Five Ways to Adjust to a New Tax Landscape

By Editor Test *Wed, Jun 30, 2010*

A consortium of advisors who represent Securities America offered these suggestions for how investors and their advisors can adjust to the expiration of EGTRRA and JGTRRA at the end of 2010.

The provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) are scheduled to expire or "sunset" at the end of 2010.

For many investors, parting will be sweet sorrow.

EGTRRA and JGTRRA reduced tax rates on ordinary income, long-term capital gains, and qualified dividends; mitigated marriage penalties; expanded the child tax credit and the child and dependent care tax credit; and phased out limitations on itemized deductions and the phase-out of personal exemptions.

With the sunset of these provisions, individual income tax rates in 2011 are expected to stay the same for low- and middle-income taxpayers, but rates for individuals earning more than $200,000 or couples making more than $250,000 may revert to pre-2001 levels.

(Here's a table that compares what income tax will look like in 2011 (after the sunset at end of 2010) with what the tax picture is today and could remain if we see a permanent extension of the 2001 and 2003.)

A consortium of advisors who are representatives of and offer securities through Securities America Inc. (www.securitiesamerica.com) have offered these suggestions for how investors and their advisors can adjust to a new tax landscape:

1. Catch the early bird special. In anticipation of higher tax rates, if your portfolio includes appreciated assets, this year might be a good time to take some gains off the table at the maximum capital gains rate of 15%, rather than the 20% currently slated for 2011. Investors in the 15% tax bracket or lower have no gains due on appreciated assets in 2010, but will face a 10% tax in 2011.

"Investors might also consider accelerating the sale of a home or business to avoid higher tax rates down the road," says Don Patrick, CPP, managing director of Atlanta-based Integrated Financial Group (www.Integrated-Financial-Group.com). He notes that unlike when investors use tax loss harvesting to book a capital loss at the end of the year, there's no wash sale rule that precludes them from buying a security right back when they sell it and register a gain.

2. Diversify retirement savings from a tax standpoint. Having taxable and non-taxable pots to draw from makes sense in an uncertain tax environment. Jim Coleman, founder of Coleman Financial Advisory Group in Waterbury, Connecticut (www.ColemanAdvisoryGroup.com), noted that the lifting of the $100,000 income limit for converting a traditional IRA to a Roth IRA makes diversifying possible for all taxpayers.

“Obviously, converting retirement assets to a Roth would result in reportable income and trigger additional income tax—and it may be difficult to consider paying income tax on a large IRA,” Coleman said.

“However, it’s important to realize that you don’t need to convert the entire account. While investors who converted in 2010 can spread taxes due over 2011 and 2012, those in the higher tax brackets may be better off having paid all those taxes in 2010. In promoting the extra time to pay, Uncle Sam fails to mention that the top tax bracket will increase to 39.6% from 35% in 2011. Either way, if the nation is indeed entering a long period of rising income tax rates, paying a conversion tax bill may seem like a bargain in retrospect.”

3. Use fraud losses. Because the Roth conversion is an ordinary income taxable event, taxes due can be offset by major losses due to fraud which are booked as an ordinary income loss as opposed to a capital loss, says Arthur Cooper, CFP, managing partner of Cooper McManus, a wealth management firm located in Orange County, California (www.CooperMcmanus.com).

“If you have the misfortune to take a straight fraud and theft deduction, you can convert the same amount from a traditional IRA into a Roth IRA conversion and end up with zero tax on that conversion,” he said.

It’s also possible to go back a few years for loss carry forwards to add to write-offs of ordinary income. “When you go back and zero-out tax liability, you save that 10-15% on a good chunk of the dollars,” Cooper added. “Plus, when you do a Roth IRA conversion, you convert taxable dollars into a future non-taxable income stream, so the effective tax savings is even more impactful than just zeroing out your tax liability.”

4. Rethink some standard financial planning advice. While he traditionally spends time with high level executives discussing the benefits of deferring some salary, Mike Flower, partner at Financial Principles in Fairfield, New Jersey (www.FinancialPrinciples.com), is advising high wage-earners who have the flexibility to receive ordinary income this year instead of in a later year when tax rates may be higher.

“Executives might decide to exercise their non-qualified stock options,” he said. In another departure, if future income tax rates truly skyrocket, Flower said tax qualified plans may lose some of their appeal.

“You still want to contribute to your workplace plan, certainly enough to qualify for any available company match, but with the question of whether you truly will be in a lower tax bracket in retirement, you might also consider funding accounts outside the tax-deferred arena for some diversity,” he said. “If your company’s retirement plan offers a Roth option, you might consider that so you have a pool of money to pull from in retirement where you will not owe taxes on distributions.”

Finally, while financial advisors traditionally encourage clients to make charitable contributions before the end of year, Flower said if you are considering a substantial charitable donation, you might be better off from a tax standpoint to spread it out or defer it to the future to gain a greater tax deduction.

5. Understand your father’s dividends will cost you more. Currently, the maximum tax rate on qualified dividends is 15%, but that will revert to regular income tax rates in 2011.

“Although President Obama has proposed a tax of 20% for both capital gains and dividends in 2011, if the reclassification of dividends lapses at the end of 2010, next year the top dividend rate could revert to 39.6%. Still others talk about a tripling of the current 15% rate,” said Clyde Wyatt, CLU, CFS, a director at Dallas-based Navigation Financial (www.NavigationFinancial.com).

“Whatever happens, the increase in tax on qualified dividends obviously makes dividend paying stocks less attractive in a retirement income stream.”

In addition, starting in 2013, the Healthcare and Education Reconciliation Act of 2010 will levy a new 3.8% Medicare tax on investment income for individuals earning more than $200,000 or couples earning $250,000. Notably, the 3.8% surtax does not apply to distributions from IRAs and other qualified retirement plans like 401(k)s, 403(b)s and 457 plans, or Roth IRAs.

“Because income from tax exempt and tax deferred vehicles like municipal bonds, tax deferred non-qualified annuities, life insurance, and non-qualified deferred compensation do not count as investment income, investments in these vehicles should become more favorable relative to investments producing income subject to the tax,” Wyatt said.

The net effect of the capital gain tax increase and Medicare tax will be a 23.8% tax rate for higher earners–the highest rate for long-term capital gains since 1997, says John Jenkins, AEP®, EA, CFP®, president and CEO of San Diego-based Asset Preservation Strategies (www.Asset-Preservation.com). “Once these higher rates kick in, high wage-earners may try to defer income in an effort to stay below the highest tax thresholds. We’ll also be considering some advanced planning strategies to offset tax liability through the use of Section 42 tax credits (low income housing tax credits) and also oil and gas investments.”

Jenkins finds it ironic that the same investors who could help promote long-term economic growth will suffer the economic brunt of these tax increases. “In 2007, taxpayers with incomes greater than $200,000 reported 47% of all interest income, 60% of all dividends and 84% of all capital gains,” he said.

“And the Joint Committee on Taxation estimates the new Medicare tax on investments will cost high-earning taxpayers an additional $30 billion annually. Further, because the modified adjusted gross income threshold at which this Medicare tax will apply will not be indexed for inflation, going forward an increasing number of taxpayers will be snared by this tax provision.”

Bottom line? The tax code is in a state of flux. In addition to these changes, the federal estate tax has already expired. If Congress doesn’t act, estate taxes will be reinstated in 2011 at a rate of 55% for estates valued at more than $1 million. While portfolios have to be re-examined in light of this change and the anticipated sunsets, planning can be done only on the basis of educated assumptions.