

# RAUPC News

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## Is Deferring Compensation the Best Answer?

By Bob Underhill

An interesting analysis concerns a decision presented to many executives and corporate directors: is it better to defer fees or compensation under a company plan, or take the money currently? The short answer is there's no quick answer, and the right answer depends on a number of factors.

The principal benefit of deferring fees or compensation (also through 401(k) deferrals) is the ability to invest pre-tax dollars. \$100 paid currently will be subjected to ordinary tax of 35%, leaving \$65 after-tax dollars to invest. Deferred amounts will obviously be taxed to you at some point, but in the meantime you have all the money working for you. So one factor is the tax rate—the higher the rate, the more a deferral option is favored. But one also has to consider what the tax rate might be in the year the money is ultimately received. Tax rates could go up, hitting the deferred amounts with an even higher tax bill. In more recent years, rates have gone down, meaning that those who

deferred from earlier years have a bit of a windfall: not only did they defer the payment of income taxes from the year earned, they get to pay those taxes at reduced rates.

A second consideration, also tax-related, is the ability to benefit from the reduced 15% rate on dividends and capital gains. Deferred compensation or salary deferrals into a 401(k) plan lose the benefit of the 15% rate: all monies are taxed as maximum rate ordinary income when distributed, even if a portion of the distribution emanates from investment earnings on the account balance. What this means is that shorter-term deferrals are less compelling. Deferrals of five years or longer still have an advantage over current compensation, even after factoring in the loss of the 15% bracket on dividends and investment gains.

*By way of example, assuming a 7% invest-*

*ment return, \$100,000 deferred for four years will result in \$91,000, after tax (assuming no change in tax rates). If the \$100,000 were taken as current compensation and invested at the same rate, it would grow to \$87,000, after tax. The deferral option produces a 3.6% advantage, which is not alto-*



## Roth vs. Traditional Retirement Accounts

By Derek Hayner

With the addition of a Roth 401(k) as an investment option offered by some employers beginning in 2006, we thought it beneficial to point out the advantages and disadvantages of using a Roth versus the traditional 401(k) accounts. Employees with access to Roth and traditional 401(k) will be limited to the same contribution cap of \$15,000 for 2006, or \$20,000 for people age 50 and over by the end of the year. The employee can contribute up to the cap to either a Roth or traditional 401(k), or they can split their contribution between the two accounts.

Roth contributions are not deductible, but upon retirement all distributions, including the earnings, are tax free. So how do you determine whether a Roth or a traditional 401(k) is more advantageous? Like most things, it requires some forecasting. Generally, Roth accounts make sense if you expect to be in the same or higher tax bracket upon retirement. If you expect to be in a lower tax bracket, you have to consider how much of a reduction in the tax rate you expect, how long the contribution has to grow before withdrawal, and the level of growth you expect in your 401(k).



For example, assume that the 401(k) grows at 7% annually, you make a \$10,000 contribution in Year 1 and withdraw the entire amount in Year 10. If you were currently taxed at a 35% marginal rate, and expected to be taxed at a 25% marginal rate in Year 10, the net assets (i.e., the after-tax distribution) associated with your 401(k) would be \$20,464 in Year 10. If your marginal tax rate stayed constant at 35%, you would have only \$18,496 in Year 10. And if your beginning tax rate was 25% and increased to 35% in Year 10, you would have \$17,176. In comparison, a \$10,000 contribution to a Roth 401(k) would net \$19,672 in Year 10. So depending on your

expectations, a Roth contribution may not make sense over a 10-year horizon.

Consider the same set of facts, but extend the time frame to 25 years. In this situation, the scenario with an initial 35% rate decreasing to 25% upon retirement would net you \$51,243 in Year 25. A constant tax rate would net \$45,924. A 25% contribution tax rate and a 35% distribution tax rate would net \$44,203. In comparison, a \$10,000 Roth contribution would net \$54,274 after 25 years. So regardless of the tax rate scenario, the Roth option is advantageous over the longer time period. (All of these scenarios assume that for the traditional 401(k), the tax savings from the deductible contribution is invested in a taxable account with 7% growth taxed at the initial marginal tax rate for that scenario.)

Another way to compare the Roth and traditional accounts is to look at it from a cash flow perspective. If you have \$10,000 for retirement accounts you can either put all \$10,000 into a traditional 401(k) or put \$6,500 into a Roth 401(k) account with the remaining \$3,500 paid to cover the taxes. Upon retirement, if your marginal tax rate is still 35% you will receive the same payout after taxes from the traditional and Roth accounts. If your distribution tax rate is higher you will receive more from the Roth, and if it is lower you will receive more from the traditional account. As the above examples suggest, your current versus expected tax rate on retirement has a significant effect on

your decision, especially over shorter timeframes. Tax rates are currently low from a historical standpoint. If Congress were to increase the top marginal rate to help cover the federal budget deficit, it makes a Roth contribution today much more appealing. Another important variable is the expected growth rate on the assets. We have used a relatively moderate (again, by historical standards) rate of investment return in the analyses above. A higher growth rate favors the Roth 401(k), as the increase in earnings comes out dollar for dollar with the Roth, while the traditional account will tax a portion of those earnings.

*Contributions to an HSA are deductible against income regardless of whether a taxpayer itemizes deductions, and contributions are not subject to phase-out.*

## Health Savings Accounts Revisited

By Jay Hanson

Back in June 2005<sup>1</sup> we brought you an article detailing the features of Health Savings Accounts (commonly referred to as HSAs). Since the time of that publication, HSAs have become one of the hottest topics in the area of health care. President Bush's State of the Union speech on January 31 once again cast the spotlight on high-deductible health plans (or HDHPs) coupled with HSAs as a device to help rein in the high costs of health care. The popularity of HSAs can be evidenced in the growth in the number of HSAs established over the past two years. It is estimated that 3 million people have chosen HSAs and that the estimated 1.03 million HSAs in existence in March 2005 have since tripled. Additionally, the Treasury Department projects that there will be 14 million HSAs in existence in 2010. With employers adding HSAs as a health care option for their employees and individuals gravitating to lower-cost health care alternatives, HSAs are likely to become a seriously attractive alternative to traditional low-deductible health care plans in the near future.

To briefly recap, an HSA is essentially the combination of an investment account and a health insurance policy. An HSA participant establishes a financial account with a bank or other financial institution and signs up for an HDHP with a health insurance provider. No permission is needed from the IRS to establish the insurance policy or financial account. Funds within an HSA are invested in the same manner as a retirement account and the account owner controls both the investment decisions and withdrawals from the account. An individual can establish an HSA if he or she is covered by an HDHP.

An HDHP is a health insurance plan with a minimum annual deductible in 2006 of at least \$1,050 for individual coverage and \$2,100 for family coverage (2 or more persons). Many commercial plans establish

deductibles above the established minimums. Under an HDHP an individual (or family) must pay for health care costs out-of-pocket until the established annual deductible is met. Thereafter, coinsurance generally kicks in until the individual (or family) spends enough to hit the policy's annual out-of-pocket maximum; thereafter, all costs are covered by the HDHP. The annual out-of-pocket maximum an HSA can establish in 2006 is \$5,250 for individual coverage and \$10,500 for family coverage. President Bush has proposed an increase in the annual contribution limit to the maximum out-of-pocket expense for the HDHP. However, the tax benefits associated with HSAs are costly to the government and there may be resistance to enact proposals which drive up the costs of the program.

To demonstrate the out-of-pocket cost of an HSA, the following example will assume an unmarried employee has an HDHP with a \$1,250 annual deductible and a \$3,750 annual out-of-pocket maximum. When the \$1,250 annual deductible is met, coinsurance will kick in to pay 80% of all health care expenses up to the out-of-pocket maximum of \$3,750. We'll assume the employee incurs \$5,000 of medical expenses during the tax year. Under this type of HDHP the employee will spend \$1,250 of her own money to reach the \$1,250 deductible threshold. The health care expenses between the \$1,250 deductible threshold and the \$3,750 out-of-pocket maximum (*i.e.*, \$2,500) will cost the employee \$500 (20% of the \$2,500 difference). Health care expenses in excess of \$3,750 are then completely covered by the employee's HDHP. Therefore, the employee will end up paying \$1,750 of her own money (not including the HDHP premiums) to cover the \$5,000 in total health care expenses.

Contributions to an HSA are deductible against income regardless of whether a taxpayer itemizes deductions, and contributions are not subject to phase-out. Contributions made by an employer to an HSA are excluded from an employee's taxable income and are not subject to payroll (FICA) taxation to the employee or employer. The maximum annual aggregate contribution to an HSA in 2006 is the lower of \$2,700 for an individual and \$5,450 for a family or the HDHP's deductible amount. The earnings on HSA assets are tax-free, as are distributions from an HSA which are used

<sup>1</sup> The Article appeared in the June 2005 Newsletter, Volume 2, Issue 2. This newsletter and our past newsletters are available for viewing at [www.raupc.com](http://www.raupc.com) or by hard copy upon request.

## Donate the Use of Your Condo? Think about this.

By Bob Underhill

A question we get asked a lot is: "How much can I deduct if I donate the use of my condo at a charitable auction?" The answer: not much. Typically, the value of a week's use of a ski or resort area condo is listed in the charity's auction book for several thousand of dollars or more (presumably based on the fair rental value of similar units). Unfortunately, however, your basis in a week's worth of use of your condo is zero, making the value of your deduction zero. It would make just as much sense to actually rent the unit for a week, and donate the rent proceeds to charity. The rent received is income, and if given to charity, you get an offsetting deduction (netting to zero).



In many cases, the latter strategy – actually renting the unit and donating the rent received – will give you a better answer. If a property is rented for less than 15 days during the year, a special rule in the tax code allows you to exclude the rents from income. If the property is rented for more than 14 days, rental expenses may go unused as so-called passive loss carryovers. By actually renting the unit, you generate additional rental income which can be covered by rental losses which would otherwise go unused. Donating the rents to charity will leave you in a net deduction position.

Aside from that, only actual out-of-pocket expenses associated with the donation of use of a condo are deductible as charitable expenses (e.g. cleaning costs, maid service, etc.).

## Phase-out of the Phase-out

By Bob Underhill

One of the more insidious provisions of the Internal Revenue Code involves the phase-out of itemized deductions based on one's level of income. Itemized deductions are reported on Schedule A of your return, and we have pointed out to many of our clients that the numbers listed for the various deductions do not "foot" to the total showing at the bottom of the schedule. The reason is the phase-out, which is an off-the-form computation that reduces the amount of the deduction.

For joint return filers in 2005, you lose deductions equal to 3% of your income over a threshold amount of \$145,950. For example, a taxpayer with total income (technically, adjusted gross income) of \$1,000,000 in 2005 will lose deductions totaling \$26,621 (\$1,000,000 less \$145,950 times 3%).

For this reason, we advise clients expecting substantial non-recurring income to avoid all discretionary deductions, such as charitable contributions, for the year in question.

The reason for the phase-out is pure politics: it was a way for Congress to raise taxes on high-income taxpayers without anybody knowing about it. At the 35% bracket, the net effect of the phase out is to raise one's marginal rate by about 1%.

As taxpayers slowly became aware of this "stealth tax," Congress responded. So the phase-out itself is scheduled to phase out, beginning in 2006 when the rate of phase-out will drop to 2%. For tax years beginning after 2009, the phase-out is fully repealed. That assumes, of course, that Congress stays the course. The phase-out raises substantial tax revenue, and Congress may have a hard time replacing it in the budget.

## New Look to K-1s

By Bob Underhill

You may have noticed that K-1s last year from partnerships and LLCs looked different. They're not a bit simpler to understand (maybe worse), but they do accomplish one important objective for the IRS: they're machine readable. Large issuers of W-2s and 1099s have long been required to submit government copies of those forms in magnetic tape or machine readable form, to aid the IRS in matching the information to corresponding tax returns. The new partnership/LLC K-1s accomplish the same objective, thereby minimizing a problem the IRS has had in assuring that partnership income was being properly (and fully) reported by partners. While the IRS has admittedly gained ground on the problem, the solution is not perfect, owing largely to the inherent complexity and categorization of the various items of partnership income, deduction, gain, loss, preference and credit. Depending upon the business or investment classification of the item, tax computations can be affected in many ways. In fact, hedge fund K-1s might contain 20-30 items of tax information, all of which have an impact on the tax liability.

This year, a similar format change comes to trust and estate K-1s, with the same objective in mind.

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## Annual Gift Tax Exclusion Now \$12,000

By Bob Underhill

The annual exclusion for gifts has been set at \$11,000 for a number of years. It is indexed for inflation, but only re-sets when inflation pushes it to the next \$1,000 increment. That has occurred for gifts beginning in 2006. The annual exclusion is per donor, per donee. So a married couple with three children can make annual exclusion gifts to their children totaling \$72,000 a year. The value of those tax-free wealth transfers is powerful if made each year.

*For example, both parents making \$12,000 annual exclusion gifts to*

*their children each year from birth to age 21 will remove over \$660,000 from their estate (assuming an 8% return on investment). With three children, that is almost \$2 million.*

One point to remember is that the primary purpose (in Congress' mind) for the annual exclusion is to keep the IRS from toting up the value of holiday and birthday gifts each year – what many would call routine family giving. Obviously the exemption amount covers more than that, making this a key part of one's long-term estate planning.

Finally, only "present interest" gifts count – gifts into trusts lacking so-called "Crummey powers" fail this test. Trusts established under Section 2503(c) which terminate upon the beneficiary attaining age 21 also qualify for the exclusion, as do gifts to minors under a state's uniform gift to minors act.

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## The IRS Gave CPAs a Bit of a Scare

By Bob Underhill

In early January the IRS published instructions to Schedule D, the schedule of your tax return that reports capital gains and losses. The instructions and initial guidance stated that each individual security sale had to be entered and listed on the government forms—Schedule D and D-1 (continuation sheet). As a result of more modern trading technology and approaches to money management, many of our clients have literally hundreds (in some cases, thousands) of securities transactions in a given year. Those have typically been disclosed in a return by attaching detail Gain/Loss Reports provided by brokers and money managers, with report totals listed on Schedule D. The IRS's new rule would have ended that very practical (and abundantly reasonable) approach and forced us to individually input each security sale (purchase date, sale date, proceeds, cost basis, gain or loss) onto Schedule D. We estimated that for some of our clients, that would add **days** of preparation time (and would not have been very fun, either).

**IRS Scare Continued on page 6**

*The value of those tax-free wealth transfers is powerful if made each year.*

**Deferring continued from page 1**

*gether compelling if other factors are considered. If the deferral period is stretched to 15 years, the deferred account will grow to \$179,000, while the current account would amount to \$155,000. On a 15-year deferral option, the decision to defer would produce a 15.4% advantage over non-deferral.*

Several other factors should affect your decision, all non-tax. The investment options available or earnings credited on deferred monies is obviously critical to the evaluation. Some plans provide for a fixed return on deferred monies. Even if the rate is less than what you might expect from other investment alternatives, a fixed return eliminates investment risk, or most of it, and the account could be viewed as filling the bond or fixed income portion of your portfolio. If a portion of the deferred money must be invested in company stock, one must consider single-stock risk, especially if options or restricted stock grants are also part of your compensation package. And one of your largest financial assets—the earning power of your job—is also tied to the same company. If the plan offers a limited menu of investment options, mutual funds for example, one should evaluate whether the ability to invest in an unlimited fashion could produce superior returns (this is especially important if the deferral period is long).

Another factor to consider is the security of the deferral. Tax rules require that the deferred amounts remain subject to the risk of the company's creditors in order to avoid constructive receipt. A similar issue involves a change in control or a new CEO or turnover on the board, with the new regime questioning the legitimacy of the payouts. Some protection can be provided by wrapping the account with a so-called Rabbi Trust, where a third-party trustee is obligated to protect the interests of the beneficiaries of the plan. A Rabbi Trust will not, however, mitigate creditor risk. If the company goes down, your deferral could go down with it.

A final consideration is the flexibility of the company's deferred compensation plan, i.e., under what circumstances can the

decision to defer be changed? As we reported in a prior newsletter, the American Jobs Creation Act of 2004 has a direct bearing on deferred compensation plans and curtailed a lot of game-playing by companies and their executives. Under the Act, distributions from a nonqualified deferred compensation plan may only be made upon the following circumstances:

- A separation from service.
- Death or disability.
- A change in control (the definition of such is to be defined by Regulations, and may parallel but be somewhat more restrictive than the "golden parachute" rules under Section 280G).
- The occurrence of an unforeseen emergency.
- A specified time or upon a specified schedule.

Thus, for all intents and purposes, deferrals are binding absent rather adverse circumstances. However, under the Act, a plan may allow for changes in the time and form of payouts (i.e., re-deferrals) subject to the following:

- The plan requires that such new election cannot be effective for at least 12 months.
- Except in the case of death, disability, unforeseen circumstances, etc., the plan requires that any additional deferral under a new election be made for at least five additional years.
- The plan requires that any election based upon a specified time be made at least 12 months prior to the date of the first payment.

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**IRS Scare Continued from page 5**

Under pressure from the American Institute of CPAs and others, the IRS has seen the light and relented with new guidance specifically allowing broker/investment manager reports to be attached to a return as support for Schedule D transactions, as long as all required information is presented.

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*If a portion of the deferred money must be invested in company stock, one must consider single-stock risk, especially if options or restricted stock grants are also part of your compensation package.*

### HSAs Continued from page 3

to pay qualified health care expenses. Qualified health care expenses encompass a broad array of expenses including co-payments and deductibles for doctors, pharmacies, lab tests, dentists, medical supplies, chiropractors and optometrists. Withdrawals from an HSA for reasons other than the payment of qualified health care expenses are subject to income tax plus a 10% penalty tax. At the age of 65, a withdrawal can be made for any purpose without incurring the 10% penalty tax. Withdrawals used to pay qualified medical expenses are still tax-free.

*HSAs benefit both employers and employees in a number of ways. High deductible plans involve lower premium costs, thereby lowering or helping control the cost of health care for both employer and employee. Employee contributions to the account are tax deductible, essentially making the cost of health care a tax deductible expense (most taxpayers cannot claim medical expenses as itemized deductions due to the high thresholds and phase-outs).*

A particularly useful feature of an HSA is that the tax-free build-up of account assets can be exceptionally beneficial for healthy account owners who tend to not draw down on their HSA assets. Several years of good health combined with maximum account contributions can have the effect of creating a sizable tax-free account balance. This type of growth gives the HSA the added benefit of acting as an additional tax-favored retirement account if account assets are allowed to grow over time.

If you would like more information regarding the operation of an HSA or would like information regarding the potential tax advantages an HSA could deliver please contact our office.



### **Busy Season Soundtrack** Songs on my iPod that remind me of tax season

By Amy Bockelman

As I was working on ideas for an amusing article for the newsletter, I perused the songs on my iPod and realized that a lot of song titles, independent of the rest of the song, could actually describe tax season. At the risk of amusing only myself, here are my top 15 could-be-tax-related song titles:

1. **Dark Days.** It's dark when we get to the office, it's dark when we go home, and it's winter in Seattle...we miss daylight. (Artist: Gerald Collier)
2. **No Rolling Back.** An accounting joke, get it? Ha ha. (Artist: Jay Farrar)
3. **Duck & Cover.** A possible strategy if the IRS decides to audit you. (Artist: Glen Phillips)
4. **Everybody Hurts.** Especially true during tax season. Pass the Advil, please. (Artist: R.E.M.)
5. **Things that Disappear.** This could be a Jeopardy category. What is "my free time," Alex? (Artist: Rhett Miller)
6. **No Blue Sky.** Seriously, we never see daylight. (Artist: The Thorns)
7. **Giving it all Away.** ...to the IRS, naturally. (Artist: Hothouse Flowers)
8. **When 3 is 2.** Is there an accounting method whereby 3 is actually 2? (Artist: Hammerbox)
9. **Can't Keep.** As in, "You can't keep all the money you make." (Artist: Pearl Jam)
10. **Damn Shame.** And it's a damn shame too (see #9 above). (Artist: Jay Farrar)
11. **Last Minute Shakedown.** Ah, the theme song for filing returns right before the due date. (Artist: Son Volt)
12. **Driving Me Mad.** So...many...tax returns... (Artist: Neil Finn)
13. **Trying to Get Through.** ...another busy season. (Artist: Hothouse Flowers)
14. **If I Had \$1,000,000.** ...I'd be a client. (Artist: Barenaked Ladies)
15. **The Long Day is Over.** The post-busy season theme song. (Artist: Norah Jones)

(Editor's Note: Amy listens to weird music.)  
(Amy's Note: Bob likes ABBA.)  
(Editor's Note #2: I'm not going to win this.)

# Tax Events Calendar

Date	Taxpayer	Event
March 15, 2006	Corporations	Due date for domestic C or S corporations or foreign corporations with U.S. offices to file their 2005 income tax return (Form 1120 or Form 1120S). File form 7004, together with payment, to obtain an automatic six-month extension of time to file.
April 17, 2006	Individuals	Due date for individuals to file their 2005 income tax returns (Form 1040, 1040-A, or Form 1040-EZ). File form 4868 to obtain an automatic six-month extension of time to file.
April 17, 2006	Individuals	First installment of 2006 estimated tax is due (Form 1040-ES).
April 17, 2006	Partnerships	Due date for partnerships and LLCs to file their 2005 income tax returns (Form 1065). File form 8736 to obtain an automatic three-month extension of time to file.
June 15, 2006	Individuals	Second installment of 2006 estimated tax is due (Form 1040-ES).
June 15, 2006	Individuals	Due date for U.S. citizens and resident aliens living and working outside the U.S. and Puerto Rico to file income tax return (Form 1040) and pay any owed tax, interest and penalties.

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