

Client Tax Letter

Tax Saving and Planning Strategies from your Trusted Business Advisorsm

Choosing the Right 401(k)



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

Many companies offer employees a choice between two 401(k) plans. The version with which you're probably most familiar is now considered a "traditional" 401(k). As before, you can choose to defer some salary and defer the income tax as well. You'll also defer the tax on any investment earnings. However, when you withdraw tax-deferred earnings and tax-deferred investment income, you'll owe income tax. You'll probably owe a 10% penalty on withdrawals before age 59½, too.

Another option you may have is a Roth 401(k). With this account, you're not deferring income tax, so you're contributing after-tax dollars. Again, you won't owe tax on any investment income inside the plan. After you've had a Roth 401(k) for 5 years and after age 59½, all withdrawals are tax-free.

Making the choice

Generally, you are better off contributing to a Roth 401(k) when you are in a low tax bracket.

Example 1: Jacob Benson is in the 15% tax bracket. If Jacob defers tax by contributing to a traditional 401(k) this year, he will get little benefit from the tax deferral because he will defer few tax dollars. Jacob eventually may pay tax at a higher rate when he takes money out. Therefore, Jacob chooses the Roth 401(k), where he will pay relatively little tax on the money he contributes while arranging for possibly tax-free withdrawals in the future.

With the same reasoning, workers in a high tax bracket may be better off in a traditional 401(k).

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Top Tax Rate

California has the highest state sales tax in the U.S., at 8.25%, but local taxes in many states can bring the total even higher.

Example 2: Diane Evans is in the 35% tax bracket. Diane will get a substantial benefit from tax deferral this year, so she chooses the traditional 401(k). Diane hopes to be in a lower tax bracket after she retires. If that is the case, Diane may be able to convert her traditional 401(k) funds to a Roth IRA and pay less tax than she would pay by contributing after-tax dollars to a Roth 401(k) now. Diane might choose to convert her traditional 401(k) to a Roth IRA after she retires because all withdrawals will be tax-free 5 years after the conversion, as long as Diane is at least age 59½. In addition, Roth IRA owners never have to take required minimum distributions.

Not so simple

At first glance, you might think this is a simple matter. You can look at your income tax return from last year and see the taxable income you reported, adjust for any increase or decrease in anticipated income from this year, and then go online to see the tax tables for 2011. If you'll be in the 10% or the 15% bracket, you might lean towards the Roth 401(k); in the 33% or 35% bracket, a traditional 401(k) may be appealing. In between (25% or 28% brackets), you could straddle the fence, contributing some to a traditional 401(k) for immediate tax relief and some to a Roth 401(k) for possible tax-free cash flow in the future.

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

all to a traditional 401(k) will lower your income and may provide other tax savings on your return.

Example 3: Previously, we had seen that Jacob Benson is in the 15% bracket. Assume that Jacob is married and reported \$60,000 in taxable income on the joint tax return that he and his wife filed for 2010. That was because Jacob deferred \$15,000 of his salary in 2010. If he puts that \$15,000 into a Roth 401(k) for 2011, the Bensons' taxable income will go from \$60,000 last year to \$75,000 this year. That will move them over the \$69,000 cap for the 15% tax bracket and into the 25% bracket.

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

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

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

Trusted Advice

Adjusting for the AMT

- ❖ Many taxpayers owe the alternative minimum tax (AMT) rather than the regular income tax.
- ❖ Officially, the AMT has two tax rates: 26% and 28%, depending on your income.
- ❖ The AMT also has an exemption amount that phases out with AMT income over \$112,500 (over \$150,000 on a joint return).
- ❖ As the AMT exemption phases out, your tax rate actually might be 32.5% or 35%. Thus, some taxpayers who pay the AMT will owe as much as 35 cents in tax for every extra dollar of income they report, as opposed to the "official" 26 or 28 cents on the dollar.
- ❖ The higher the AMT rate, the greater the benefit of deferring tax with a traditional 401(k).

Did You Know

States have set aside a total of \$2.35 trillion to pay for employees' retirements, but the cost of those benefits is \$3.35 trillion. That leaves a \$1 trillion gap. Only four states have fully-funded pension systems: Florida, New York, Washington, and Wisconsin.

Source: Pew Center on the States

Avoid Higher Medicare Premiums

For several years, upper-income Medicare enrollees have had to pay higher-than-standard premiums for Medicare Part B, which covers doctors' bills and other outpatient charges. Starting in 2011, those same seniors also owe elevated premiums for Part D, which covers prescription drugs. These added charges use income "cliffs," meaning that you pay the full amount if you go over the threshold by even \$1.

Many Medicare enrollees pay \$96.40 a month for Part B, and some others pay \$110.50 or \$115.40 a month. (This depends on when they enrolled in Part B and whether the premium is deducted from their Social Security checks.) However, you will pay much more this year if your modified adjusted gross income (MAGI) exceeds certain levels. For this purpose, MAGI includes tax-exempt interest from municipal bonds and muni funds.

Here are the numbers for Part B premium payments in 2011:

The monthly premiums are per person, so a married couple would pay double that amount if both spouses are on Medicare. Thus, a married couple on Medicare with MAGI of \$170,001 would pay \$323 a month for Part B (\$161.50 times two). *Considering that a married couple with MAGI of \$170,000 might pay as little as \$192.80 a month (\$96.40 times two), the extra*

dollar of MAGI could cost the first couple about \$130 a month in extra Part B premiums in 2011.

Additional expense

The same income thresholds now apply for Medicare Part D plans for prescription drugs. Premiums vary for these plans, which differ in the drugs they cover. However, some seniors will pay a surcharge to Medicare in addition to the normal premium. Surcharges in 2011 range from \$12 to \$69.10 a month, depending on income, and the breakpoints are the same as for Part B. Therefore, an individual with MAGI of \$85,001 will pay a \$12 monthly surcharge, whereas an individual with MAGI of \$214,001 will pay a \$69.10 monthly surcharge.

In your planning, keep in mind that your Part D and Part B premiums will be based on your MAGI from two years before. Your 2011 MAGI, for example, will set your premiums for 2013, if you are enrolled in Medicare then. That's how long it takes for the federal government to mine information from tax returns and apply it to Medicare premiums.

Some tactics may help you hold down these Medicare premiums. For example, you might want to take capital gains and execute Roth IRA conversions before the calendar year you reach age 63.

Then, those transactions won't enlarge your MAGI at age 65 or older, when you're enrolled in Medicare.



You also can keep the MAGI breakpoints in mind at age 63 or older.

Example: George Caldwell, an unmarried Medicare enrollee age 70, estimates his MAGI at \$50,000 this year. George has a \$60,000 traditional IRA he wants to convert to a Roth IRA. That would boost his MAGI by \$60,000, to a total of \$110,000. With that MAGI, George's Part B premiums and Part D surcharge would total \$261.80 per month (assuming 2011 premium levels): \$230.70 for Medicare Part B plus a \$31.10 surcharge for Medicare Part D.

George now pays only \$96.40 a month for Part B and owes no Part D surcharge. Thus, besides paying income tax on the \$60,000 Roth IRA conversion, George would increase his Medicare costs in 2013 by about \$165 a month, or approximately \$2,000 for the year. Instead, George could convert \$30,000 of his traditional IRA to a Roth IRA in 2011 and the remaining \$30,000 in 2012 and avoid any extra Medicare costs. ■

Individuals	MAGI	
	Couples Filing Jointly	Monthly Premium
\$85,001–\$107,000	\$170,001–\$214,000	\$161.50
\$107,001–\$160,000	\$214,001–\$320,000	\$230.70
\$160,001–\$214,000	\$320,001–\$428,000	\$299.90
Above \$214,000	Above \$428,000	\$369.10

With Savings Bonds, Prepaying Tax May Be a Good Tactic



U.S. savings bonds can be good investments, especially if purchased for young children. They're issued by the federal government, so bond holders don't have to worry about a default. Yields are comparable to the yields on bank accounts. They're fairly liquid: owners can cash in savings bonds one year after the purchase and can redeem these bonds with no loss of interest after five years. (If you redeem savings bonds within five years, you'll lose the interest for the latest three months.)

Taxes, too

Owners of savings bonds also receive tax advantages. The interest is exempt from state and local income tax. Savings bonds are issued by the U.S. Treasury Department so they enjoy this tax treatment, along with all Treasury bills, notes, and bonds.

Moreover, individual owners of savings bonds can defer the tax on that interest as long as the bonds aren't cashed in.

Example: John Smith buys a \$100 I Bond (an inflation-protected savings bond) as a birthday gift for his newborn niece, Kaylyn Jones. Buying online at www.treasurydirect.gov, he pays face value for a \$100 bond.

Kaylyn puts away the bond until age 36, when she decides to cash it in. She redeems the bond then for \$400, which represents an annualized return of around 4%. Kaylyn reports a \$300 gain on the bond and owes tax at ordinary

income rates. Because Kaylyn will be established in her career by then with a substantial income, she'll owe tax at a high rate. Although Kaylyn's actual tax bill is modest in this example, an individual taxpayer who cashes in a large amount of savings bonds in one year could owe a significant amount of tax.

An alternative approach

When a child owns a savings bond, the parents may prefer to pay the tax each year rather than defer the tax. In the Kaylyn Jones example, the annual income might be around \$4 or \$5 a year while she is a youngster. As long as Kaylyn has little or no taxable income, the tax bill will be scant.

A parent can make this choice for a child at any time. To do so, you file a tax return for the child and report all the interest earned on the bonds from the date of their acquisition through year-end that has not previously been reported. You'd also state on the return that your child chooses to report the interest each year. Be sure to keep a copy of this return indefinitely. If your child is not required to file a tax return for any year after making this election, he or she does not have to file a return just to show the annual accrual of U.S. savings bond interest. Public Debt Form 3501, available at www.treasurydirect.gov, shows annual interest on savings bonds, which will help you keep track of interest accruals. You'll include the annual interest on the child's tax return in any year that he or she is required to file one.

This strategy is not necessarily limited to children who own savings bonds. A taxpayer who finds himself in a low tax bracket in a given year

Trusted Advice

Tax-Free Savings Bonds

- ❖ The interest from savings bonds you cash in may be tax-free. That can be the case if you use the money for college tuition and fees.
- ❖ Several conditions apply. For example, you must have been at least age 24 when you bought the bonds.
- ❖ Either you or your spouse must own the savings bonds.
- ❖ The bond proceeds may be used for the owner's education, the owner's spouse's education, or the education of a dependent for whom the owner claims an income tax exemption.
- ❖ Income limits exist for this tax benefit. For completely tax-free income, your modified adjusted gross income (MAGI) in 2011 must be no more than \$106,650 on a joint tax return or \$71,100 on other returns. The tax exclusion is completely phased out with MAGI of \$136,650 on joint returns and \$86,100 on other returns. These numbers increase with inflation.

might choose to pay tax on accrued savings bond interest at that time if he expects to return to a higher bracket in the future. When you make such a payment, you're electing to pay tax each year on all savings bonds you own as well as any purchased in the future. You can, however, revoke this election and go back to deferring interest income by attaching a statement to a future tax return. ■

Use Appreciated Assets for Charitable Donations



Writing a check is the easiest way to make charitable contributions. However, donating appreciated assets can be more tax-efficient. That's true if the donated assets have been held longer than one year and, thus, would qualify for long-term capital gains tax treatment on a sale.

Example: Mark Parker wants to donate \$5,000 to a local animal shelter. If he writes a check for \$5,000, he'll get a \$5,000 tax deduction. Mark's cost for this deduction is \$5,000, after-tax.

Instead, Mark goes through his portfolio and finds a stock he bought in 2009 for \$3,000 and, thus, would qualify for long-term capital gains treatment. That stock now sells for \$5,000. Mark decides to donate the stock to the animal shelter. With this approach, Mark gives a donation of \$5,000, the fair market value of the donated assets. However, those shares are really not worth \$5,000 to Mark. To cash

them in, he would owe tax on a \$2,000 long-term capital gain. At a 15% tax rate, Mark would owe \$300. Therefore, by donating the shares, Mark gets a \$5,000 tax deduction by relinquishing an asset that would be worth only \$4,700 to him, after-tax.

After the contribution, the animal shelter can sell the donated shares.

As a charitable organization, the shelter owes no tax on the sale. Consequently, the charity gets the same \$5,000 contribution with this strategy, and Mark is better off than he would have been writing a check.

To implement this strategy, you can call the charity and get its brokerage account number. Then, call your own broker or mutual fund company and explain what you want to do and provide the charity's account number. If you wish to donate part of a position, specify the shares you wish to contribute. Follow up by sending an e-mail to your broker or fund company and eventually check with the charity to confirm the transaction.

Note: Different rules apply to contributions of tangible personal property, patents and other intellectual property, and property contributed to certain private foundations. In most cases, the deduction for a property in one of

these categories will be limited to the property's fair market value less the long-term capital gain that would have been recognized if the property had been sold for fair market value at the time of contribution.

Spreading the wealth

The procedure described in the previous paragraph can work well if you are making one or two relatively large charitable contributions.

However, if you plan to make \$500 contributions to each of 20 charities, the process may get cumbersome. Instead, consider donating through a donor-advised fund (DAF).

Many financial firms and local community foundations offer a DAF. You make donations directly to the fund; the minimum initial contribution might be a lump sum donation of \$10,000. You'd get a charitable deduction for the year the assets go into the DAF. If you donate appreciated assets held longer than one year, your deduction usually will be the assets' fair market value.

The DAF typically will create an account in your name after it has received your initial contribution. Then, the DAF will sell the donated assets, owe no tax, and put the cash into your account. Subsequently, you can request the DAF to make "grants" to specified charities from your account. For multiple donations of appreciated securities, using a DAF will simplify the process. ■

State Taxes Can Crimp Your Cash Flow

If your company does business solely in one state, it probably owes tax to that state, as well as to the federal government. Many companies, however, operate across state lines, and therefore, may owe tax to more than one state. In the current economic slowdown, some states are

endeavoring to address tax shortfalls by aggressively seeking more tax from companies based in other states.

Types of tax

State taxes come in several categories. The most common include



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- **income taxes.** If your company has net income from operations within a state, that state may tax those profits.
- **sales taxes.** These taxes generally are imposed on the retail sale of goods (that is, when goods are sold to an end user). The buyer usually pays this tax, but the seller is ultimately responsible for collecting the tax and remitting the money to the state.
- **use taxes.** Buyers who avoid sales tax on a purchase will generally owe a use tax on it. A *use tax* is a tax on the storage, use, or consumption of tangible personal property within a state. In some states, use taxes also apply to purchases of certain services. Use taxes are complementary to sales taxes; if a taxpayer pays sales tax on an item or service, it will be exempt from use tax.
- For example, suppose a company based in Maine purchases goods from a supplier located in Massachusetts and uses the goods in Maine. If the company in Maine does not pay a sales tax, it will owe a use tax. Use tax rates are the same as sales tax rates.
- **other taxes.** States sometimes also employ a variety of other taxes in addition to or in place of the taxes discussed previously. These include franchise taxes, which are taxes imposed for the privilege of doing business in that state, and taxes on a taxpayer's gross receipts.

Complex connections

Even if your company has some out-of-state activity, it may not owe any or all of these taxes to every state in which it operates. Generally, your company's tax obligation will depend

on whether its activities in a given state are sufficient to create *nexus*. This term describes a connection to a state that reaches a level justifying taxation. If a company has nexus with a state with regards to a particular type of tax, it will be subject to that tax in that state.

Although the principle of nexus is easy to understand, determining when a business has nexus with a state for a specific type of tax can sometimes be anything but easy. Within broad parameters prescribed by the U.S. Constitution and certain federal laws, each state can set its own nexus standards, and these standards can vary widely from state to state. Also, within the same state, the standards for nexus for one type of tax can be significantly different than for another type of tax. In addition, because the ways that companies do business are constantly changing (for example, selling through the Internet and employing telecommuters), and the states are constantly seeking to expand the boundaries of nexus in order to increase their potential tax base, the rules in this area are seldom stable. Activities or situations that, in the recent past, may not have been a source of nexus with a particular state may now or in the future result in a company's being taxed by the state.

The bottom line is that states differ in what they consider nexus, and the rules in the area are continuously evolving. Due to the very serious repercussions that having nexus with a state can cause, many cases challenging a state's assertion of nexus have come before different states' courts, with varying outcomes. Before you expand your operations beyond your home state, check the nexus laws

Trusted Advice

Voluntary Disclosure

- ❖ Companies may discover that they had nexus in a given state and, thus, owe back taxes.
- ❖ Most states allow voluntary disclosure agreements (VDAs). These agreements call for the company to submit delinquent tax returns and pay the required taxes.
- ❖ Typically, a VDA will limit the lookback period to three or four years. ~~No penalties will be assessed if the company pays taxes in full for those years.~~

of the new states in which you are planning to do business and decide whether the business opportunities justify the potential tax cost. Our office can help you learn about the nexus rules in states your company has targeted for business. ■