CPA

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# Client Bulletin

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

## Choosing the Right 401(k)

**June 2011**

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 five years and after age 59½, all withdrawals are tax-free.

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).

### 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).

**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

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## What's Inside



### Opening Bell

*The initial enrollment period for Medicare starts three months before the month of your 65th birthday and lasts a total of seven months.*

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## 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).

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 five 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. ■

## Notice

In the April 2011 issue of the *CPA Client Bulletin*, we featured an article on the expanded 1099 reporting requirements included in last year's health care law.

As of this writing, this requirement has been repealed by Congress and is expected to be signed by the President.

The provision would have required businesses to file 1099 forms with every vendor with which they buy at least $600 worth of goods and services.

The repeal bill will require taxpayers who receive federal health insurance subsidies to reimburse the IRS, in full or in part, depending on their household income for the current year.

# 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:

| MAGI | | |
|---|---|---|
| Individuals | 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 |

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, while 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. ■

# Small Businesses Fight Soaring Health Care Costs

*The New York Times* recently reported that "health insurance costs are still rising, particularly for small businesses."

What can business owners do about this threat to the bottom line? One tactic is to stop offering a health plan to employees; however, that may not be practical. Starting in 2014, businesses with 50 or more full-time employees will owe fines if they don't offer health insurance plans.

Smaller companies won't be required to offer health insurance; however, under current law, most people will be required to have health insurance by 2014, so employees of companies not offering coverage generally will have to buy their own. As a result, a company that does not provide an employee health plan will be at a disadvantage in attracting and retaining capable workers.

## High deductibles, low premiums

Companies that want to provide health insurance but control costs can choose high-deductible plans. As is the case with any type of insurance policy, a higher deductible means that the insured individual will pay more before the insurance takes effect. Insurers have less exposure, so the consumer's cost is lower.

What's more, certain types of high-deductible health insurance plans can be paired with a health savings account (HSA). Individuals enjoy major tax advantages with HSAs, so employees might appreciate a high-deductible health plan that is compatible with HSAs.

## Qualifying criteria

In order for a health plan to be matched with HSAs, the insurance policies must meet certain tests. Here are the rules for 2011:

**Individual coverage.** The deductible must be at least $1,200. Insured individuals must have a maximum out-of-pocket cost (for deductibles, copays, coinsurance, etc.) of no more than $5,950 before the insurance pays all ongoing costs. If those conditions are met, the maximum HSA contribution in 2011 is $3,050 ($4,050 for people 55 and older).

**Family coverage.** The deductible must be at least $2,400. The insured family must have a maximum out-of-pocket cost of no more than $11,900. If those conditions are met, the maximum HSA contribution in 2011 is $6,150 ($7,150 for people 55 and older).

## Helping out

While business owners save money by providing high-deductible health insurance, employees have more financial exposure because of the increased deductible. Therefore, some companies make tax-deductible contributions to employees' HSAs. Even after these contributions, a business owner might have a lower total cost because of savings from choosing a high-deductible plan.

**Example**: ABC Corp. offers a health plan with a $1,500 deductible for individual coverage. The company also contributes $1,500 to the HSA of Alice Brady, a covered employee. Alice, age 33, can contribute up to $1,550 of her own money, tax-deductible, in 2011. This would bring the total contribution to her HSA to $3,050 this year, the maximum amount.

Therefore, if Alice incurs substantial health care expenses this year, she can use pretax HSA dollars to pay the bill until the deductible is covered and the insurance takes effect. Money left in an HSA at year-end can be retained indefinitely and eventually used for health care not covered by insurance. ■

# TAX CALENDAR

### JUNE 2011

**June 15**

**Individuals.** If you are not paying your 2011 income tax through withholding (or will not pay enough tax during the year that way), pay the second installment of your 2011 estimated tax.

If you are a U.S. citizen or resident alien living and working (or on military duty) outside the United States and Puerto Rico, file Form 1040 and pay any tax, interest, and penalties due for 2010. If you want additional time to file your return, file Form 4868 to obtain four additional months to file. Then, file Form 1040 by October 17.

**Corporations.** Deposit the second installment of estimated tax for 2011.

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

### JULY 2011

**July 15**

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

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