The C&A Advantage

Volume XLIII
No. 20
October 15, 2015

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The C&A Advantage is mailed first-class to subscribers twice each month – $265 annual subscription rate.

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**October 15th Deadline Quickly Approaching for Roth IRA Conversions You'd Like to Undo**: This is a little known tax procedure called a **recharacterizaton**, and it means undoing or reversing an IRA contribution or a Roth IRA conversion. The recharacterization must be done by October 15 of the year following the mistake, or else you've missed the deadline.

Here are situations that warrant a recharacterization:

1. An individual changes his mind about which type of IRA he wants to contribute to. If he was eligible for both a traditional or Roth IRA in 2014, then he can recharacterize that contribution to the other IRA by Oct. 15, 2015.

2. An individual contributes to either a traditional IRA or a Roth IRA, but because of the contribution restrictions, that contribution wasn't permitted.

3. An individual converts a substantial amount of traditional IRA money to a Roth IRA and sees the account value plummet in the recent stock market correction. In order to avoid a large tax bill on what is now a small amount, he makes a recharacterization back to the traditional IRA.

4. An individual converts his traditional IRA to a Roth IRA thinking it will be tax-free, not appreciating that he has a "cream in the coffee problem" and the conversion is almost all taxable. This is the one we'd be most concerned about.

We have covered this topic extensively in the Newsletter and at our seminars, but it bears repeating.

For the past ten years, we have been recommending making non-deductible contributions to traditional IRAs followed by conversions to Roth IRAs. This is referred to as the back-door Roth IRA, and it's effective for someone whose income is too high to make a direct Roth IRA contribution. (It is also a viable alternative for someone who is prevented from making a tax-deductible contribution to a traditional IRA because they participate in a practice retirement plan).

**This is a great concept, which we have been using for years, but there is a potential problem that can render this entire exercise pointless**. If you have a substantial

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amount of pre-tax money in your traditional IRAs, then the Roth conversion will be mostly taxable even though you think you're converting your non-deductible contributions. We call this the cream in the coffee problem, and it can be explained by the following example.

Assume you have traditional IRAs that altogether total $1,000,000. $950,000 of the total came from a rollover from a former company retirement plan, plus several years of tax-deductible contributions and tax-free growth that has built up. The remaining $50,000 represents non-deductible (i.e., after-tax) contributions of, say, $5,000 per year for 10 years.

If you convert $50,000 from this traditional IRA to a Roth IRA, you will be in for a big surprise. 95% of what you convert will be taxable! The tax laws do not permit you to convert only the after-tax contributions (the cream) and have that be a tax-free Roth IRA conversion. Once the cream has been mixed in with dollars that have not yet been taxed (the coffee), it can't be extracted out. If we had such a large pre-tax IRA, we would not have been making the annual non-deductible contributions to begin with.

**Recharacterizing the Conversion**: We know that there are some Newsletter readers who do not fully understand this concept and may get burned with a large tax bill for a Roth conversion they thought was going to be tax-free. If you made the conversion in 2014, you still have time to reverse it, **BUT YOU MUST ACT QUICKLY**.

Your broker or investment manager can give you the forms to do the recharacterization. You will be moving the converted money from the Roth IRA to the traditional IRA plus or minus some earnings or losses. This must be done within the next couple of days by October 15th.

**Can a Tax-Free Roth IRA Conversion Still be Salvaged Under the Above Example?** Perhaps. The only way around this problem is if you are a participant in a qualified retirement plan through your practice. The first step is that the recharacterization must be completed by October 15th. The second step is to transfer the pre-tax money ($950,000 in the above example) from the traditional IRA to the qualified plan, leaving just the $50,000 of after-tax contributions remaining. The tax laws permit this type of reverse rollover, though you will need to confirm with your plan provider that this is permitted under your plan documents. It is permitted if you are a Collier & Associates plan client.

**Incidentally, how are you supposed to know how much of the total account value is pre-tax versus after-tax money?** The answer, in theory at least, is simple. For each year you made a non-deductible contribution to a traditional IRA, your accountant should have filed IRS Form 8606 with your 1040 tax return. Form 8606 keeps a running total of your current and historic non-deductible contributions. The total reported on Form 8606 is your cream. Everything in excess of that is coffee. If you have not been filing the 8606, then you will have to try to piece this information together with cancelled checks . . . or your imagination.

The effect of this reverse rollover is to move most of the money out of the IRA and into the plan where it will be maintained under a special sub-account for your benefit. This removes the coffee and leaves the cream. At this point, you will do the $50,000 conversion, and it will be fully tax-free.

**Keep Annual Employee Reviews and Discussions About Pay Raises Separate**: These can be emotional meetings for an employee. Have the performance evaluation earlier in the year and keep it focused on the employee's strengths and weaknesses. Keep compensation out of the discussions. But, use the evaluation at the end of the year to help determine if a raise is in order.

**Rewarding Top Employees with Education Assistance**: In addition to a raise, you might like to offer employees a tax-free education assistance benefit. This is permissible under Section 127 of the tax code. It requires a short written plan document that is handed out to the

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eligible employees. It is not submitted to the IRS. **The plan can offer up to $5,250 of tax-deductible (to the employer) and tax-free (to the employee) payment or reimbursement of education expenses**.

We know one dentist who wants to offer two of his key hygienists $1,000 per year for repayment of loans taken to pay for their hygiene degrees. He rightly believes that this will foster added loyalty to the practice. The practice cannot deduct a loan repayment, and this would likely be treated as taxable income to the employee. On the other hand, the payment can be made under the Section 127 plan. The employee will provide documentation that the tuition expense has been incurred, and the practice will pay her $1,000. She can then use the money to prepay her loan.

Some reasonable discrimination is permitted in a Section 127 plan, so long as the plan truly covers the staff. For example, the plan could offer a $1,000 per year benefit for up to five years to those employees who have completed their hygiene training. Only the hygienists would qualify, and in this case, the plan would have a maximum payout of $5,000 per person.

*If you are interested in a Section 127 plan, please call our office at (216) 765-1199. We will need to discuss the specific details you'd like to have in the plan. The legal fees to prepare the plan paperwork should be modest.*

**Can a Practice Owner's Child Who Works in The Practice Qualify for $5,250 Per Year of Tax Free College Assistance?** Probably not. The plan can indeed provide that employers can deduct up to $5,250 toward college and graduate school education costs of employees (including, but not limited to, tuition, fees and books). What makes this so tempting is that the courses can be unrelated to the business of the employer (costs for related courses are deductible as continuing education).

The idea would be that the practice owner with children on the payroll provide an employee education assistance plan and let the practice pay up to $5,250 per child per year as a tax free fringe benefit. Unfortunately, there are non-discrimination rules that will make this unusable if that is the goal. For example, not more than 5% of the plan's costs in a year can go for more-than-5% owners (or their spouses or dependents). The plan has to be in writing and communicated to all eligible employees. If even one employee you did not wish to favor took advantage of the plan, those costs would outweigh the tax savings from the payments for your child.

**Renting a Home to a Relative at Below Market Rates Will Hurt for Tax Purposes**: In a recent Tax Court Case (*Okonkwo*, TC Memo 2015-181), the wealthy parents rented their second home to their daughter for $2,000 per month or $24,000 per year. They then claimed business losses for mortgage interest, property taxes, insurance and depreciation on the rental property for well over $100,000 per year. Since the rental income wasn't nearly enough to soak up all of the losses, the parents claimed the excess losses against their primary income from their cardiology practice. The IRS argued that these were "passive" losses that could only be used to offset the passive rental income, and the IRS won in court.

The problem here was that in the years prior to renting the home to their daughter, the parents rented the property to an unrelated tenant who paid $6,000 per month. Once he left and the daughter moved in, the rent dropped by two-thirds. The IRS correctly claimed that this was not a fair market rental and parents' excess losses were disallowed. We know many doctors that are leasing a second home to a child. If you wish to preserve the tax advantages, we recommend treating this like an arms-length transaction. This means having a written lease agreement and a reasonable monthly rent payment.

**The Office Telephone Should be Used to Welcome New Patients In, Not Screen Them Out**: One reason that a practice may not be bringing in a steady flow of new patients is that they are being screened out during their initial phone call. Your front desk should not introduce dental insurance early in the phone

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call, as in, "We do not participate with Delta, so you will have to pay in full at the time of service and claim your benefits directly from them." This gives the impression that the patient may not really be wanted in the practice or would be foolish to come to this practice.

Don't even raise the issue of insurance until after the patient has been verbally welcomed into the practice and their initial concerns addressed. Insurance should come up when addressing other questions. For instance, you might ask whether you can contact the patient's previous dentist for records. This can be followed by, "Do you have dental insurance you'd like us to help process for you? Great. Just bring your insurance card and we can go over it during your first visit." Your receptionist should not be defensive or apologetic if you are an out-of-network provider. Don't make a big deal out of it, and your patients won't either.

**Is it Deceptive Not to Volunteer that Your Practice is Out-of-Network?** Not at all. In the **very rare** case that a new patient might complain that they were somehow duped, then your front desk should have the **limited authority** to write off the excess portion of the fee and politely volunteer to forward the patient's records to their next doctor. This should be followed with an explanation that the practice's primary focus is on providing high quality professional care to meet its patients' dental needs. Your primary concern is with your patients, not whichever dental insurance company they might happen to have (though you'll be happy to help them process their claims).

**Based on the Holding of a Recent Missouri Federal Court Case, it Makes Sense to Review Existing Associate Employment Contracts**: Let's say you have an employment contract with an associate that contains a covenant not to compete. If you sell your practice to someone other than that associate, the buyer will want to know that the associate's covenant not to compete remains in place.

A federal district court in Missouri (*Symphony Diagnostic Services v. Greenbaum*, No. 13-4196, W.D. Mo., 2015) recently ruled that a buyer of a business could not enforce a covenant not to compete given by one of the seller's employees unless the employment contract expressly stated that the covenant not to compete was assignable (or the employee consented to the assignment). In that case, which involved an X-ray technician, one of the seller's employees did not remain with the buyer. She went to work for a competitor in violation of the original covenant. The buyer sued, and the Court held the covenant was given to the seller and was not enforceable by the buyer - unless the contract expressly stated that the restrictive covenants were assignable (which it didn't).

The implication is that if your key-employee associate could compete with a practice buyer, your goodwill may not be as saleable or may not be as valuable as it would otherwise be. If you think you might sell your practice to someone other than your associate, review his or her employment agreement with your attorney. Several states follow this approach, so it could be prudent to be sure the section that contains the restrictive covenants includes a clause expressly permitting their assignment. There should also be a clause in the contract dealing with the assignability of the contract generally, but we would also want a specific reference to a permitted assignment in the restrictive covenant section as well.

We would definitely add this to new employment agreements. We might also want to enter into new employment agreements with our existing associate(s) so as to include new express assignability language. In most states, to be enforceable, the new agreement (or an amendment to the existing agreement) has to have some new and adequate improvement for the associate. The promise of continued employment could qualify as that improvement. This is not a do-it-yourself issue. Most courts do not favor covenants not to compete in employer-employee settings and do not need much incentive to decline enforcing them. So if this could apply to you, definitely review these issues with your attorney.

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