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Client Bulletin

Smart Tax, Business & Planning Ideas *from your* **Trusted Business Advisor**[sm]

October 2015

Cons and Pros of Roth IRAs

Annual contributions to IRAs, including Roth IRAs, are now capped at $5,500 ($6,500 if you're 50 or older). Roth IRA contributions aren't tax deductible, they're available only to workers and their spouses, and they're off-limits to high-income taxpayers.

Nevertheless, there is a way to get large amounts into a Roth IRA, regardless of your income or your work status. You can convert a tax deferred account such as a traditional IRA or a 401(k) to a Roth IRA. Such a conversion, though, probably will trigger income tax much earlier than necessary.

Example 1: Jill Kent, age 60, has $400,000 in her traditional IRA, all of which came from deductible contributions. A complete Roth IRA conversion would add $400,000 to her income for the year. That would put her in the top 39.6% tax bracket and expose her to other tax obligations, such as the 3.8% Medicare surtax. Counting state income tax, Jill might owe close to $200,000 in tax on this conversion, for 2015. If she didn't convert her traditional IRA, Jill could avoid taking any taxable distributions for more than 10 years; going forward, she would be required to withdraw relatively modest amounts each year.

Roth rewards

The biggest drawback of a Roth IRA conversion is the upfront tax obligation. In addition, Roth IRAs are subject to recordkeeping requirements and federal rules, which can change.

Despite these drawbacks, Roth IRAs are increasingly popular. The big attraction is the lure of tax-free cash flow. Once your Roth IRA has been in place for five years and you reach age 59½, all distributions are tax-free.

Qualified Roth IRA distributions will be untaxed, no matter how much income you report or how high tax rates might be in the future. Thus, having some money in a Roth IRA offers a hedge against rising income tax rates, which many observers predict.

Staying power

Another advantage of Roth IRAs is that owners have no required minimum distributions (RMDs). With traditional

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Living Longer

Among today's 65-year-olds, 62% of men and 71% of women will reach age 80 versus 41% and 62%, respectively, 50 years ago.

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Trusted Advice

Roth IRA Contributions

- The amount you can contribute to a Roth IRA each year is determined by your modified adjusted gross income (MAGI).
- For this purpose, the MAGI calculation starts with your AGI, found at the bottom of page 1 of your tax return. Subtract any income you report as a result of a Roth IRA conversion or a rollover from a qualified retirement plan to a Roth IRA.
- To get MAGI, start with AGI and then add any deductions or exclusions you report for a regular contribution to a traditional IRA, student loan interest, qualified tuition and related expenses, foreign earned income, foreign housing, interest income from series EE bonds, employer-paid adoption expenses and domestic production activities.
- In 2015, you can contribute the maximum $5,500 ($6,500 at age 50 or older) if your MAGI is under $116,000 as a single taxpayer, or under $183,000 on a joint tax return.
- You can make a partial contribution with MAGI between $116,000 and $131,000 (single) or between $183,000 and $193,000 (joint). With MAGI beyond those amounts, no contributions can be made.

IRAs, 401(k)s, and so on, you generally must take out certain amounts each year after age 70½, or face a 50% penalty on any shortfall.

Example 2: With a $400,000 traditional IRA at age 60, Jill Kent could have a much larger account by age 70½. She might have to take taxable withdrawals of at least $15,000, $20,000, or more each year, regardless of whether she needs all the money.

If she converts her entire traditional IRA to a Roth IRA before that age, Jill will have no RMDs. She eventually can withdraw as much or as little as she wants, tax-free, and leave the balance to her beneficiaries. Those beneficiaries—who might be in their own high tax brackets when they inherit the account—can take untaxed distributions, although they will be on an RMD schedule.

By converting her traditional IRA to a Roth IRA in 2015, Jill will be reducing or eliminating her RMD obligation while creating a long-term, tax-free investment account.

Perfect hindsight

Two other features of Roth IRAs make them especially attractive. One, partial conversions are allowed. Jill might convert, say, $40,000 of her Roth IRA in 2015. If she does this every year, Jill could move most or all of her traditional IRA to a tax-free, RMD-free Roth IRA in 10 years.

The second appealing feature of a Roth IRA conversion is the ability to recharacterize (reverse) the conversion back to a traditional IRA by October 15 of the following year. This can be done in full or in part, so you effectively have the ability to specify the amount of tax you'll have to pay.

Example 3: Jill converts her entire $400,000 IRA to a Roth IRA in 2015. In 2016, when Jill prepares her 2015 tax return, her CPA calculates her tax bill at various conversion amounts. Jill discovers that the total tax rate on an $80,000 (20% of $400,000) Roth IRA conversion would be 35% in this hypothetical scenario. She decides to make the conversion, resulting in a tax bill of $28,000. She recharacterizes the other 80% of her Roth IRA back to a traditional IRA, planning to repeat the process at the end of 2016.

Our office can help you determine the amount to recharacterize, if you wish to execute a Roth IRA conversion in 2015 and perhaps a recharacterization in 2016, to hold down the tax you'll owe. ■

Where to Find Investment Income

Yields on bank accounts and money market funds continue to be negligible. That's discouraging for people who anticipate cash flow from their savings. In some cases, such income is vital for paying ongoing expenses. Even if that's not the case, the unearned cash flow would be a nice way to pad your portfolio. Of course, be sure to understand any investment carefully before you commit.

For taxable accounts

Generally, you should consider holding investments with tax advantages in a regular account. Some possibilities:

Municipal bonds. The interest is exempt from federal income tax, and local issues may be totally tax free. Some municipal bond funds have low expenses and strong track records. However, if you prefer more control over your holdings, you might construct a bond ladder—individual bonds with staggered maturities.

Example: Heath Jensen buys $50,000 of municipal bonds maturing in 2016, $50,000 of munis maturing in 2017, and so on, out to 2022. As the bonds mature each year, Heath will use the redemption proceeds to buy $50,000 of bonds one year further out, adding a rung to his ladder as a replacement.

Ultimately, Heath will wind up with bonds bought at a 7-year maturity, often a good combination of yield and reasonable waiting time

till maturity. If yields should rise, as many people expect, Heath will be reinvesting the proceeds at those higher yields.

Dividend paying stocks. For the most part, people pay only 15% in tax on stock dividends. Those with modest incomes (taxable income up to $74,900 this year on a joint return, for example) owe 0% tax. The good news is that stock dividends can grow over time, if the company's business is successful.

Of course, stock prices can fall sharply. If that happens, a 2% or 3% dividend won't be much of a consolation. Still, steady investing in companies that are profitable enough to pay dividends has been a successful strategy, over the long term.

Equity REITs. Some real estate investment trusts (REITs) buy mortgages, whereas others own investment properties. Either way, REITs must distribute most of their profits in order to avoid corporate income tax. Thus, some REITs pay relatively high distributions to their investors.

What's more, some distributions from REITs that own properties (known as equity REITs) are untaxed returns of capital. You might get 6% from an equity REIT but owe tax only on 4%. In this hypothetical scenario, the 2% that avoids current tax is subtracted from your basis in the REIT. A lower basis, in turn, can increase tax on a future sale. Even so, tax deferral and a possible shift to a lower tax rate on a future sale can amplify the benefits of holding equity REITs. (Again, REIT prices can drop, so there is risk to investors.)

For tax-deferred accounts

In your IRA, 401(k), or other tax-deferred retirement accounts, consider income producing assets that have no protection from current taxation. You can defer the tax on the investment income, perhaps until you're retired, in a low tax bracket. Some possibilities:

Ginnie Mae funds. These funds hold mortgages that are supported by the Government National Mortgage Association (GNMA). The interest paid by homeowners is passed through to investors in the fund. Unlike other mortgage-backed securities, Ginnie Mae interest and principal repayment is guaranteed by the federal government.

Yields on Ginnie Mae funds are usually a bit higher than Treasury bond yields. Among other reasons, Ginnie Mae payouts are not exempt from state and local income tax, which is the case with Treasury bond interest. You can buy individual Ginnie Mae securities, but they can be complex because homeowners are repaying principal along with their monthly interest, so investing through a fund can offer simplicity.

High-yield bond funds. If you're looking for yields, why not put some money into a fund with a name that promises steep payouts? Typically, these funds hold corporate bonds that are low-rated or unrated, often known as junk bonds. Because their credit quality is suspect, issuers must promise substantial yields to bond buyers.

It's unlikely you would want to hold nothing but junk bonds in your retirement fund. Still, a partial allocation might deliver some significant income, if you can stand the volatility of this asset class. A financial adviser may be able to help you find a high-yield fund with relatively low yields and a solid performance history.

Floating-rate funds. These funds acquire loans made by banks and other lenders, often to companies with relatively low credit ratings. Not only do investors receive attractive yields, they also may get some protection against rising interest rates. That's because the loans held by floating-rate funds typically have interest rates that reset periodically. Rising interest rates devalue most bonds and bond funds; with floating-rate funds, rising rates translate into higher yields for investors.

Floating-rate funds can be volatile—they lost heavily in the financial crisis of 2008. As is the case whenever you depart from familiar investments in search of higher yields, you should be sure you fully understand what you're buying and what risks you might be facing. ■

Social Media for Business Owners

The explosion of social media has changed marketing plans for many companies, large and small. Indeed, you already may be using Facebook, LinkedIn, Twitter and so on to boost your business. If you're not up and running on social media, though, there's no need to panic. Some basic steps can get you off to a good start.

Recognize your resources

In all likelihood, some of your employees are comfortable using social media. Bring them in for conversations when developing your plans. If it's practical, ask one of your workers to take charge of this area—with appropriate compensation.

Similarly, your children, nieces, or nephews (even your grandchildren) might be able to help you develop a social media strategy. Employing a child can be especially tax effective, if you can shift income to a lower tax bracket. Earned income is not subject to the potentially painful "kiddie tax" limits.

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Monitor online comments

Regardless of whether you post company related items on social media, you should be aware of what others are saying about you and your firm. Responding can provide ways to strengthen your operations and your image. Indeed, this step can be combined with the tactic of hiring relatives, mentioned previously.

Example: Linda Morgan manages a chain hotel in a major city. She hires her son Nate, a high school senior, to keep an eye on travel websites that rate hotels. Whenever Nate spots a mention of the hotel, pro or con, he brings it to his mother's attention. Then Linda and Nate work up an online response to be posted on that website. If action is needed to address an online complaint, Linda can make sure such action is taken and use the response to report it.

If you don't have a relative or employee who is willing and able to track online comments about your company, social media monitoring services are available.

Concentrate your output

An effective social medial strategy should be proactive as well as reactive. That is, you should be posting original comments or notifying followers of interesting online items relating to your industry. However, you probably should not try to cover too much ground, adding entries on half a dozen social media platforms.

Instead, start with one platform that's relevant to your customers, prospects, and other business contacts. Your in-house and in-family "experts" may be able to point you in the right direction. Once you pick one channel, focus your efforts on getting to know how it works best for your company. Eventually, you can broaden your online presence to other platforms.

Soften the sales pitch

You certainly can use social media to promote your company's reputation, announce new products, and highlight key personnel. However, an effective social media plan will include educational and entertaining elements as well.

Go beyond posts about your company to talk about national or global developments of interest to your industry; offer links to articles you'd like to share with followers. Include visuals as well, to attract more interest. Building up your company's reputation as a thoughtful, responsive resource can be as valuable as informing the world about your products or services.

Perhaps most important, be sure to check over any company-originated content before it is posted on social media by anyone. Give your own messages a second reading, too. Once your company sends out anything that can be construed (or misconstrued) as offensive, the damage might be difficult to undo. ■

TAX CALENDAR

OCTOBER 2015

October 15

Individuals. If you have an automatic six-month extension to file your income tax return for 2014, file Form 1040, 1040A, or 1040EZ and pay any tax, interest or penalties due.

Employers. For Social Security, Medicare, withheld income tax and nonpayroll withholding, deposit the tax for payments in September if the monthly rule applies.

Electing large partnerships. If you were given an additional six-month extension, file a 2014 calendar year tax return (Form 1065-B).

NOVEMBER 2015

November 2

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2015. Deposit any undeposited tax. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until November 10 to file the return.

For federal unemployment tax, deposit the tax owed through September if more than $500.

November 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2015. This due date applies only if you deposited the tax for the quarter in full and on time.

November 16

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in October if the monthly rule applies.

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