tax IMPACT

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Roth or traditional: Which is better?

Roth IRAs allow you to withdraw contributions and earnings tax-free, if you meet certain requirements, so it's no surprise that their popularity has soared in recent years. But don't write off traditional IRAs and 401(k) accounts just yet. Under certain circumstances, traditional accounts may generate more retirement income than their Roth counterparts.

Pay now or later

Withdrawals from a Roth account are tax-free (provided you opened the account at least five years ago and have reached age 59½), but contributions are nondeductible. In contrast, withdrawals from traditional accounts are taxable, but contributions are deductible if you meet certain requirements.

The right type of account, therefore, depends on whether it's best to pay the tax now or later. An oft-cited rule of thumb says that, if you expect your tax rate to be higher in retirement, a Roth account is more desirable. But if you expect your tax rate to go down, a traditional account is the best choice. As the following example demonstrates, however, in some situations a Roth account is preferable, even if you expect your tax rate to drop.

Anna, age 50, wants to defer $24,000 of income (the current maximum for someone 50 or older) to her employer's 401(k) plan. The plan allows her to choose between a traditional account and a Roth account. Anna is in the 33% tax bracket and expects to be in the 28% bracket when she retires in 15 years. She opts for a Roth account, which earns a return of 6% per year. At retirement, the account has grown to $57,517, which Anna withdraws tax-free.

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If, instead, she chooses a traditional 401(k) account earning the same 6% return, she'll still end up with $57,517. But when she withdraws the funds, she'll owe $16,105 in taxes (at 28%), leaving her with $41,412 after taxes. That's not the end of the story, though. Anna's contribution is deductible, which generates tax savings of $7,920 ($24,000 × 33%). If she invests the savings in a taxable portfolio that also earns 6%,

for an after-tax return of about 4%, the funds will grow to $14,263 after taxes at retirement. Combining this amount with the after-tax 401(k) withdrawal results in total retirement income of $55,675 — $1,842 less than the Roth account.

Contrary to the rule of thumb, Anna is slightly better off with a Roth 401(k), even though her tax rate is lower in retirement. The outcome changes, however, if we change the assumptions. For example, if Anna's tax rate drops to 25% in retirement, traditional and Roth accounts would yield nearly identical results. If we increase the rate of return or the number of years until retirement, the Roth account's advantage increases.

Another factor to consider is whether you plan to max out your contributions. Suppose, going back to our example, that Anna defers $16,000 rather than the $24,000 maximum. In that case, she's better off with a traditional 401(k) account. Why? Because, instead of investing her tax savings in a separate taxable account, she can simply increase her 401(k) contribution to the pretax equivalent — in this case, $23,881 (at 33%). In other words, a $23,881 pretax contribution to a traditional 401(k) is equivalent to a $16,000 after-tax contribution to a Roth 401(k).

Consider your retirement needs

Our example assumes that the funds are withdrawn in a lump sum at retirement. But what if you withdraw them gradually over time? The longer you leave the funds in the account, the greater the Roth account's advantages. Unlike a traditional IRA or 401(k), which mandate distributions starting at age 70½, a Roth account's funds can continue growing tax-free for as long as you want. If you don't need the money, you can leave it in the account for the rest of your life, and after your death, it can provide a source of tax-free wealth for your children or other heirs.

Hedge your bets

To determine which type of account is best for you, ask your tax advisor to run some numbers using various pre- and postretirement tax rates, rates of return, distribution schedules and other assumptions. Keep in mind, though, that there's always a possibility that Congress will change tax rates or limit the benefits of Roth accounts in the future. To hedge your bets, consider diversifying your retirement funds by setting aside some of your money in a Roth account, if you qualify, and some in a traditional account.

Will lawmakers close the door on "backdoor" Roth IRAs?

The ability to contribute to a Roth IRA is phased out once your income reaches certain levels. For 2015, contributions for single filers are phased out beginning at modified adjusted gross income (MAGI) of $116,000 and eliminated when MAGI reaches $131,000. The phaseout range for joint filers is $183,000 to $193,000. To get around these limits, many high-income taxpayers use "backdoor" Roth IRAs — that is, they contribute to a nondeductible traditional IRA and then convert it to a Roth IRA. (There's no income limit on conversions.)

The president's fiscal-year 2016 budget contains a proposal to eliminate the benefits of backdoor IRAs. It's uncertain whether the proposal will become law, but, if you're considering this strategy, it may be best to act sooner rather than later.

How you can avoid a huge tax trap

Beware of the generation-skipping tax

As you plan your estate, don't overlook the generation-skipping transfer (GST) tax. Despite a generous, $5.43 million GST exemption, complexities surrounding its allocation create several tax traps for the unwary.

GST basics

The GST tax is a flat, 40% tax on transfers to "skip persons," including grandchildren, family members more than a generation below you, nonfamily members more than 37½ years younger than you, and certain trusts (if all of their beneficiaries are skip persons). If your child predeceases his or her children, however, they're no longer considered skip persons.

Your exemption is automatically allocated to direct skips as well as to contributions to "GST trusts."

GST tax applies to gifts or bequests directly to a skip person (a "direct skip") and to certain transfers by trusts to skip persons. Gifts that fall within the annual gift tax exclusion (currently, $14,000 per recipient; $28,000 for gifts split by married couples) are also shielded from GST tax.

Allocation traps

To take advantage of the GST exemption, you (or your estate's representative) must allocate it to specific gifts and bequests (on a timely filed gift or estate tax return). Allocating the exemption wisely can provide substantial tax benefits. Suppose, for example, that you contribute $2 million to a trust for the benefit of your grandchildren. If you allocate $2 million of your GST exemption to the trust, it will be shielded from GST taxes, even if it grows to $10 million. If you don't allocate the exemption, you could trigger a seven-figure GST tax bill.

To avoid costly mistakes, the tax code and regulations provide for automatic allocation under certain circumstances. Your exemption is automatically allocated to direct skips as well as to contributions to "GST trusts." These are trusts that *could* produce a generation-skipping transfer, subject to several exceptions.

Often, the automatic allocation rules work well, ensuring that your exemption is allocated in the most tax-advantageous manner. But in some cases, they can lead to undesirable results. Suppose you establish a trust for your children, with the remainder passing to your grandchildren.

You assume the automatic allocation rules will shield the trust from GST tax. But the trust gives one of your children a general power of appointment over 50% of the trust assets, disqualifying it from GST trust status. Unless you affirmatively allocate your exemption to the trust, distributions or other transfers to your grandchildren will be subject to GST taxes.

Here's another example: You establish a trust for your children, but there's a remote possibility that the trust will make a generation-skipping transfer, so it's a GST trust for automatic allocation purposes. Because the trust is unlikely to result in GST taxes, your exemption is wasted. That's not a problem if your estate is well within the exemption amount, but what if you need to allocate your exemption elsewhere? If so, you're better off opting out of automatic allocation and allocating your exemption to direct skips or to trusts that are more likely to trigger GST taxes.

Handle with care

If you plan to make gifts to skip persons, or to trusts that may benefit skip persons, consider your potential GST tax exposure. Your advisors can help you allocate your GST exemption in the most tax-advantageous manner. ◎

The IRS is watching …

Understanding the difference between an employee and an independent contractor

It's an age-old conundrum: determining whether a worker is an employee or an independent contractor. While it might seem like a simple question, it's not. And the IRS is hot on the heels of any contractor who doesn't understand the difference.

For example, in the traditional employer-employee relationship, the employer is responsible for a number of tasks, such as withholding federal and state income taxes, paying unemployment taxes (FUTA), withholding the employee's share of FICA and Medicare taxes, remitting the amounts withheld, and paying both the employee and employer portions of FICA and Medicare taxes.

Independent contractors are responsible for their own taxes. In addition to making estimated tax payments for their federal and state income tax liabilities, they're subject to self-employment tax, which covers both the employer and employee shares of FICA. (They are, however, entitled to a deduction for the "employer's" portion.)

Why the IRS prefers employee status

Because it's easier and cheaper to collect taxes from a single employer than from multiple independent contractors, the IRS has a strong preference for employee status. If the IRS reclassifies independent

contractors as employees, it can go after your company for back taxes that should have been paid, payroll and income taxes that should have been withheld, and penalties and interest.

Additional penalties may apply if the IRS finds that you intentionally disregarded your tax obligations. And, of course, your state may impose penalties of its own. Finally, "responsible persons" — including certain officers, partners and managers — could be personally liable for uncollected taxes.

Even if workers you treat as independent contractors have paid their taxes, you're not necessarily safe. If the IRS finds they should have been classified as employees, it still may hit you with penalties equal to 20% of your tax liability.

Avoiding the consequences

The simplest way to avoid these consequences is to treat workers as employees unless they clearly qualify as independent contractors. The IRS typically examines and weighs numerous factors to determine whether a worker is an employee or independent contractor. These considerations indicate to the agency the degree of control exercised by the employer and the degree of independence of the worker.

For instance, the IRS looks at behavioral control such as instruction (employees usually receive detailed instructions about when, where and how to work) and training (employees often receive training on how to perform their job duties).

Other indicators can help determine the relationship

The type of relationship is also important. Does the individual receive benefits? Is he or she working for the business indefinitely? Are his or her services critical to the company's ongoing operations? Affirmative answers to any or all of these questions would bolster an IRS case that the person in question is an employee, not an independent contractor.

Another important issue is financial control. The IRS will look for unreimbursed business expenses, which are usually incurred by independent contractors, not employees. Independent contractors often make significant investments in facilities and equipment as well. Employees don't.

In addition, employees are usually paid by the hour, week or some other period. But independent contractors generally receive a flat fee or submit an invoice for services. So method of payment is a key consideration. Independent contractors will also often continue marketing themselves while working on a given project and risk suffering a profit loss on every job.

Ultimately, no one factor controls the outcome. You need to examine and weigh all the factors to determine whether a particular worker is an employee or independent contractor.

Stay on the right side of the IRS

If you are uncertain about the status of your workers, contact your tax advisor. He or she can help you determine which workers are truly employees and which are independent contractors. In the event that contractors are misclassified, your tax pro can advise you whether the IRS Voluntary Classification Settlement Program is a good option for you. ◎

tax TIPS

Investors: Have your cake and eat it too

A good tax-planning technique is to sell a poor-performing security to "harvest" the loss and offset it against your capital gains. But what if you have high hopes for the security and would like to keep it in your portfolio? One strategy is to sell it at a loss and then buy it back at roughly the same price.

Just be sure to mind the "wash sale rule," which prohibits you from taking a loss on a security if you buy a substantially identical security within 30 days before or after you sell the original security. The simplest way to comply is to sell the security, wait 31 days and repurchase the same security — provided you're willing to assume the risk that the price will go up during that time.

One way to hedge your bets is to double your holdings of the security, wait 31 days and then sell the original securities. Or you can sell the securities and immediately buy securities that are similar but not substantially identical.

If you violate the wash sale rule, you won't lose the loss permanently. You'll just have to wait until you sell the replacement security before you can recognize it. ◎

Are you eligible for the Small Business Health Care Tax Credit?

This refundable, two-year credit — up to 50% of premiums (35% for nonprofits) — is available to employers that 1) have fewer than 25 full-time-equivalent employees (FTEs); 2) pay average annual wages of less than $51,600 (for 2015); and 3) pay a uniform percentage for all employees of at least 50% of premium costs. To qualify for the credit, an employer must purchase coverage through an exchange that's part of the Small Business Health Options Program (SHOP) Marketplace.

Note: The full credit is available to employers with 10 or fewer FTEs and average annual wages of $25,800 or less (for 2015). The credit begins to phase out once those thresholds are reached. ◎

ABLE plan can assist disabled family members

If a family member is disabled, check with your home state to see if it will offer an ABLE ("achieving a better life experience") plan. Created by last year's tax extenders legislation, the ABLE plan is modeled after the Section 529 college savings plan. Added to the tax code as Sec. 529A, the ABLE plan allows qualifying disabled individuals to set aside funds (up to $100,000 or more) for certain expenses — including housing, transportation, health care and education — without affecting their eligibility for federal and state government aid. Distributions used for qualifying expenses are tax-free. ◎

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