Tax Impact

May/June 2019

The "backdoor" Roth IRA remains open

The Roth IRA is an attractive savings vehicle, offering tax-free retirement income and other significant benefits. Unfortunately, income limitations prevent many people from contributing to these accounts. But even if you can't contribute directly, there's no limit on *converting* a traditional IRA into a Roth. This "backdoor Roth IRA" strategy allows anyone, regardless of income, to enjoy a Roth IRA's benefits.

Although some lawmakers proposed closing the back door, the Tax Cuts and Jobs Act (TCJA) preserved this option.

Would you benefit?

Before considering a backdoor Roth IRA, first determine whether a Roth is right for you. The main difference between traditional and Roth IRAs is the timing of income taxes. Traditional IRA contributions are deductible — that is, they're made with pretax dollars — while withdrawals of both contributions and investment earnings are taxable. In addition, withdrawals of contributions or earnings before age 59½ are subject to a 10% penalty.

Roth IRAs work in the opposite way: Contributions are taxed up front (they're nondeductible), but qualified withdrawals of contributions and earnings are tax- and penalty-free. Generally, you can withdraw direct contributions anytime and backdoor contributions after a five-year waiting period. To avoid taxes and penalties on withdrawn *earnings*, however, you must be at least age 59½ *and* the Roth IRA must be at least five years old.

From a tax perspective, a Roth IRA makes sense if you expect your tax rate to be higher in retirement: You're better off paying the tax upfront, when your rate is lower. If you expect your tax rate to be *lower* in retirement, a traditional IRA may be preferable.

Roth IRAs may also be advantageous if you want to allow the funds to continue growing tax-free, or continue making contributions, beyond age 70½. With a traditional IRA, you must stop making contributions and begin taking required minimum distributions when you reach that age. A Roth IRA is particularly valuable if you wish to leave the account to your heirs income-tax-free.

What are the contribution and income limits?

Currently, the maximum contribution to a traditional or Roth IRA is $6,000; $7,000 if you're

50 or older. Roth IRA contributions are phased out when your modified adjusted gross income (MAGI) reaches a certain threshold. This year, contributions for single filers are gradually reduced when MAGI tops $122,000 and eliminated altogether when it reaches $137,000. For joint filers and qualifying widows or widowers, the phaseout range is $193,000 to $203,000.

> ***Roth IRAs may be advantageous if you want to allow the funds to continue growing tax-free, or continue making contributions, beyond age 70½.***

There are also income limits on the *deductibility* of traditional IRA contributions if you or your spouse is covered by an employer-sponsored retirement plan. But you can still make *nondeductible* contributions up to the amounts specified above.

How does a backdoor Roth work?

The backdoor technique works best if you don't have an existing traditional IRA and you're ineligible for deductible contributions. To make a backdoor contribution, you simply make a nondeductible contribution to a new traditional IRA and then convert it to a Roth IRA. Because your contribution is nondeductible, the conversion won't be taxable except to the extent there are any earnings in the account before you convert. If you convert quickly, the tax consequences of a backdoor contribution are virtually the same as a direct contribution.

If you have a traditional IRA with substantial pretax funds, the backdoor technique will come at a tax cost. That's because of the so-called "aggregation" rule. When you withdraw or convert funds from a traditional IRA, this rule treats *all* of your traditional IRAs as one big account and allocates the funds among those accounts on a pro-rata basis. (See "Aggregation rule in action" at right.)

Aggregation rule in action

Suppose you have an existing traditional IRA with a $24,000 balance, consisting entirely of deductible contributions and earnings, and you wish to make a backdoor contribution to a Roth IRA this year. To accomplish this, you make a $6,000 nondeductible contribution to a new traditional IRA and immediately convert it into a Roth IRA.

Under the aggregation rule, the conversion is treated as if the funds were withdrawn from all of your traditional IRAs on a pro-rata basis. In this case, you have $24,000 of pretax dollars in the existing IRA and $6,000 of after-tax dollars in the new IRA. In other words, 80% of your aggregate balance ($24,000/$30,000) is pretax.

The result? When you do the conversion, 80% of the converted amount ($4,800) is taxed as ordinary income.

You may be better off converting the entire account balance into a Roth IRA. Although you'll owe tax on all pretax funds in the account in the year of conversion, you'll enjoy the benefits of a Roth IRA from that point forward. Plus, you'll no longer have a traditional IRA, so you'll be able to make tax-free backdoor contributions in future years.

Should you convert?

Now may be an ideal time to convert a traditional IRA into a Roth, since the TCJA reduced individual income tax rates through 2025. But beware: Depending on the size of your IRA and your other income, converting the account all at once could push you into a higher tax bracket. You may be better off converting the account gradually over several years. Talk to your financial advisor before taking any action. ■

Estate planning and business succession planning

The lines blur when a family business comes into play

For many business owners, estate planning and succession planning go hand in hand. If you're the owner of a closely held business, you likely have a significant portion of your wealth tied up in the business. If you don't take the proper estate planning steps to ensure that the business lives on after you're gone, you may be placing your family at risk.

Separate ownership and management succession

One reason transferring a family business is such a challenge is the distinction between ownership and management succession. When a business is sold to a third party, ownership and management succession typically happen simultaneously. But in the family business context, there may be reasons to separate the two.

From an estate planning perspective, transferring assets to the younger generation as early as possible allows you to remove future appreciation from your estate, minimizing estate taxes. On the other hand, you may not be ready to hand over the reins of your business or you may feel that your children aren't yet ready to take over.

There are several strategies owners can use to transfer ownership without immediately giving up control, including:

- Placing business interests in a trust, family limited partnership (FLP) or other vehicle that allows the owner to transfer substantial ownership interests to the younger generation while retaining management control,
- Transferring ownership to the next generation in the form of nonvoting stock, or
- Establishing an employee stock ownership plan.

Another reason to separate ownership and management succession is to deal with family members who aren't involved in the business. Providing heirs outside the business with nonvoting stock or other equity interests that don't confer control can be an effective way to share the wealth while allowing those who work in the business to take over management.

Work around conflicts

Another unique challenge presented by family businesses is that the older and younger generations may have conflicting financial needs. Fortunately, several strategies are available to generate cash flow for the owner while minimizing the burden on the next generation. They include:

An installment sale of the business to children or other family members. This provides liquidity for the owners while easing the burden on the younger generation and improving the chances that the purchase can be funded by cash flows from the business. Plus, as long as the price and terms are comparable to arm's-length transactions between unrelated parties, the sale shouldn't trigger gift or estate taxes.

A grantor retained annuity trust (GRAT). By transferring business interests to a GRAT, owners obtain a variety of gift and estate tax benefits (provided they survive the trust term) while enjoying a fixed income stream for a period of years. At the end of the term, the business is transferred to the owners' children or other beneficiaries. GRATs are typically designed to be gift-tax-free.

An installment sale to an intentionally defective grantor trust (IDGT). This is a somewhat complex transaction, but essentially a properly structured IDGT allows an owner to sell the business on a tax-advantaged basis while enjoying an income stream and retaining control during the trust term. Once the installment payments are complete, the business passes to the owner's beneficiaries free of gift taxes.

Because each family business is different, it's important to work with your estate planning advisor to identify appropriate strategies in line with your objectives and resources.

> ***One reason transferring a family business is such a challenge is the distinction between ownership and management succession.***

Get an early start

Regardless of your strategy, the earlier you start planning the better. Transitioning the business gradually over several years or even a decade or more gives you time to educate family members about your succession planning philosophy. It also allows you to relinquish control over time, and to implement tax-efficient business structures and transfer strategies. ■

When can you deduct business meals?

The Tax Cuts and Jobs Act (TCJA) eliminated most tax deductions for business-related entertainment, beginning in 2018. It also created confusion over the continued deductibility of business meals. Late last year, the IRS issued a notice clarifying that taxpayers may continue to deduct 50% of eligible business meal expenses and providing temporary guidance on the subject. Businesses may rely on this guidance until proposed regulations become effective.

Five-part test

The notice sets forth a five-part test to determine whether business meal expenses are deductible. Taxpayers may deduct 50% of an otherwise allowable business meal expense if:

1. The expense is an ordinary and necessary business expense,
2. The expense isn't lavish or extravagant under the circumstances,

3. The taxpayer, or an employee, is present,

4. Food and beverages are provided to a current or potential business customer, client, consultant or similar business contact, and

5. In the case of food and beverages provided during or at an entertainment activity, the food and beverages are purchased separately from the entertainment or their cost is stated separately on one or more bills, invoices or receipts. The meal cost must also be reasonable — that is, you can't circumvent the disallowance of entertainment deductions by inflating the charges for food and beverages.

The notice provides several examples to illustrate the deductibility of meal expenses at an entertainment event. Say you invite a business contact to a baseball game. You buy the tickets and, at the game, treat your guest to hot dogs and drinks. Although the tickets are a nondeductible entertainment expense, the hot dogs and drinks, which are purchased separately, are 50% deductible.

Now, suppose that you and your contact attend the game in a corporate suite, which provides food and beverages. If the invoice for the suite covers the entire expense, without separately stating the cost of food and beverages, the entire amount is a nondeductible entertainment expense. But if the invoice separately states the cost of food and beverages, that cost is 50% deductible (provided it's reasonable).

Certain expenses remain deductible

The IRS notice focuses on business meals and entertainment activities with current and prospective customers and other business contacts. But several other types of expenses remain deductible after the TCJA. For example:

- Meal expenses while traveling on business continue to be 50% deductible.
- Meal and entertainment expenses may be 100% deductible if they're treated as compensation to employees or income to nonemployees.
- Reasonable expenses for company recreational or social activities, such as holiday parties and picnics, continue to be deductible. You can deduct 100% of the cost of both meals and entertainment, as long as an activity primarily benefits employees other than officers, owners or highly compensated employees.
- Meal and entertainment expenses directly related to certain business meetings of stockholders, directors or employees continue to be deductible. Meals are 50% deductible, but apparently entertainment is, at least in certain circumstances, fully deductible.

Previously, certain meals provided to employees were fully deductible, including meals provided so employees can work overtime and meals furnished on or near the employer's premises (including certain operating expenses for on-premises dining facilities). The TCJA imposes a 50% limit on these deductions through 2025, after which they're disallowed entirely.

Know the rules

If you incur business-related meal and entertainment expenses, familiarize yourself with current rules on their deductibility and document your expenses carefully. And be sure to keep an eye on regulatory developments that may change the rules. ■

Behind on your retirement savings? Consider a cash balance plan

Business owners looking for ways to boost their retirement savings should consider a cash balance plan. One problem with 401(k) and other defined contribution plans is that nondiscrimination rules prevent business owners from favoring themselves over rank-and-file employees when it comes to contributions.

A cash balance plan, although it looks and feels much like a defined contribution plan, is actually a defined *benefit* plan. Thus, to comply with nondiscrimination rules, benefits paid to highly compensated employees (HCEs) and non-HCEs must be comparable. As long as projected benefits don't discriminate, contributions may be as high as necessary to fund those benefits. Often, that means dramatically higher contributions for owners approaching retirement than for younger employees. ■

Have you inadvertently disinherited your spouse?

Now that the federal gift and estate tax exemption has reached $11.40 million ($22.8 million for married couples), review your estate planning documents for provisions that can produce unintended results, and amend them if necessary. It's not unusual, especially in older plans, for a "formula-funding clause" to provide for an amount up to the current exemption to go into a credit shelter trust, with the balance going to a marital trust or directly to one's surviving spouse. This approach may have worked well in the past, if the value of your estate exceeded the exemption amount. But if that's no longer the case, a formula-funding clause can cause all your property to go into the credit shelter trust, effectively disinheriting your spouse. ■

Hang on to your passport

A 2015 law allows the U.S. State Department to deny your passport application — or revoke or limit your current passport — if the IRS certifies that you have a seriously delinquent tax debt (SDTD). You have an SDTD if 1) you owe more than $51,000 (as indexed for inflation) in back taxes, penalties and interest, 2) the IRS has filed a Notice of Federal Tax Lien, *and* 3) the period to challenge the lien has expired or the IRS has issued a levy.

If you find yourself in this situation, there are several steps to take to avoid losing your passport, including:

- Paying your tax debt in full,
- Paying your debt on a timely basis according to an approved installment agreement, accepted offer in compromise, or settlement agreement with the Justice Department,
- Requesting a collection due process hearing regarding a levy, or
- Having collection suspended through a request for innocent spouse relief.

Typically, the IRS won't notify the State Department of an SDTD if there are extenuating circumstances, such as bankruptcy, identity theft, federally declared disasters or other hardships. ■