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# Client Bulletin

Smart Tax, Business & Planning Ideas *from your Trusted Business Advisor*<sup>SM</sup>

## Nondeductible Contributions to Traditional IRAs



Many people think IRAs come in two flavors. Traditional IRAs, as they're known, often hold pretax dollars. They offer tax deferral, but you'll owe income tax on withdrawals. Alternatively, Roth IRAs are funded with aftertax dollars. Earnings inside the account are tax-free, as they are with traditional

IRAs, and withdrawals also are tax-free if you are at least 59½ years old and have had a Roth IRA for at least 5 years.

In some cases, however, you might find that you cannot make a deductible contribution to a traditional IRA or a nondeductible contribution to a Roth IRA. If so, you should consider contributing aftertax dollars to a traditional IRA, even though such contributions are not deductible.

**Example 1:** Paul and Lois Matthews, both age 55, work at jobs where they participate in a retirement plan. Their combined income this year is over \$250,000. Neither spouse qualifies for a deductible contribution to a traditional IRA because couples filing a 2012 joint tax return can't make deductible contributions if they have modified adjusted gross income (MAGI) of \$112,000 or more, and if both spouses are covered by an employer's retirement plan.

This couple can't make Roth IRA contributions, either. For 2012, a couple filing jointly can't contribute to a Roth IRA if their MAGI is \$183,000 or more.

However, both Paul and Lois can make full aftertax contributions to a traditional IRA for 2012. Such contributions have no income limits. Because they are both over 50, Paul and Lois can each contribute up to \$6,000 to a traditional IRA this year. They'll get no deductions for their contributions, but they will enjoy other tax benefits.

### Multiple benefits

After contributing nondeductible money to a traditional IRA, all investment earnings are tax-deferred until money is withdrawn. In addition, individuals will owe less tax on Roth IRA conversions and traditional IRA withdrawals.

**Example 2:** Paul Matthews has no traditional IRA. For 2012, he makes a \$6,000 nondeductible contribution to his first traditional IRA. Once the account is open, he converts this IRA to a Roth IRA; there are no income

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### College Prep

*Total assets in 529 college savings plans were \$157.5 billion as of June 30, 2012, up from around \$3 billion at the beginning of this century.*

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### Trusted Advice

### **Roth IRA Conversion**

- You can convert money held in a traditional IRA to a Roth IRA by

limits on Roth IRA conversions.

If Paul's traditional IRA is worth \$6,000, then all of the money is aftertax. Thus, Paul owes no tax on the conversion. He can do this year after year, building up a Roth IRA for eventual taxfree distributions. A quirk in the tax code places no income limits on Roth IRA conversions, even though there are income limits for Roth IRA contributions. As explained in the next example, though, contributing aftertax dollars to a traditional IRA and then converting to a Roth IRA may generate a tax obligation.

**Example 3:** Lois Matthews has a traditional IRA. For 2012, she makes a \$6,000 nondeductible contribution to a new traditional IRA. Lois keeps making such contributions for the next several years.

By 2017, Lois has a total of \$100,000 in her traditional IRAs. Of that amount, \$30,000 is aftertax money and \$70,000 is pretax. Lois decides to convert \$20,000 to a Roth IRA. Because her traditional IRA money is 30% aftertax, the conversion is only 70% taxable: on a \$20,000 conversion, Lois will report \$14,000 (70% of \$20,000) in taxable income. That will be the result no matter which traditional IRA Lois taps for the conversion.

If Lois decides to withdraw funds from her traditional IRA for spending money then, instead of for a Roth IRA conversion, the tax treatment would be the same. Lois would report taxable income equal to 70% of the withdrawal and a 30% tax-free return of aftertax money. ■

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receiving a distribution. For a conversion, you must contribute up to the same amount to a Roth IRA within 60 days.

- You also can convert by directing the trustee of your traditional IRA to transfer funds to the trustee of the Roth IRA.
- Alternatively, you can direct the trustee of your traditional IRA to transfer money to a Roth IRA. Such conversions with the same trustee can be made by redesignating the traditional IRA as a Roth IRA, rather than by opening a new account.
- You must include in your gross income the amount of any distributions from your traditional IRA that you would have had to include if you had not converted the money to a Roth IRA.

### Did You Know?

From 1990 to 2010, education expenditures increased by 80% for those age 45 to 54 and by 22% for those age 55 to 64. During that time, clothing expenses fell 42% for those age 45 to 54 and fell 70% for those 55 to 64.

*Source:* National Center for Policy Analysis

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## In Your Estate Plan, Include a Letter of Instruction

Your estate plan should include a will, drafted by an experienced attorney. However, your will probably won't cover everything. You are not likely to list your computer passwords in your will or to list all of your professional advisors. To fill in such gaps, you can supplement your will with a letter of instruction.

### Reliable roadmap

With a letter of instruction, you can spell out all the details about your finances for your executor and your loved ones. You can list all of your bank, brokerage, and mutual fund accounts, for example. You can explain where to find real estate deeds, documents relating to a family business, even where to find gold coins. You also can list all the contact information for your accountant, your attorney, and other advisors. Make sure to list your life insurance policies, so your heirs can collect after your death.

Today, you may leave behind few paper records because you handle most of your finances online. Therefore, your letter of instruction also should include all of your user names, PIN numbers, passwords, and any other information necessary for complete access to your electronic records.

If you have made advance plans for your funeral or burial, or both, be sure to mention them in your letter of instruction. Otherwise, your surviving family members might make their own arrangements and pay for them, thus, wasting the money you've prepaid.

Some companies and organizations offer financial recordkeeping systems to help you track down such information. The more help you provide to your heirs, the less money they'll have to pay professional advisors for gathering the data.

### **Providing for possessions**

When you draft your will, you probably will have to decide how to dispose of your personal possessions. You might, for example, say that your children and grandchildren will decide amongst themselves who gets the furniture, jewelry, silverware, china, artworks, family mementos, and so on. Your executor can be designated to resolve any disagreements.

However, such a solution won't guarantee that certain items wind up with the people you'd choose to inherit them. To make sure that your granddaughter gets the love seat she has always admired, you can mention that in your will. Be careful to avoid language such as "I leave the contents of my desk drawer to my son Josh" because you don't know what will be there at the time of your death.

As a practical matter, you probably won't want to revise your will every time you buy something new, or every time you make a "who gets what" decision. Can you use a letter of instruction to accomplish these goals? That depends on where you live and the terminology you employ.

Generally, a letter of instruction is not legally binding. You can spell out your wishes regarding specific possessions in your letter, but it will be up to your heirs to decide whether to follow them. If your loved ones usually get along with each other, such a letter may help with the eventual disposition of your personal property.

### **Property rights**

That said, many states recognize a "property memorandum" or a "memorandum of tangible personal property items." Such a document can serve many of the same purposes as a letter of instruction, when it comes to listing possessions and stating who shall receive specific items. If you refer to such a memorandum in your will, it can be legally binding.

Like a letter of instruction, you can update your property memorandum easily, especially if it's stored on a word processor.

Therefore, you can keep ongoing track of your possessions and provide your intentions about their disposition.

In any event, you should go over your letter of instruction periodically to keep up with your finances and your disposition desires. Keep the letter where it's accessible, and let your executor know where it can be found. ■

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## **Two Keys to a Successful Buy-Sell Agreement**

If you're the owner or co-owner of a successful small business, you probably have a valuable asset. At some point, you may want to retire and cash in on that value. Even if you intend to work at your company as long as possible, you'll still want to protect yourself and your loved ones in case of a personal catastrophe.

With a buy-sell agreement, you can make sure that someone will pay to acquire your company, or your interest in the company, if and when you decide to retire. If you die or become disabled, the would-be buyer may have a similar obligation, which includes purchasing your business interest from your heirs.

You'll naturally want to work with a knowledgeable accountant and attorney when creating a buy-sell agreement to achieve an arrangement that suits both buyer and seller. In particular, you'll want to make sure that two bases are wellcovered: how the transferred interest will be valued and where the money will come from.

### Setting the price

As is true with any transaction, you'll want to receive a fair price for the asset you relinquish in a buy-sell. Similarly, the buyer wants to avoid overpaying. If you are a co-owner and enter into a mutual buy-sell agreement, you'll understand the buyer's point of view as well as the seller's.

Therefore, you'll need to set a fair price in order to have a successful buy-sell agreement. In practice, you can choose among many different methods to set that price. Some examples:

**Example 1:** Art Barnes and Claire Davis, equal co-owners of ABC Corporation, have a mutual buy-sell. In case of death, disability, or departure, the remaining owner will be the buyer. Every January, Art and Claire get together and agree on a value for ABC, which they formally record. That will be the buyout number for the rest of the calendar year.

**Example 2:** Eve Foster and Gregg Harris, equal co-owners of DEF Corporation, also have a mutual buy-sell. The agreement states that the purchase price will be three times the net operating income of the previous year, which is normal in DEF's industry.



**Example 3:** Ira Jenkins is the sole owner of GHI Corporation. He enters into a buy-sell agreement with Kim Lawson, an executive who was recently hired to succeed Ira. The agreement states that Kim will pay a price determined by a local consulting firm, which is named in the agreement as the appraiser that will set the value.

These are just a few possible solutions. The main point is that your buy-sell should contain a mechanism for setting the price of the transaction. Our office can help you develop a strategy for placing an acceptable value on the transaction.

### Finding the funds

When a buy-sell agreement is triggered, the price is often six, seven, or even eight figures. Where will the buyer raise that much cash?

Often, buy-sell agreements are funded by life insurance. In the previous example 1, Art might be the beneficiary of a policy on Claire's life, and vice versa. If Art dies, Claire will use the policy's death benefits to buy Art's share of the company from Art's heirs.

You may need other tactics to fund a disability or a retirement buyout. For instance, you might use disability insurance to provide buyout funds in case an illness or injury prevents a co-owner from working.

For buyouts that are triggered by retirement or another type of departure from the company, you may have to use an extended payout period. Suppose Claire retires and sells her interest in the company to Art, under their buy-sell agreement. Claire might agree to an installment sale that spreads the payments over several years. In this type of arrangement, Claire typically depends on the ongoing success of the company to provide the full purchase price. Consequently, if you enter into a buy-sell agreement where the price may be paid over time, you should be confident that the buyer will continue to run the company profitably. ■

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## TAX CALENDAR

### DECEMBER 2012

#### December 17

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

**Corporations.** Deposit the fourth installment of

not considered employees; (2) dividends and other corporate distributions; (3) interest; (4) rents; (5) royalties; (6) payments to attorneys; (7) profit-sharing distributions; (8) retirement plan distributions; (9) original issue discounts; (10) prizes and awards; (11) medical and health care payments; (12) debt cancellations (treated as payment to debtor); (13) payments of Indian gaming profits to tribal members; and (14) cash payments over \$10,000. There are

estimated income tax for 2012.

## JANUARY 2013

### January 15

**Individuals.** Make a payment of your estimated tax for 2012 if you did not pay your income tax for the year through withholding (or did not pay enough in tax that way). Use Form 1040-ES. This is the final installment date for 2012 estimated tax. However, you don't have to make this payment if you file your 2012 return and pay any tax due by January 31, 2013.

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

### January 31

**All businesses.** Give annual information statements (Forms 1099) to recipients of certain payments you made during 2012. Payments that are covered include (1) compensation for workers who are

different forms for different types of payments.

**Employers.** Give your employees their copies of Form W-2 for 2012.

For nonpayroll taxes, file Form 945 to report income tax withheld for 2012 on all nonpayroll items, such as backup withholding and withholding on pensions, annuities, and IRAs.

For Social Security, Medicare, and withheld income tax, file Form 941 for the fourth quarter of 2012. Deposit or pay any undeposited tax. If your tax liability is less than \$2,500, you can pay it with the return. If you deposited the tax for the quarter in full and on time, you have until February 11 to file the return.

For federal unemployment tax, file Form 940 (or 940-EZ) for 2012. If your undeposited tax is \$500 or less, you can either pay it with your return or deposit it. If it is more than \$500, you must deposit it. However, if you already deposited the tax for the year in full and on time, you have until February 11 to file the return.

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