

Taxation, Probate, and Trust Law Section

Idaho State Bar

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Summer Edition

ROTH OR PRE-TAX 401(k) CONTRIBUTIONS: WHAT SHOULD YOUR FINANCIAL ADVISOR BE TELLING PARTICIPANTS? Part II

BY BOB WREGGELSWORTH

RULES OF THUMB FOR CONTRIBUTIONS:

Plan participants now in their 20s are probably better off allocating all 401(k) contributions to the plan as Roth 401(k) contributions because you are likely to have lower earnings and be in a lower tax bracket at this time in your life. In addition, you will benefit from many years of accumulated tax free compounded growth on the contributed funds and the earnings on them through retirement.

Plan participants now in their 30s and 40s will probably benefit from a mixed contribution strategy. In other words, it may be best for you to make some of your contributions to a Roth 401(k) and some to a regular pre-tax 401(k). The amount to allocate between a Roth 401(k) and regular pre-tax 401(k) depends to a significant extent on whether you are at a high or low tax bracket during this time of your life. The higher your earnings during these years, the more advantageous it is to allocate a greater share of your

contributions to a regular pre-tax 401(k). Conversely, if your earnings are lower during these years, consider contributing a greater share of your contributions to the Roth 401(k). In addition, if you are in your 30s, you will have a longer time period for tax free compounded growth in the Roth 401(k) before retirement. Less so if you are in your 40s. A mixed contribution strategy may be appropriate because it is difficult to know in your 30s and 40s whether you will be in a higher, lower or the same tax rate at retirement.

Plan participants now in their 50s and 60s may find that, since you are in your peak earning years, you will benefit from allocating more of your contributions to a regular pre-taxed 401(k) rather than a Roth 401(k) so that you can lessen your current tax burden. You also have fewer years for tax-free compounding of earnings and contributions before retirement. However, a mixed contribution strategy still may be appropriate

because it is difficult to know whether you will be in a higher, lower or the same tax rate at retirement. In addition, a mixed contribution strategy will provide you with the opportunity to diversify your overall financial plan. For example, social security benefits are currently not taxable during retirement if your retirement taxable income is kept under the taxable limit. Also, as a participant in your 50s and 60s, you may find that you want to

CONGRATULATIONS!!

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The Tax Section would like to congratulate its valued member, John McGown, on receiving the 2014 Idaho State Bar Distinguished Lawyer Award. John's dedication and service to the Bar is widely known and appreciated. The award acknowledges all of our sentiments.

Congratulations John!

utilize the Roth 401(k) as a means to diversify your financial assets so that you can pass on more wealth to your heirs tax-free by means of a Roth 401(k). For these reasons, if you are now in your 50s or 60s, you may benefit from a mixed contribution strategy.

An alternative approach for high-earning participants of any age seeking a mixed contribution strategy

– Regardless of age, if you are a high-earning participant in a 401(k) plan, you may want to take advantage of a different kind of mixed contribution strategy by making regular pre-tax 401(k) contributions to your 401(k) plan (to reduce your taxable income) while simultaneously, or no later than April 15th of the following year, contributing the maximum amount to a Roth IRA. The advantage of this approach is that,

unlike Roth 401(k) contributions, you have access to the “after-tax” contributions made to your Roth IRA in the event you need to withdraw funds for emergency purposes. This unique feature of a Roth IRA is due to the ordering rules for withdrawals from a Roth IRA. For example, regardless of how long the Roth IRA account has been open and regardless of whether you have reached age 59 ½, the ordering rules provide that withdrawals from a Roth IRA are deemed to come first from “after-tax” contributions. As a result, you will pay no income taxes and no penalty for early withdrawal if you withdraw only “after-tax” contributions from your Roth IRA. In addition, once you have had the Roth IRA account opened for at least five (5) years and reached the age of 59 ½, earnings can be withdrawn from your Roth IRA tax-free and penalty free. You, as a participant in a 401(k) plan, can contribute \$5,500 (\$6,500 if you are age 50 or older) to a Roth IRA in 2014. You can contribute up to the limit unless you earn less than that amount. However, you may not contribute more than your taxable compensation for the year. In addition to the above limitations, a Roth IRA contribution may also be limited by your income and filing status. For example, if you are a single person, you can make a Roth IRA contribution up to the limit if your income is less than \$114,000 in 2014. The maximum

Roth IRA contribution is phased-out for single filers with income of \$114,000 to \$129,000 and completely phased-out when your income is \$129,000 or more. If you are a married person, you can make a Roth IRA contribution up to the limit if your income is less than \$181,000 in 2014. The maximum Roth IRA contribution is phased-out for married filers with income of \$181,000 to \$191,000 and completely phased-out when your income is above \$191,000. Ultra high earners, whose contribution to a Roth IRA is phased-out due to the income limits, may instead make a non-deductible Traditional IRA contribution while simultaneously participating in a 401(k) plan and then convert the non-deductible Traditional IRA contribution to a Roth IRA. If the conversion is made soon after the contribution to the Traditional IRA, no income or a very nominal amount of income will have to be recognized on the conversion from a Traditional IRA to a Roth IRA. Note, due to the “aggregation rules” for multiple Traditional IRA accounts, this strategy is only available to the ultra-high earner who has no other Traditional IRA accounts at the time of conversion. The combined annual contribution limit to a Traditional IRA and a Roth IRA is \$5,500 (\$6,500 if 50 or older) in 2014.

NOTE – Contributing the maximum amount to a Roth IRA is a good idea *regardless of age* and

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The Tax Section Governing Council is seeking applicants interested in serving as the Section Secretary/Treasurer. The time commitments are minimal, and this is a fantastic way to meet your fellow attorneys and give back to our section! If you are interested, please contact Natasha Hazlett at Natasha@angstman.com.

regardless of whether you are in a high income tax bracket because the ordering rules for a Roth IRA allow income tax-free and penalty free withdrawals of “after-tax” money contributed to the Roth IRA. In essence, a Roth IRA can be utilized as a retirement savings vehicle that grows tax-free while also serving as an “emergency” savings fund in the event you need to withdraw funds (up to the amount of accumulated “after-tax” contributions) to pay for unexpected emergencies such as a loss of a job or for health reasons.

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TAXATION OF PERSONAL PROPERTY IN IDAHO

Part II BY GEORGE BROWN

HB 315 produced questions that, to properly administer the new law, must be answered. The first is, “What is a *taxpayer* for purposes of the \$100,000 exemption?” That question was substantially answered in Property Tax Rule 626, applied as a temporary rule after the 2013 legislative session and accepted as a permanent rule by the legislature in 2014. Idaho Code § 63-602KK defines “taxpayer” as “two (2) or more individuals using the property in a common enterprise or a related group of two (2) or more organizations when the individuals or organizations are

within a relationship described in section 267 of the Internal Revenue Code.” Section 267 describes certain familial and business relationships. The definition of taxpayer is necessary to prevent businesses from being split into many smaller entities solely to benefit from multiple exemptions. Rule 626 defines which entities will be considered as a taxpayer eligible for the exemption by looking at ownership of businesses and how they operate as a “common enterprise.” Rule 626 has several graphical examples of business structures and shows what parts of those structures are eligible for a separate exemption based on not only the structure of the enterprise but ownership of each business entity involved.

The second question brought on by HB 315 is, “What is an *item* of property that qualifies for the \$3,000 per item exemption?” An “item” is defined in Idaho Code § 63-602KK as “equipment, machinery, furniture or other personal property that is functioning at its highest and best use for the purpose it was designed and constructed and is generally capable of performing that function without being combined with other items of personal property.” This language eliminates the ability to break a large item down into its

component parts and enjoy an exemption on its full value. This is important because the loss in revenue from the per item exemption is not being replaced by the state, and will cause a growing shift in the tax base from previously non-exempt personal property owners to other taxpayers. This shift results from the fact that much of taxable personal property is depreciated over time. If all personal property is taxed, then tax on depreciated property value is generally replaced with tax on new property value in a continuous cycle. However, with the new per

Mark your Calendar! Tax Section Events

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August 21, 5:45 p.m.

Tax Section Social
Bardenay Downtown Boise
Contact Natasha Hazlett for
more information
Natasha@angstman.com

September 12th-13th

Annual Estate Planning
Seminar, Sun Valley, Idaho.

**October 2014 CLE hosted by
the ISB Tax Section and
Young Lawyers Section.**

Hosted by Hawley Troxell
Details forthcoming!

November 11th, 12:00 p.m.

Tax Section Meeting
ISB Law Center

item exemption, depreciated property value is not replaced on items under \$3,000, it simply disappears as a taxable source of value because the replacement items are not taxable. The “item” definition, then, is a limitation on the amount of property tax that is ultimately shifted to other taxpayers.

Finally, and perhaps most important, “What is ‘personal property’?” Because there was never a broad exemption of personal property in effect, there was never a need to define exactly what property is included in the term. Most items of personal property can be identified as such with little debate. However, there has been debate on whether certain types of business and industrial property, especially equipment and machines used in industrial processes, should be included in the definition. Personal property is defined in Idaho Code § 63-201 as “everything that is the subject of ownership and that is not included within the term ‘real property,’” real property includes “improvements,” and “improvements” include buildings, structures, and “fixtures.”

Fixtures law is familiar in non-tax property law for determining who owns leasehold

improvements, and is often analyzed by statute and under common law principles using a three factor test. In short, those three factors are integration, injury, and intent. An item of personal property will be considered a fixture, and therefore real property, if (1) it is attached to real property in a manner that makes it integral to the use of the real property, (2) if its removal would cause material injury to the real property, and (3) if the intent of affixing it was to make a permanent addition to the real property. In Idaho, this three factor test was supplemented with an additional sentence: “[f]ixtures’ does not include machinery, equipment or other articles that are affixed to real property to enable the proper utilization of such articles.” This extra sentence resulted in disagreement on to which types of items it would apply. In order to simplify the analysis for assessment purposes, and to ensure that case law from states using the three factor test could be relied on in Idaho, the HB 441(aaS) eliminated the extra sentence.

Prior to HB 315, there was no need to explicitly define “personal property” because that

2014 Annual Advanced Estate Planning Seminar

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Sept. 12-13th
Sun Valley Resort
10.5 CLE Credit (1.0 Ethics
Credit)

\$250.00 ISB Tax Section
Members; \$300.00 Non-
Member Registration

Registration and a schedule of events is available online. In addition to fantastic speakers and topics, this year’s Seminar will feature a number of hosted social events and opportunities to network with other practitioners! We hope everyone plans on attending.

property did not enjoy special treatment. Though recent statutory changes and rule promulgation helped to more efficiently administer Idaho’s personal property tax exemptions by attempting to further define “personal property” more discussion and changes may be necessary to apply the exemptions. As the exemptions are applied and data is gathered on their effects, policy level changes may also be warranted.

NEWSLETTER ARTICLE SUBMISSIONS

The Tax Section invites members to submit articles for publication in its next Newsletter. [Choose your topic!](#) Please submit your articles for consideration to Chelsea Kidney at chelsea.kidney@tax.idaho.gov.