

# FOCUS

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## Roth IRA Conversions: Figure In the Variables

The floodgates are finally open to high-income taxpayers: Beginning in 2010, an individual can convert a traditional IRA into a Roth IRA, regardless of his or her income level. Prior to this year, a conversion was allowed only in a year in which the individual's modified adjusted gross income (MAGI) did not exceed \$100,000.

Normally, such a conversion is taxed at ordinary income tax

*Should a high-income taxpayer convert or not this year? The answer is not always as simple as it first appears.*

rates in the year of the conversion. However, for a conversion in 2010, the participant may pay the tax over the following two years — 2011 and 2012.

These changes have been in the works for years. They were included in the Tax Increase

Prevention and Reconciliation Act of 2005 (TIPRA), which was enacted in 2006.

Should a high-income taxpayer convert or not this year? The answer is not always as simple as it first appears.

**Background:** As with a traditional IRA, a participant may contribute up to \$5,000 to a Roth IRA (less any traditional IRA contributions) for the 2009 tax year. An extra \$1,000 "catch-up contribution" is allowed for someone age 50 or older. But the ability to make contributions is phased out for taxpayers with a MAGI above certain income levels.

One key benefit of Roth IRAs is that "qualified distributions" are completely exempt from income tax. To qualify, a distribution must be made from a Roth in existence for at least five years and after the participant has reached age 59½, upon the death or disability of the participant or to pay for first-



time home-buyer expenses (up to a lifetime limit of \$10,000). Pre-age 59½ withdrawals are also subject to a 10 percent tax penalty.

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Certified Public Accountants  
Business Consultants

3001 W. Big Beaver Road, Suite 700, Troy, MI 48084-3108  
248.649.3400 Fax 248.649.2187  
www.dksscpas.com

## Roth IRA Conversions: Figure In the Variables

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Nevertheless, the decision to convert or not must take into account a number of variables. *These include the following:*

- *The age of the IRA participant, his or her spouse (if married) and the ages of the beneficiaries*
- *The value of the assets in the traditional IRAs*
- *The tax year of the conversion*
- *The need to receive Roth IRA distributions in the future*
- *The projected investment rate of return*
- *The participant's current income tax rate and expected tax rate in the future*
- *State and local tax liability on the conversion*
- *Amounts that were contributed to traditional IRAs on a nondeductible basis*
- *Whether any portion of the tax must be paid out of IRA funds*



These variables will have a substantial impact on the decision. *For example*, if the tax must be paid out of IRA funds, it will dilute the benefit of the conversion. Other “wild cards,” such as inflation and the likelihood of future tax rate increases, should also be considered. Note that a partial conversion of funds in a participant's traditional IRAs is permitted.

### Bottom line:

Do not make assumptions about Roth IRA conversions. Online calculators often do not include all the necessary variables. With professional guidance, an informed decision can be reached. ■

## Sensible Estate Planning for Business Owners

The uncertainty over the future estate-tax law has put many business owners — not to mention their advisers — in a tizzy. Yet one of the worst things to do is to completely ignore the situation. This is especially true if a business owner is contemplating retirement or a sale of the business, or both, in the upcoming years.

Conversely, a comprehensive plan emphasizing flexibility can minimize potential estate-tax liability, regardless of any changes in the estate-tax law that may be enacted. Moreover, an estate plan may avoid a “distress sale” of a business interest while preserving assets for the owner's heirs.

**The initial step is to identify the objectives of the estate plan.** Determine the benefits to be derived, the risk assumptions and the amount needed to sustain a comfortable retirement. Once these goals have been established, professional advisers can help formulate the best way to achieve them.

*Determine the benefits to be derived, the risk assumptions and the amount needed to sustain a comfortable retirement.*

The plan may also utilize a buy-sell agreement providing a blueprint for the future sale. Such an agreement may facilitate a transfer of power to the younger generation or a sale to outsiders.

Seeking to minimize potential estate taxes is more problematic in the current environment. At the crux of the matter is the scheduled repeal of the federal estate tax for 2010. This is to be followed by a restoration of the tax in 2011 with a less favorable exemption and revision of the “carryover basis” rules for inheritances. However, even during this period of uncertainty, business owners may benefit from the use of the unlimited marital deduction and astute trust arrangements for family members.

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**Furthermore, the size of a business owner's estate may continue to be reduced through lifetime gifts.** For 2010, the annual gift-tax exclusion covers gifts of up to \$13,000 per recipient, before any portion of the \$1 million lifetime gift-tax exemption is used. Also, special estate-tax breaks for business interests may be available. For instance, the federal estate tax due on a large business interest may be spread out over a 14-year period if certain conditions are met.

**Finally, consider life insurance as part of the plan.** In particular, business owners may rely on life insurance for its liquidity. If the policy is structured carefully, the proceeds can be received free of both estate and income taxes.

Of course, this general overview does not take any extenuating circumstances into account. Consult with knowledgeable advisers to arrange a plan designed to fit the specific needs of the situation. ■



**Next, provide the advisers with an inventory of assets.** This can be accomplished simply by listing all the assets owned in addition to the business interest (e.g., real estate, stocks, bonds, bank accounts, life insurance, etc.). The advisers can make a reasonable projection of the future net worth of these assets.

## New Law Broadens COBRA Subsidy Program

A new defense spending law signed late last year — the Defense Appropriations Act of 2010 — extends and expands the COBRA subsidy program included in the recently enacted economic recovery law. As this is being written, an additional extension is being considered by Congress.

**Background:** Under the Consolidated Omnibus Budget Reconciliation Act of 1985 (commonly known as “COBRA”), an employee who is terminated from work by an employer with 20 or more employees may elect to continue employer-provided health insurance coverage for as long as 18 months (even longer in certain situations). Generally, the employee (or a beneficiary) is required to pay the entire cost of the health insurance premiums, plus a 2 percent administrative fee. Thus, the cost may still be a hardship for someone who loses his or her job.

The American Recovery and Reinvestment Act of 2009 (ARRA) provided some relief. A worker who was “involuntarily terminated” from employment between September 1, 2008, and December 31, 2009, was entitled to a subsidy for a maximum

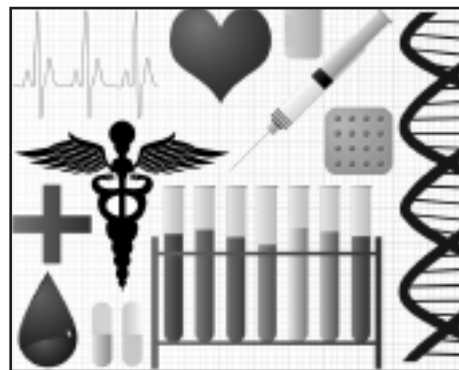
period of nine months. The worker had to pay only 35 percent of the cost while his or her ex-employer was responsible for the remaining 65 percent of the premiums.

For this purpose, an involuntary termination covered most layoffs and dismissals. However, if an employee was fired due to gross misconduct, the subsidy did not apply.

**NOTE:** The COBRA discount was not available to certain high-income taxpayers. It was phased out through an additional tax for joint filers with a modified adjusted gross income (MAGI) between \$250,000 and \$290,000 and single filers with a MAGI between 125,000 and \$145,000.

Employers could recover their portion of the cost through a special payroll tax credit or reduced withholding deposits. Thus, the federal government was effectively paying for the subsidies.

Now the new law extends the eligibility period for COBRA assistance by two months. It also covers workers involuntarily terminated from their jobs from January 1, 2010 through February 28, 2010. In addition, the maximum period is



extended by six months, from nine months under prior law to a total of 15 months.

An employer must credit the account of a worker who paid the full amount of premiums but is now eligible for the discount. Employers are also required to inform laid off workers about the latest changes in the COBRA subsidy program. Most of the other elements of the ARRA rules for the program, including the 35 percent to 65 percent payment ratio and the phase-out for high-income taxpayers, continue to apply under the new law.

Both employees and employers may benefit from expert assistance. Do not hesitate to call with any questions. ■

## Taxing Issues: Social Security Benefits

Although individual taxpayers must pay tax into the Social Security system during their working years, that is not the end of the line. Depending on their income, they may also be liable for tax on Social Security benefits received in retirement.

**Background:** For 2010, the Social Security “wage base” is \$106,800 (the same as it was for 2009). In other words, an employee must pay the 6.2 percent OASDI portion of Social Security tax on the first \$106,800 of wages. The 1.45 percent HI portion of the tax applies to all wages. These figures are doubled for self-employed taxpayers (although half of the self-employment tax is tax-deductible).

That is pretty straightforward. Conversely, the rules for taxing Social Security benefits received in retirement are considerably more complicated.

For starters, an individual’s “provisional income” determines his or her tax liability, if any. Provisional income is defined as modified adjusted gross income (regular AGI plus certain technical adjustments), plus any tax-exempt income received, plus one-half of the Social Security benefits received. If provisional income is less than the annual “base amount,” none of the benefits are taxable. The base amount is \$32,000 for joint filers; \$25,000 for single filers. (For married taxpayers filing separate returns, the base amount is zero.)

However, if provisional income exceeds the base amount, the recipient is taxed on Social Security benefits. The amount depends on whether either one or two thresholds are surpassed.

**1.** If provisional income is between \$32,000 and \$44,000 (\$25,000 and \$34,000 for single filers), tax is paid on the lesser of (a) one-half of the Social Security benefits or (b) 50 percent of the amount by which provisional income exceeds \$32,000 (\$25,000 for single filers).

## Telling Employees “What Not to Wear”

In the tumultuous sixties, employers and employees often clashed over long hair and tie-dyed shirts. Today, a workplace dispute may occur over piercings or skin art.

What is at stake? Essentially, the rights of employees to look and dress as they please versus an employer’s desire to maintain a professional appearance.

**Background:** Under Title VII of the Civil Rights Act of 1964 and subsequent amendments, dress and grooming codes that are discriminatory can cause legal complications. The key is to set up a company policy that relates to either health or safety in the workplace or the company’s public image.

The basic guideline is that management may set a reasonable policy for dress and grooming. It may also be possible to establish separate rules for men and women. But be aware of these three key points:

**1.** The company must have some legitimate business purpose behind its policy. For example, it would be unreasonable for most manual laborers to be required to wear suits and dresses.



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## Taxing Issues: Social Security Benefits

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**Example:** Linda Green is a joint filer; her provisional income is \$40,000, and she receives \$10,000 in annual Social Security benefits. In this case, she must pay tax on \$5,000, since half of the benefits received exceed half of the excess over the base amount, or \$4,000. If Linda is in the 25 percent tax bracket overall, she must pay \$1,250 of tax on her benefits.

**2.** If provisional income is more than \$44,000 (\$34,000 for single filers), the calculation is more complicated. The recipient must pay tax on 85 percent of the amount by which provisional income exceeds \$44,000 (\$34,000 for single filers) plus the lesser of (a) the amount determined under the first threshold or (b) a base amount of \$6,000 (\$4,500 for single filers). In no event, however, can the amount exceed 85 percent of the benefits received.

Note that investments generating tax-exempt income, such as municipal bonds or municipal bond funds, may increase provisional income. This category may also include interest on U.S. Savings Bonds used to pay college tuition.

*This is a complex area of the tax law, and it could have an impact on retirement decisions. Obtain professional assistance concerning the implications. ■*

## Telling Employees “What Not to Wear”

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**2.** Be sure all employees are advised of the policy. The policy should be included in a written employee manual. If there is no manual in place, now may be a good time to create one.

**3.** Make the policy as fair as possible. For instance, allowing one gender to come to work dressed casually while the other has to wear uniforms may be considered unreasonable. Consider special situations such as religious affiliations.

**CAUTION:** Using common sense is important. If the policy is reasonable under the circumstances, it should be able to stand up to any legal challenges. ■

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## How to Deter Computer Hackers

Proper management of its computers is essential to the growth and survival of a company. A business manager can improve security — as well as provide some more peace of mind — by following a few basic steps. *For example:*

**Take initial precautions.** Whenever a new computer is brought online, apply operating systems updates, install an antivirus program and reset default passwords (e.g., the password for the administrator's account). Consider use of a firewall program, but check with the information technology supervisor or an outside computer adviser first.

**Establish a security routine.** This may include automating operating systems and antivirus updates. Be sure to run a spyware program regularly. If possible, do other work in non-administrator accounts.

**Prepare for contingencies.** Significantly, ensure that the necessary files are backed up regularly. In addition, improve the ability to rebuild the system in case of an infection. Have a plan in place for handling emergencies and facilitating upgrades.

**Be suspicious and vigilant.** Do not open unexpected e-mail attachments or download unknown programs. Do not share passwords with others. Keep proprietary information off-limits to outsiders.

Of course, there are no guarantees that the system will not be invaded. Nevertheless, it makes sense to take precautions that can only help but cannot hurt. ■

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Troy, Michigan 48084-3108  
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