

Ideas for Your Success

First Quarter 2010

Crossing the line

Consider multistate tax liability if you conduct business in other states

It's no secret that many states are struggling mightily to meet their financial obligations. A primary way for states to plug budget shortfalls is finding additional tax revenues. If your company conducts business in multiple states, it may be liable for taxes in some states without your realizing it. And those states are likely eager to collect those tax dollars.

Nexus requirements

Another state can apply its income, franchise or sales and use taxes to your business if you've established a sufficient connection, or "nexus," with that state. Historically, nexus required a physical presence in the state, such as offices, manufacturing facilities or employees.

Physical presence is still required to trigger sales and use tax collection obligations, but many states require only a minimal presence to establish nexus for income tax purposes. The courts have agreed.

Federal law prohibits a state from taxing a company's income if its only activity in the state consists of

soliciting orders or sales of tangible personal property, which are approved and shipped from outside the state. But the law doesn't apply to *intangible* property.

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Thus, several recent cases have allowed states to tax an out-of-state firm's income on intangibles, such as trademark licenses or credit cards, even though the firm had no *physical* presence in the state. A substantial *economic* presence was sufficient.

Franchise tax, which is a tax on the privilege of doing business in a state, often requires even less of a connection. Simply soliciting orders or sales in the state may be enough.

Using nexus to your advantage

Multistate taxation isn't always a negative. For example, to avoid multiple taxation of the same income, most states require that you apportion income among various states, typically using a formula based on your company's sales, property and payroll in each state, though various states weight each factor differently or use only one or two of the factors.

Suppose that your company is located in a state with a high corporate income tax, but you do a significant



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Time for a talk

Ask your aging parents about their finances while they're still healthy

Thanks to modern medicine and healthier lifestyles, people are living longer. If your parents are enjoying good health during their golden years, that's great!

And now may be the perfect time to discuss their finances with them. While this may be a difficult conversation, learning about their financial affairs now, while they're healthy and have full mental capacity, can be beneficial if they become incapacitated in the future and you have to take charge.

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Powers of attorney

The most critical items to discuss while your parents are of sound mind are powers of attorney for health care and property. If your parents should become incompetent without such documents in place, court proceedings — which can be lengthy, expensive and even contentious — will be required to determine who will make health care and financial decisions for them.

With powers of attorney, your parents can appoint you (or another trusted person) to make such decisions — they can even name one person for health care and someone else for property.

Another benefit of a power of attorney is that the power can be applied flexibly, with your parents choosing under what circumstances control should be granted. The primary drawback is that the power of attorney agreement must be drafted carefully to avoid undesired consequences, such as having power granted prematurely.

Financial matters

There are additional ways you can help manage your parents' finances, and it's important to discuss them with your parents so they can select the options that best meet their needs. For example, your parents can simply add you to an existing checking account, enabling you to pay their bills from that account.

This provides them with significant control because they can maintain full ownership over the assets held in other

accounts. It can be especially useful if there's a period of time before a power of attorney is granted when your parents need some help managing their finances. It's best suited to couples with moderate amounts of wealth; high net worth couples may require a more comprehensive solution.

A revocable living trust is another tool that can provide your parents with extensive financial protections. So long as he or she is capable, each of your parents can serve as trustee of his or her own trust. You (or another trusted person) can be named as successor trustee should your parent become incompetent.

Living trusts also enable your parents' estates to avoid probate on their deaths. Because the trustee will have control only over assets that have been transferred to the trust, it's critical that all appropriate assets be retitled in the trust's name.

Long-term care

Elder care is another important issue to discuss with your parents. Start by asking them about their wishes — and encourage them to be candid. Family members also need to be open about what kind of help they feel they can and can't provide.

Of course, the financial aspects also need to be considered. Elder care can be expensive, whether your parents remain in their own home, move in with family, or enter an assisted living or nursing home facility.

Prepare today for tomorrow's needs

It's never pleasant to think that one day you may need to step in to help your ailing parents. But if that day comes, you'll be thankful you took the time to discuss their financial affairs and long-term care wishes with them during better times. Your financial advisor and attorney can help your family address these issues.



Are you selling your home at a loss? If so, be aware of cancellation of debt income

When it rains, it pours: Thanks to the economic downturn and the resulting high unemployment rate, more people are being forced to sell their homes because they can no longer afford to pay the mortgage. And because many homes have lost a great deal of value since the recession began, some of these homeowners are selling their residences at a loss. Counterintuitive as it may seem, such sales can result in tax liability.

COD income

The problem is cancellation of debt (COD) income. If you sell your home for less than the total mortgage principal and unpaid interest and penalties on the property, and the lender forgives the excess debt, you may have COD income that's taxable at ordinary income tax rates. Typically, this happens when a home is sold at a loss, but you can have COD income even if you sell it at a gain.

Like most tax rules, there are a few exceptions. COD income isn't taxable if the debt is discharged in bankruptcy or if you're insolvent when the debt is canceled. Determining whether you're insolvent is complicated, but generally it means that your total debts exceed the fair market value of your assets.

Keep in mind that cancellation of a nonrecourse loan in connection with a foreclosure doesn't result in COD income. (In this situation, you're not personally liable for the debt, so the lender's only remedy is to take possession of the home.)

Congress offers relief

The Mortgage Forgiveness Debt Relief Act of 2007 (MFDRA) provides some temporary relief. For 2007



through 2012, the act allows homeowners to exclude up to \$2 million of COD income in connection with qualified principal residence indebtedness. This relief is available not only for foreclosures, but also for short sales and mortgage workouts in which the lender agrees to new terms that lower monthly payments.

To qualify, the debt must have been used to acquire, construct or substantially improve your home. In other words, COD relief isn't available for a home equity loan that's not used for home improvement.

Seek professional advice

If you're in a situation where you have to sell your home at a loss, it's important to know the tax consequences. To learn more about the effects of COD, contact your tax advisor.

Estate tax uncertainty may lead to lost confidence in your plan

You wanted the peace of mind that after you die your loved ones will be taken care of according to your wishes. This is why you took the time and expense to carefully craft an estate plan. But now, because of all the uncertainty surrounding the estate tax, you may have lost some confidence that your estate plan will work the way you intended.

It's hard to believe that this uncertainty is rooted in a tax law that's nearly 10 years old, but that's the truth: The 2001 tax act has increased the estate tax exemption and reduced the top estate tax rate over the past several years. It also repealed the estate tax for 2010 only and included a sunset provision mandating that the estate tax exemptions and rates return to levels prescribed by pre-2001 law — a \$1 million estate tax exemption and a 55% top estate tax rate — in 2011.

Many figured Congress would repeal the repeal by the end of 2009, but that didn't happen. So, as of this writing, the

estate tax repeal is in effect, though it's fairly certain that Congress will eventually repeal the repeal. (By the time you read this article, this may already have happened.) Here are three frequently discussed scenarios:

1. The 2009 levels — \$3.5 million estate tax exemption and 45% top estate tax rate — are retained permanently.
2. Different levels are set permanently.
3. The 2009 levels are retained for 2010 only and Congress reassesses the estate tax in 2011.

What's the best way to regain the peace of mind your estate plan once provided? Review it with your estate planning advisor today and, if Congress hasn't yet taken action, review your plan again after it does. He or she can help you build flexibility into your plan and better ensure it will continue to meet your estate planning goals.

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amount of business in states with low or no income taxes. Because you lack nexus with those states, all your income will be taxed by your home state. But if you create nexus with one or more of those states — by setting up a small office, for example, in a state where your sales are significant — you may be able to allocate some income to those states, lowering your overall tax bill. (See “Multistate taxation working in your favor” to the right for a fictional example.)

States looking for your tax dollars

With many states today desperate for tax dollars, those where you conduct business will be eager to determine if your company is liable for multistate taxation. To avoid unexpected tax liability, penalties and interest — and perhaps even to *reduce* income taxes — proactively determine where you have state tax obligations and ensure you're in compliance.

Multistate taxation working in your favor

You own a successful services-based company with headquarters in State A. Your clients are located primarily in your home state, but you also have customers in State B. You have no physical presence in State B. While State A's applicable income tax rate is 9%, State B's is only 5%. Both states apportion income using the same formula.

Let's assume your company's taxable income is \$2 million. If the business has no nexus with State B, all of its income will be taxed by State A, for a tax liability of \$180,000 (\$2 million × 9%). If you establish nexus with State B, some of its income could be taxed at the lower 5% rate, reducing the company's overall tax bill.

Bear in mind that how much income tax you can save by creating a nexus in another state depends on a variety of factors. And before taking steps to establish nexus in State B, you also need to consider the other potential business and tax consequences.