

Tax Talk

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Dear Clients and Friends,

We are well into the traditional “busy season” now. It comes as a surprise to most people that September 15 (extended due date for most entity returns) and October 15 (extended due date for individual returns) are probably bigger deadlines for us than March 15 and April 15. Nevertheless, this is clearly a busy time of the year for us as we try to get out audited financial statements and Schedule K-1s, along with structuring transactions, handling IRS and DOR matters, and doing ongoing planning for our clients.

I sent out an e-mail recently discussing the factors to consider in deciding whether to make a Roth IRA conversion under the new rules in effect for 2010. Because of the importance of this topic, I will repeat it here. Also in this issue we will discuss the research tax credit, when you should claim social security benefits, the current state of

uncertainty with respect to the estate tax, a recent district court case pertaining to whether FICA tax applies to severance pay, and how S-corps should report their owners’ health insurance premiums, and, as always, highlight a member of our firm and one of our clients.

We hope that you will enjoy this issue and gain from it some useful information.

Sincerely,

Kent Bridges



Kent Bridges,
Managing Partner

2010: The Year of the Roth Conversion Opportunity

Prior to 2010, the ability to convert a traditional IRA to a Roth IRA was limited to those with income below \$100,000. Effective January 1, 2010, taxpayers can convert their traditional IRAs to Roth status, regardless of their income level. This rule change represents a potentially substantial tax savings opportunity; or a potentially substantial tax detriment, depending on your personal circumstances and future tax laws. Accordingly, it is important that everyone carefully consider the possibility of a Roth conversion during 2010. Even if you do not presently have any significant amount of money in an IRA, don’t stop reading yet; the matters discussed in this article may be very pertinent to you because of the potential applicability to amounts in qualified plans (e.g. 401(k) plans) or because of the potential benefit of making an initial contribution to a Roth IRA now.

With a traditional deductible IRA or 401(k), you get an income tax deduction on the front end when the money goes into the plan, the inside build-up is tax-deferred, and then you pay tax on distributions when taken. There is no penalty on the distributions, so long as you are at least age 59 ½ when you take the distribution, and you must begin taking distributions at age 70 ½. The value of the account at your death is included in your taxable estate (unless left to charity), and your beneficiaries pay income tax on the distributions when they receive them.

Legislation enacted in 1997 introduced a new type of IRA, the “Roth”. With the Roth IRA, you get no deduction on the front end, but you pay no tax on the distributions. The required minimum distribution rules do not apply to a Roth during the owner’s lifetime (they take effect after death, and apply with

respect to the beneficiaries). As with a traditional IRA or qualified plan, the value of the Roth is included in the owner’s taxable estate at death (unless left to charity). The beneficiaries, however, do not incur any income tax on distributions.

Income limitations on who can contribute to a Roth and contribution limits on the amount that can be contributed to a Roth have made it difficult for most taxpayers to get significant dollars into a Roth (if any at all). Beginning with 2006, employers were able to add a Roth feature to 401(k) plans, which has enabled taxpayers to get somewhat more money into Roths. However, the primary method for getting significant dollars into a Roth is to convert money from a traditional IRA or qualified plan into a Roth IRA. The conversion is a taxable event, but, in the right circumstances, can be very beneficial over the long-term.

Prior to 2010, the ability to convert to a Roth was limited to those whose income for the year of conversion was otherwise less than \$100,000. This income-based limitation shut out some of those who might have most benefited from conversion. Effective January 1, 2010, however, anyone can convert to Roth status, regardless of income level. Further, for conversions taking place in 2010, you have the option of either recognizing the resulting income on your 2010 tax return, or spreading it over 2011 and 2012.

The primary factors for consideration in making the Roth conversion decision are:

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Brock W. Bullard, CPA

Member in the Spotlight – Brock Bullard

Brock Bullard recently celebrated his 10th anniversary with Bridges & Dunn-Rankin. Brock joined the firm in early 2000 after a 2-year stint with Ernst & Young in Charlotte, NC. Brock, a native of Valdosta, Georgia, received both his BBA in Accounting and his Masters with Emphasis in Taxation from The University of Georgia. He was awarded the Silver Medal by the North Carolina Association of Certified Public Accountants for scoring the second highest on the May 1999 CPA Examination.

Brock's wife, Heather, formerly a cardiothoracic nurse, is now a full-time mom to sons Braxton, Harrison, and Thatcher. In his younger years, Brock was a world-class dirt-bike rider, traveling the country with his family to compete in motocross events. Fortunately for us, he no longer rides his motorcycle and now spends most of his outside time with Braxton, Harrison, and Thatcher.

Bridges & Dunn-Rankin is proud to have Brock Bullard as a member of our firm.

2010: The Year of the Roth Conversion Opportunity – continued

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Future tax laws and rates – To the extent that the tax rates which would apply to the IRA distributions when taken in the future exceed the rates which apply to the conversion, then a Roth conversion is probably advantageous. Conversely, if the IRA distributions could be taken in a future year(s) at a lower rate than the rate which would apply to conversion, then conversion is less likely to be advantageous. This is probably the biggest unknown we face in making the decision about whether or not to convert.

Required minimum distributions (RMDs) – With a traditional IRA, you must begin to take distributions at age 70 ½. With a Roth IRA, these RMDs can be postponed until after your death, and then be based on the life expectancy of your heirs. This means that with a Roth the money may stay in a tax-deferred vehicle for a significantly longer period of time. This is one of the primary wealth-building advantages of the Roth.

Ability to pay the conversion tax with non-IRA funds – If you will have to use some of the IRA money in order to pay the conversion tax, then this will negate much, if not all, of the potential advantage of making the conversion.

Estate tax – Do you expect to have an estate subject to the estate tax? If so, a Roth conversion may have an advantage in that you are removing from your taxable estate the dollars needed to essentially prepay the income tax that would otherwise apply to the IRA distributions. Some of this advantage is negated by the loss of the income tax deduction that heirs receive for estate tax paid on the value of an IRA, but generally not all; especially if you incur a state level estate tax (which is not deductible for income tax purposes).

Expected growth rate of IRA versus non-IRA assets – If you have in your IRA a unique asset that you believe has a potential growth rate far in excess of the potential growth rate of your non-IRA funds, then converting to Roth status could be very advantageous. This is particularly true if the IRA assets currently have a very low value, such that the conversion tax would be very small.

Creditor protection – Amounts in qualified plans subject to ERISA enjoy great protection from creditors. Amounts in IRAs may enjoy somewhat similar, but generally not as complete, protection under Federal bankruptcy law or state laws.

Charitable intentions – IRAs and qualified plan money can be

good assets to leave to charity. To the extent you name a charity as the beneficiary, the amount is excludable from your taxable estate and the amount also escapes income tax. Accordingly, if you plan to leave your IRA to charity you would not want to make a Roth conversion.

Not an all or nothing decision - You have the ability to choose the amount you convert.

Assets in a qualified plan - While you cannot do a Roth conversion inside a qualified plan (e.g. 401(k) plan), you can roll amounts from a qualified plan to a Roth IRA; assuming that your plan permits such.

Getting the 5-year clock running - In order to be completely tax and penalty free, a distribution from a Roth must be made after either age 59 ½, death or disability or for a qualified special purpose; and at least 5 tax years must have lapsed since the first tax year in which the individual made a Roth contribution or did a Roth conversion. Accordingly, one of the benefits of doing a Roth conversion or contribution of at least some small amount is that it gets the 5-year clock running for any future Roth distribution.

Spread over 2011 and 2012, or recognize in 2010? - A special feature of converting to Roth status during 2010 is that you have the option to either include the conversion amount in your 2010 taxable income or spread it over 2011 and 2012. Were it not for the possibility of tax rates increasing (which appears likely to be the case), opting for the spread over 2011 and 2012 would likely be the way to go. Under the circumstances, however, careful analysis will be required to determine which is the better option.

State income tax considerations - It is important not to forget the potential state income tax implications of a Roth conversion, both in terms of the potential conversion tax and a potential change in residency between time of conversion and time of distribution.

Ability to recharacterize (a "do-over") - One of the great features of the Roth conversion is that you essentially get a "do-over". If you convert to Roth status during the tax year, you have up until the extended due date of your income tax return for that year to decide you want to undo it. This provides a great opportunity to use some 20/20 hindsight in making the decision.

Risk factors - Might Congress decide in the future to tax Roth distributions, effectively renege on the implied promise that you

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have going into the Roth? Consider that today social security benefits are taxable for those with income over certain threshold amounts. Or consider the 15% excise tax (“success tax”) that applied for a while during the late 80’s and early 90’s to excess distributions from or excess accumulations in qualified plans. It is possible. Or what if the income tax is replaced by a consumption-based tax (e.g. the “Fair Tax”)? That would really be the ultimate

R&D Tax Credits

Tax rules generally provide for very favorable treatment of research expenses. You can claim a current deduction for such, and can also claim a tax credit for a portion of the expenses.

The mathematical computation of the credit is complex, and it varies according to how many years you have been in business and had both revenue and R&D expenses and what computational method you elect. However, while the Federal credit is referred to as a 20% credit, it generally works out to be about 6.5% of the amount of your R&D expenses.

The term "research or experimental expenditures", for purposes of the R&D tax credit, means expenditures which represent research and development costs in the experimental or laboratory sense. The term includes generally all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned. The term does not include expenditures such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions. In addition to

Client in the Spotlight – Gibbs Landscape Company

Following his graduation from the University of Georgia in 1965 with a major in horticulture and a minor in landscape architecture, Jim Gibbs started the landscape design/build division of Green Brothers Nurseries. Subsequently, he bought out Green Brothers, and changed the name of the company to Gibbs Landscape Company. Since that time, Gibbs Landscape has gone on to win over 200 awards for its landscape designs, and has become the premier residential and commercial landscape design, installation and maintenance company in the Atlanta area.

Jim Gibbs has retired from the day-to-day operations of the landscape company, and now focuses his efforts on his approximately 300-acre garden in Ball Ground, Georgia, which has

When Should You Begin to Take Social Security Benefits?

You can begin to claim social security benefits at any age between 62 and 70. The longer you defer, the larger the monthly benefit. Accordingly, clients sometimes ask us when they should begin to take the benefits. There is no easy right or wrong answer to this question, but generally we find that one should begin taking the benefits at age 62 if:

- They have a current need for the cash flow;
- They do not expect to live to their actuarial life expectancy

in double taxation; to have paid tax on your IRA or qualified plan money to get it into a Roth, and then effectively be taxed on it again when you take distributions by virtue of a consumption-based tax that has replaced the income tax or an income tax that applies to Roth distributions. Also, those with Medicare Part B premiums need to consider that the additional income from a Roth conversion may cause their premiums to increase.

meeting the requirements above, the activity must be one which is undertaken for the purpose of discovering information which is technological in nature and substantially all of the activities of which constitute elements of a process of experimentation for a purpose related to a new or improved function, performance or reliability or quality.

For S-corps, LLCs, and other pass-through entities, the R&D credit flows through to the owners and is taken as a credit on their personal returns. The credit taken cannot exceed the amount of tax incurred with respect to taxable income flowing through from the company. Unused credits may be carried forward to future years. It should be noted that owners of such entities who do not “materially participate” in the business have to capitalize their share of R&D expenses for purposes of the alternative minimum tax and amortize such over 10 years.

Many states have a research tax credit similar to that of the Federal credit. The Federal credit expired on December 31, 2009. However, it has expired many times before, and has always been subsequently extended (usually retroactively).

long been the center piece of the company’s marketing and advertising and which he plans to open to the public within the next two years. Meanwhile, under the leadership of son David Gibbs and son-in-law Peter Copses, Gibbs Landscape Company continues to grow and continues its award-winning tradition.

Bridges & Dunn-Rankin is proud to be associated with Gibbs Landscape Company.



- (based on current health, family history, etc.);
- They do not have any confidence that the social security system will survive long-term; and/or
 - They are aggressive investors and believe that they can invest the early benefit payments in a manner that will produce a high rate of return and are willing to take this investment risk with their social security benefits.

On the other hand, deferring benefit payments generally makes

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When Should You Begin to Take Social Security Benefits? – continued

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the most sense if:

- You do not have a current need for the cash flow;
- You believe you will live to life expectancy or beyond;
- You are in a higher tax rate bracket now than you anticipate in later years;
- You are a conservative investor (at least with respect to your

Estate Tax Uncertainty

Legislation enacted in 2001 provided for a gradual increase in the estate tax exemption amount to \$3.5 million, a gradual decrease in the highest estate tax rate to 45%, a complete repeal of the estate tax for 2010, and then a reinstatement of the estate tax in 2011 with only a \$1,000,000 exemption and a maximum rate of 55%. Almost no one actually expected this to happen. Most expected Congress to act before the end of 2009 to make the estate tax permanent, but with a higher exemption amount and a lower rate. To date, however, Congress has not acted, leaving us with much

District Court Rules that Severance Pay is not Subject to FICA

In a recent Michigan case, a district court ruled that severance pay is not subject to FICA. While the IRS does not agree with this decision, employers or employees who have been affected by this

Health Insurance for Owners of S-corps

Prior to 2003, self-employed persons (including owners of S-corps) were limited in their ability to deduct health insurance (HI) premiums, whereas for other employees the employer company could pay the premiums and exclude such from the employee's W-2. Rules in effect since 2003 have essentially leveled the playing field in this area by providing a deduction for 100% of a self-employed person's HI premiums, provided certain criteria are met. A 2% or more owner of an S-corp may claim a deduction on their personal return in computing adjusted gross income for HI premiums provided:

- social security benefits); and/or
- You view social security as a safety net.

If there is a spouse involved, the decision gets a little more complicated, but it often makes sense for the spouse with the lower earnings history (especially if that spouse has a longer life expectancy) to begin benefit payments at age 62, and then switch to survivor benefits later.

uncertainty as to the future (and the immediate past, because of the possibility of a retroactive restoration of the tax).

Those whose wills include a formula clause with the amount going to a surviving spouse or charity tied to the amount of the estate tax exemption may find that their will does not carry out their wishes (potentially leaving nothing to the surviving spouse or charity). Accordingly, if you have not had your will reviewed recently, now may be the time to do so.

issue may want to consider whether a position exists for avoiding FICA, and, if they have already paid the tax, may want to consider filing a protective refund claim.

- The shareholder is not eligible to participate in subsidized plan maintained by another employer or the spouse's employer;
- The S-corp pays the HI premiums, or if the shareholder pays such directly he submits proof to the S-corp and it reimburses him; and
- The S-corp includes the amount of the HI premiums in the shareholder-employee's W-2 as an amount subject to income tax, but not FICA. The S-corp gets an income tax deduction for this same amount.

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Your Referrals Are Appreciated

We are sometimes asked whether we are accepting new clients. The answer is yes. We have been very blessed over the years, and always seem to have plenty to do. However, due to natural attrition (e.g. clients selling their business) and the need to provide growth opportunities for our employees, we must always be on the lookout for new clients. Our new business comes almost exclusively from referrals, and so we greatly appreciate your referrals.

Bridges & Dunn-Rankin, LLP is an Atlanta-based full-service accounting firm serving clients in the technology, real estate, services, manufacturing, distribution, construction and healthcare industries, as well as high net worth families.

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