers and to the thousands of taxpayers facing default or restructuring of their home mortgages.

Legislative Continued on page 9

***Legislative* Continued from page 8**

2009 brings a new Congress and a new administration, and tax policy changes will likely be an early order of business.

A few popular extenders didn't make it into law, but could return in 2009:

- Extending the residential energy credit (which expired in 2007)
- Extending the research credit
- Extending the deduction for sales taxes (in lieu of state income taxes) which expired at the end of 2007
- Reinstating the deduction for teachers' supplies

Looking forward to 2009, or the next major tax bill, changes may depend upon who ultimately wins the presidential election. Obama favors returning the tax rate on capital gains to 28% and uncapping the Medicare/Medicaid portion of FICA/self-employment tax. Clinton has advocated returning the capital gain rate to 20%. Huckabee wants a national sales tax and repeal of the income tax code. Of the proposals, Obama's and Clinton's are realistic possibilities, although many studies have shown that lowering of capital gains rates actually frees up capital, resulting in increased tax receipts by the fisc. McCain would appear to favor continuing the Bush tax cuts but would be saddled with a crippling deficit.

A nonpartisan presidential task force in Bush's first term viewed any meaningful replacement of the income tax with a national sales tax as impossible.

As for Huckabee's proposal, our income tax system is well entrenched and well established, and actually works more efficiently than similar systems in the rest of the free world. Having a fundamentally different tax system than most major nations would create some difficult trade and parity issues. A sales tax would need a very high rate (estimates are from 30-40%) to replace the revenue of our income tax system. That in turn would create the need for myriad exemptions for certain goods and services to keep the system from crippling the middle class and below. And the black market that would develop to gain an effective 40+% discount for goods and services (counting state sales taxes) would be an enforcement nightmare. A nonpartisan presidential task force in Bush's first term viewed any meaningful replacement of the income tax with a national sales tax as impossible.

Apart from rates on investment income, other measures that will likely receive attention are:

- AMT reform/repeal. How to pay for it? Increase rates on ordinary income above the current top 35%. Raise rates on dividends and capital gains above the current 15% (these rates are actually due to expire in 2010—returning capital gain rates to 28% and rates on dividend income to 35%). Leave the estate and gift tax largely intact.
- Debate on what to do with the estate tax must occur. An earlier Congress laid that albatross on the 2009 Congress by rigging the law such that the estate tax is repealed in 2010 and restored to its old 2001 self in 2011. Both these outcomes are absurd and impossible for responsible legislators to let ensue. Full and permanent repeal got close in 2004—and then Hurricane Katrina hit. The suffering and government spending triggered by that storm made repeal of a tax on the wealthy a bit unseemly from a political standpoint. Repeal now seems very unlikely. Most professionals feel that a moderating of the top rate to 35% and increase of the estate (not gift) exemption to $2.5-$3.5 million per person is a likely compromise and represents more reasonable tax and social policy than either the recent top rate of 55% or outright repeal.
- A lowering of the top corporate tax rate from 35% to 30%. We currently have one of the highest corporate tax rates in the free world. However, lowering the corporate rate could be accompanied by an increase in the tax rate on dividends (one of the key theoretical reasons for lowering the tax on dividends to the current 15% was to mitigate the effect of the double tax on corporate income).
  - A lowering of the corporate income tax could also have the effect of making operating a business in partnership, LLC or S corporation format marginally less attractive. These business forms involve a single level of tax at the owner level, but those earnings could be taxed at a higher rate applied to individuals, whereas corporate earnings would be *initially* taxed at a lower rate (albeit taxed again when paid out as dividends or upon sale or liquidation of the company).

***Legislative* Continued on page 10**

Legislative **Continued from page 9**

- Repeal of the manufacturer's deduction under Section 199. This provision, when fully phased in, allows for a special deduction equal to 9% of qualifying wages on domestic manufacturing production (essentially lowering the tax rate on corporate income by 3 percentage points). Retailers and service industries get no such tax break and some would argue that they are as important to the US economy as manufacturers. If corporate tax rates are lowered, this deduction likely goes on the chopping block.
- There has been discussion of an additional reporting measure to be imposed on the securities industry to help close the so-called "tax gap" (the difference between the tax legally owed and what is actually reported/remitted). In addition to reporting securities sales proceeds on Form 1099-B, brokers and investment custodians would be required to report the tax basis. The industry fought the measure several years ago—it sounds simple in concept but is complicated to implement. In many cases, taxpayers themselves would have to provide the information to the firms, such as for inherited or gifted securities, or where the securities were distributed from funds or investment partnerships. In addition, securities are commonly transferred into accounts from other brokers when money manager relationships change. These are precisely the situations now where basis is hard to determine. It won't be any easier for taxpayers to figure it out in order to provide the information to a brokerage than it is when filling out a tax return.

Tax Events Calendar

Date	Taxpayer	Event
March 17, 2008	Corporations	Last day for calendar-year domestic corporations or foreign corporations with offices in the U.S. to file prior-year income tax return (Form 1120 series). File form 7004, together with payment, to obtain an automatic six-month extension of time to file.
April 15, 2008	Individuals	Due date for individuals to file their 2007 income tax returns (Form 1040, 1040-A or 1040-EZ). File form 4868 to obtain an automatic six-month extension of time to file.
April 15, 2008	Individuals	First installment of 2008 estimated tax is due (Form 1040-ES).
April 15, 2008	Partnerships	Due date for partnerships and LLCs to file their 2007 income tax returns (Form 1065). File form 7004 to obtain an automatic six-month extension of time to file.
June 16, 2008	Individuals	Second installment of 2008 estimated tax is due (Form 1040-ES).
June 16, 2008	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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