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TAX IMPACT

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Is a Roth 401(k) right for your business?

This year, your business has another benefit it can offer employees — Roth 401(k) plans. They can be a very attractive option, especially for employees who are ineligible for contributing to Roth IRAs. But they also mean additional expense and risk for you and more complex planning for your workers.

Contributions and distributions

Traditional 401(k) contributions and earnings are tax deferred — that is, employees don't pay any income taxes until they take a distribution. With a Roth 401(k) contribution, employees pay the taxes upfront, but qualified withdrawals of contributions and earnings are tax free.

Although a Roth 401(k) is similar to a Roth IRA, there are some important differences. Most significant, there are no income limits on participation in a Roth 401(k). Singles with modified adjusted gross income (MAGI) exceeding $110,000 and joint filers with MAGI exceeding $160,000 are ineligible to contribute to a Roth IRA. But employees at all income levels can make contributions to a Roth 401(k).

Roth 401(k)s also enjoy the same contribution limits as traditional 401(k) plans: $15,000 in 2006, plus an additional $5,000 "catch-up" contribution for employees at least age 50 by year end. For 2006, Roth IRA contributions are capped at $4,000 plus a $1,000 catch-up contribution.

If the tax rate is constant, the choice between traditional and Roth contributions is a wash.

Distribution rules for Roth 401(k) plans are similar to those for Roth IRAs. To qualify for tax-free withdrawals, you must keep the funds in the account for at least five years. Tax- and penalty-free withdrawals are available when you reach age 59½, die or become disabled. Early withdrawals are generally subject to tax and a 10% penalty on your earnings.

Unlike Roth IRAs, Roth 401(k)s don't allow early tax-free withdrawals for first-time home purchases and are subject to mandatory distribution rules that kick in at age 70½.

The employer's perspective

Allowing Roth contributions to your company's 401(k) plan can be a relatively inexpensive way to provide your staff with a valuable benefit, which may help you attract and retain talent. But note that employer matching contributions may not be allocated to a Roth 401(k) account; they must be contributed to a traditional 401(k) account.

Adding this feature adds to your administrative burden. You'll need to amend your plan to permit Roth 401(k) contributions. (Remember that employee Roth 401(k) contributions won't reduce their wages.) You'll also have to maintain Roth contributions in separate accounts and set up a separate accounting system to track contributions, gains and losses, and distributions allocable to those accounts.

Another potential drawback is that the Roth option adds complexity to participants' investment decisions. Some employers fear this additional complication could cause overall plan participation to drop, potentially throwing off the percentages used to evaluate a plan's compliance with nondiscrimination rules. (Both plans are tested together for nondiscrimination testing.) To avoid this result, educate employees about the relative merits of Roth and traditional contributions.

The employee's perspective

The decision between pretax (traditional) and after-tax (Roth) contributions isn't a simple one for employees. It requires them to consider:

- Current and future income,
- The amount of time they have until retirement, and
- Current and future tax rates.

As a rule of thumb, for employees who plan to retire relatively soon, Roth contributions benefit those who expect their marginal tax rate to increase when they retire. For example, if employees believe the government will increase tax rates or their marginal rates will rise in retirement because they'll have fewer itemized deductions, paying the tax now — rather than later — may be their best bet. But if they believe their marginal tax rate will be lower when they retire, a traditional tax-deductible contribution may be the way to go.

For employees with some time to go before retirement, a Roth 401(k) is typically more beneficial because they'll owe no taxes ever on the earnings (if they take only qualified withdrawals) and over that period of time those earnings may be significant.

Determining the right choice

To better see how these options compare, let's look at a simplified example. Katherine, who turns 50 in 2006, is in the 33% tax bracket. She can afford to contribute $20,000, before taxes, to her company's 401(k) plan. The plan allows employees to choose between traditional and Roth contributions. Suppose Katherine makes a $20,000 pretax contribution to the plan and her investment earns an 8% annual return. When she retires at age 65, her investment will have grown to $63,443. If she withdraws the funds at that time, and assuming she'll remain in the 33% tax bracket, Katherine will end up with $42,507.

If Katherine instead elects to pay the tax upfront and make a Roth 401(k) contribution, she'll pay $6,600 in tax on the $20,000 in income, leaving $13,400 to contribute to the plan. Plus, her account will continue to grow tax-free. When she retires, her account will grow to $42,507, which she can withdraw tax-free.

As you can see, if the tax rate is constant, the choice between traditional and Roth contributions is a wash. But tax rates are anything but constant, so your employees' decisions will require a bit of crystal-ball gazing.

Economics aside, a Roth 401(k) account offers the advantage of certainty: The entire account balance will be available to employees when they retire, regardless of what happens to the tax rates between now and then.

One effective strategy is for employees to hedge their bets by splitting their contributions between Roth and traditional 401(k) accounts. The contribution limit is an aggregate limit on elective deferrals, which means that in 2006 an employee can allocate up to $15,000 ($20,000 if age 50 or older) between both accounts.

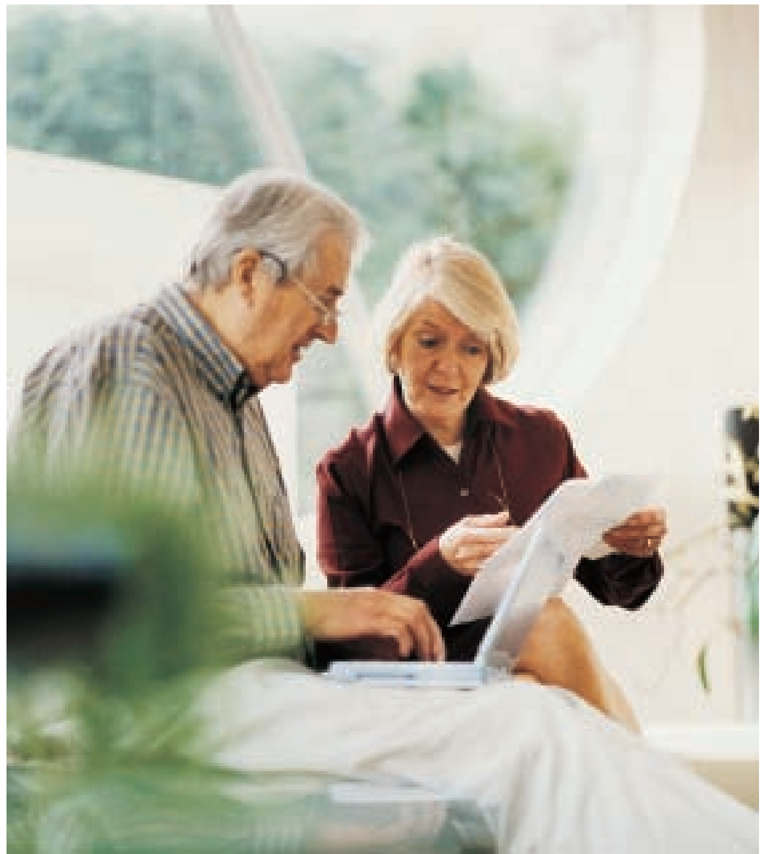
Bear in mind that the Economic Growth and Tax Relief Reconciliation Act of 2001, which created the Roth 401(k) plan, expires in 2010. Unless Congress extends the Roth provisions, participants won't be able to make new Roth 401(k) contributions after 2010. But they should be able to leave their previous contributions in their accounts or roll them over into a Roth IRA.

Advantages for all

Roth 401(k)s are a great new benefit for all. Employees will have a tax-advantaged way to save for retirement and your business will have another tool to attract and retain star workers.

Why lifetime giving still makes sense

There's a popular misconception that the repeal of the estate tax by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) makes lifetime gifts unnecessary. After all, a fundamental goal of a lifetime giving strategy is to reduce estate taxes. But there are a number of tax and nontax reasons that lifetime giving should remain an integral part of your estate plan.



Traditional estate planning strategies still relevant

As things now stand, the pre-EGTRRA gift and estate tax system will be restored in 2011 — though many experts expect Congress to intervene in some way. So if you expect to live at least five more years, traditional estate planning techniques will continue to provide important tax benefits.

For example, by taking advantage of the annual gift tax exclusion (now $12,000 per recipient), you can make tax-free gifts that reduce your estate without using your exemptions. Suppose, for example, that you have three children and nine grandchildren. At $12,000 per recipient, the annual exclusion would allow you to transfer $144,000 per year tax-free — $288,000 annually if you split gifts with your spouse.

If your net worth is large enough to make estate tax liability a concern, regular annual exclusion gifts will enable you to remove large amounts of wealth from your taxable estate.

There also may be a benefit to making gifts beyond the annual exclusion amount, especially gifts of property expected to appreciate in value. For example, Joe's estate consists of $950,000 in publicly traded stock and he has not used any of his lifetime gift tax exemption. If he gives the stock to his daughter, Lisa, there will be no gift tax payable this year. Plus, so long as Joe lives at least three years after he makes the gift, the stock and any appreciation in its value are removed from his estate and shielded from estate taxes.

Suppose, instead, Joe keeps the stock and dies in 2011, when its value has increased to $1.5 million. The entire amount will be included in his estate. Unless Congress modifies EGTRRA, the pre-EGTRRA law will apply. If Joe's entire lifetime exemption amount is available at his death, his estate will have to pay $210,000 in tax.

Why you should keep giving

There are important nontax reasons to make lifetime gifts, even if the estate tax is repealed permanently or the lifetime exemption amount remains at an increased level. For instance, if you own a business, you may need to begin transferring ownership to the next generation before you retire. By taking advantage of the annual gift tax exclusion and using family limited partnerships or other tax-advantaged business structures to leverage your lifetime gift tax exemption, you can achieve these goals at the lowest possible tax cost.

Exemptions and rates

Year	Estate tax exemption[1]	Top estate tax rate	Gift tax exemption	Top gift tax rate
2006	$2 million	46%	$1 million	46%
2007	$2 million	45%	$1 million	45%
2008	$2 million	45%	$1 million	45%
2009	$3.5 million	45%	$1 million	45%
2010	Estate tax repealed	Estate tax repealed	$1 million	35%[4]
2011[2]	$1 million	55%[3]	$1 million	55%

[1] Less any gift tax exemption already used
[2] If the repeal is not extended
[3] Excluding 5% surtax
[4] Equal to highest marginal rate, which currently is 35%

Another reason to give is uncertainty over the future of the estate tax. If Congress allows EGTRRA to run its course, the estate tax will be repealed for only one year. So unless you're planning to die in 2010, lifetime gifts will continue to provide significant estate tax benefits.

Your lifetime gift tax exemption

Deciding whether to make additional gifts that use up your $1 million lifetime gift tax exemption is a harder call. On the one hand, this strategy is of limited value as long as the estate tax exemption is substantially higher than the gift tax exemption — unless your taxable estate is in excess of the estate tax exemption. On the other hand, if the pre-EGTRRA gift and estate tax system is restored, you'll benefit by removing appreciating assets from your estate.

Complicating matters further, you also need to think about the income tax implications. Historically, assets transferred at death have received a "stepped-up" basis equal to their fair market value, so your heirs could sell the assets without triggering capital gains taxes. But when you make a gift during your lifetime, your basis carries over to the recipient. This can mean a hefty income tax bill if the assets have appreciated significantly since you acquired them.

Before EGTRRA, income taxes generated by lifetime gifts weren't as big a concern because they were usually overshadowed by the estate tax savings. But if the estate tax is repealed permanently or if the gap between the gift and estate tax exemptions remains, income taxes will play a bigger role in estate planning. Note that, when the estate tax is repealed in 2010, the stepped-up basis for assets transferred at death is also eliminated, with certain exceptions.

If your net worth is large enough to make estate tax liability a concern, regular annual exclusion gifts will enable you to remove large amounts of wealth from your taxable estate.

The strategy of making taxable gifts is risky under the current system. Gifts in excess of the $1 million lifetime exemption may pay off if the estate tax repeal isn't extended and you die after 2010, when the gift and estate taxes have been reunified. But if you die before 2011, or if Congress changes the law, you may end up paying gift taxes on assets that could have been transferred tax-free at your death.

Why you should stay tuned

Lifetime giving will continue to be an important planning tool. But the most effective strategies ultimately depend on the fate of the estate tax. So keep abreast of legislative developments and be prepared to quickly adapt your estate plan when the future becomes more certain.

It pays to learn about the education deduction and credits

If you paid higher education expenses in 2005 for yourself, your spouse or a dependent, you may qualify for the Hope credit, the Lifetime Learning credit or an above-the-line deduction on your 2005 federal tax return, due April 17. But you can't claim more than one of these tax breaks for the same student — regardless of how much you spent on education — so you'll need to figure out which one will provide the greatest tax benefit.

What are the qualifications?

The deduction applies to qualified expenses paid during 2005 in connection with enrollment at an eligible institution during 2005 or for an academic term beginning in 2005 or in the first three months of 2006. The Hope and Lifetime Learning credits apply to qualified expenses paid during 2005 in connection with an academic period beginning in 2005 or the first three months of 2006.

The deduction is available for qualified tuition and fees (not including room, board and books), up to $4,000. "Above the line" means you can deduct the expenses in determining your adjusted gross income (AGI) even if you don't itemize. (Keep in mind, eligible expenses may be reduced.)

The Hope credit is available for 100% of the first $1,000 in qualified tuition and related fees (but not room, board and books) for an eligible student and 50% of the next $1,000, for a maximum credit of $1,500. To qualify, the expenses must be for the first two years of a degree or certificate program and the student must be enrolled at least half time.

The Lifetime Learning credit is available for 20% of qualified tuition and fees up to $10,000, for a maximum credit of $2,000 for any number of students. The credit isn't limited to the first two years of college and the students don't have to be enrolled in a degree or certificate program. So the credit would be available for courses designed to improve job skills.

What are the income limits?

If you're single, the Hope and Lifetime Learning credits are phased out beginning at $43,000 of modified AGI (MAGI) and eliminated when your MAGI tops $53,000. For married couples filing joint returns, the phaseout range is $87,000 to $107,000. The deduction is reduced to $2,000 if your MAGI exceeds $65,000 ($130,000 for joint filers) and is eliminated if your MAGI exceeds $80,000 ($160,000 for joint filers).

If your income disqualifies you from claiming the credits or the deduction and your children pay their own education expenses, they may be able to take advantage of these tax breaks — as long as you don't claim them as dependents. In many cases, the tax benefits to children outweigh the value of the dependency exemption for parents.

Take the deduction or a credit?

So, which tax break should you claim? The income limits may already have made the decision for you. But if you're eligible for all, the Lifetime Learning credit is probably your best bet because it can save you as much as $2,000 in federal income taxes, compared to the $1,500 maximum Hope credit savings and the maximum deduction, which would probably save you only $1,000 in taxes.

Crunching the numbers

There are exceptions, so have your tax advisor crunch the numbers to see which tax break would be best for you. After all, there may be other factors, such as two or more children attending college or qualifying for only a partial credit, influencing your situation.

Tax Tips

How to succeed in business

A recent Tax Court opinion is good news for students getting a master's degree in business administration (MBA). In a reversal of its previous position, the court permitted a taxpayer to deduct the cost of obtaining an MBA as a business expense.

As a general rule, educational expenses aren't deductible if they lead to a degree that prepares the taxpayer for a new trade or business or satisfies a minimum educational requirement for his or her job.

In this case, the Tax Court found the MBA helped the taxpayer advance in his company, but it wasn't a condition of employment and it didn't prepare him for a new trade or business. Rather, the court explained, his studies "improved pre-existing skills that (the) petitioner used before enrolling in the MBA program."

Don't overlook partial home-sale exclusion

The tax code allows you to exclude from income up to $250,000 ($500,000 for joint filers) in gain on the sale or exchange of your principal residence. To qualify, you must have owned and used the property as a principal residence for at least two of the previous five years.

But even if you don't satisfy the two-year-use requirement, you may be eligible for a partial exclusion if you're forced to sell due to a change in place of employment or health, or due to unforeseen circumstances such as:

- Death,
- Divorce,
- Multiple births from the same pregnancy,
- Termination of employment, if it qualifies you for unemployment compensation or renders you unable to pay your living and housing costs,
- A natural or man-made disaster or an act of war or terrorism, and
- Involuntary conversion of the residence — for example, through condemnation or eminent domain.

If you qualify, you can claim a partial exclusion based on the amount of time you owned or used the property as your principal residence compared to the two-year-use requirement. For example, if you and your spouse bought a home in January 2005 and sold it in January 2006 because of a job relocation, you would have met 50% of the requirement and could exclude up to $250,000 in gain (50% of $500,000).

Reap energy incentives

The Energy Tax Incentives Act of 2005 provides more than $14 billion in tax breaks to promote energy production and conservation. Although most of the incentives are reserved for energy producers, businesses and consumers can benefit as well. Tax breaks for companies include a:

- $2,000-per-unit tax credit for construction of new homes that meet a 50% energy-efficiency standard,
- $1,000-per-unit credit for manufactured homes that meet a 30% energy-efficiency standard,
- Deduction for qualifying costs of major energy-saving improvements to commercial buildings, and
- Credit for manufacturers of energy-efficient appliances.

Individuals can claim a 10% credit up to a $500 lifetime limit for certain energy-efficient home improvements and a 30% credit for qualifying home installations of solar hot water heaters, electricity-generating solar equipment or fuel cells. The act also replaces the deduction for hybrid and other fuel-efficient vehicles with a credit.

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I am pleased to announce the addition of Emilio Escandon and Jeffrey Blinn to our team of tax experts.

Emilio Escandon joined as partner effective May 30th, 2005. Formerly with Deloitte Tax LLP, Escandon will lead the firm's Fort Lauderdale tax department, focusing his practice on tax and financial planning, as well as corporate tax management. Escandon has more than 24 years of multifaceted tax experience serving industries such as manufacturing, food & beverage, consumer products, pharmaceuticals, telecommunications, advertising and financial institutions. Over the last year, he has assisted clients in deals that total more than $2 billion. Escandon also served as senior vice president of corporate tax at Intercontinental Bank in South Florida.

Escandon is a graduate of the University of Florida with a bachelor of science degree in accounting. He is a member of the American Institute of Certified Public Accountants, the Florida Institute of Public Accountants, former chair of the Federal Taxation Committee, a member of the Editorial Committee for CPA Today, and past chairman of the Junior Achievement of Greater Miami.

Jeffrey Blinn, who joins the firm as International Tax Director, will focus his practice on planning, compliance, tax accounting, and audits with an emphasis on beneficial treasury and net income impacts for both individual and corporate international clients. Formerly with Deloitte & Touche LLP, Blinn has extensive experience working with New York Stock Exchange companies on implementing strategies to locate debt and increase after-tax earnings, as well as multi-million dollar tax structures for overseas investments. He also served as a senior tax attorney for Shell Oil Company and brings a wealth of international legal experience to MBAF.

Blinn is a graduate of Dickens College with a bachelor of arts degree and went on to receive his law degree from Washington College of Law at American University and his LL.M. degree in taxation from the Georgetown University Law Center. Blinn is a licensed certified public accountant in Florida and Texas, as well as a member of the American Institute of Certified Public Accountants and the South Florida International Fiscal Association. He is also a member of the District of Colombia, New Jersey and Pennsylvania Bar Associations.

Morrison, Brown, Argiz & Farra takes great pride in offering comprehensive tax counseling to preserve wealth, optimize taxes and maintain state and federal compliance. We offer much more than standard compliance work. Our goal is to work closely with our clients to make sure that they are taking advantage of the many tax planning strategies available. We also want to ensure that they are in compliance with income tax laws and assist in preparing all necessary tax returns.

Our professionals hold master degrees in taxation and are diligent when it comes to obtaining advanced training through industry associations. We are proud of our integrated communications between team members, which enables us to provide our clients with the best services and the value they expect. In addition to our human capital, we also have access to an extensive on-site library and online research services to ensure that we are in step with the latest industry news and developments.

Sincerely,

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Partners

Kashyap Bakhai, CPA

Bakhai is regarded in the professional community as one of the best tax minds in South Florida. He deals with such topics as the tax benefits of LLCs, year-end tax planning, and qualified subchapter S subsidiaries, the innocent spouse relief provision under Section 6015, and IRS regulations on valuing and substantiating charitable contributions.

Raul Incera, CPA

Raul focuses his practice on international tax services with an emphasis on financial institutions. He has exceptional depth of knowledge in cross-border transactions and investments, income tax treaties and foreign tax credits.

Santiago Pujals, CPA

Santiago's expertise includes tax planning, sales and use tax consulting, and representation of clients during examinations by the Internal Revenue Service and Florida Department of Revenue. He also provides senior counsel to MBAF clients on tax planning issues, with an emphasis on state and local taxation (SALT).

Barry I. Ross, CPA

Barry brings over 40 years of experience handling sophisticated foreign and domestic transactions, including acquisitions and mergers, public and private debt and equity financing, complex tax cases, estate planning, litigation and valuations.