Tax Planning for the 2010 Year End is Especially Challenging

If we were to pick a single word to describe tax planning between now and the end of the year 2010, that word would be "uncertainty." Significant changes in the income tax law are scheduled to take effect on January 1, 2011, as a result of the sunset provisions in the 2001 Economic Growth and Tax Relief Reconciliation Act and the 2003 Jobs and Growth Tax Relief Reconciliation Act. Uncertainty is the key because we still do not know whether Congress will act to alter any of those changes.

Until something does happen, we have to assume the changes scheduled to take effect on January 1 will in fact occur. We will review below the most significant changes and discuss the planning considerations they entail.

Tax Rate on Long-Term Capital Gain Increases from 15% to 20%

On January 1, 2011, the federal income tax rate on long-term capital gain income increases from its current 15% to 20%, a 33 1/3% increase. The rate is currently scheduled to further increase to 23.8% on January 1, 2013, when the additional 3.8% Medicare tax takes effect. This raises the question whether appreciated capital assets should be sold before the end of the year to take advantage of the lower 15% rate? The answer to that question is "it depends." The change in tax rates needs to be evaluated along with your investment analysis of a particular asset. In the simplest of cases, you hold a stock for which circumstances exist that cause you to believe you should sell that stock. Selling this year and paying a 15% capital gain tax is preferable to selling in January and paying a 20% capital gain tax. Unfortunately, few situations are that simple.

Beyond this very simple case, determining whether you should sell in 2010 to capture your current tax gain at the lower 15% rate depends on a number of variables, including: i) the rate at which you expect the investment to continue to appreciate; ii) the rate of return you expect on the asset you will acquire with your after-tax sales proceeds; iii) how long you would hold the investment before selling it if taxes were not a factor; iv) the state tax rate you will pay on the capital gain; v) your view on whether the next Congress will change the rates presently scheduled to take effect; and vi) whether you are likely to die before you believe the investment should be sold. To make the analysis even more complicated, another tax rate will potentially be applicable to capital gains. If you sell a capital asset after December 31, 2010, that you acquired after December 31, 2000, and have held for more than five years, the federal tax rate will be 18% instead of 20%. After 2012, the 18% rate will become 21.8% when the 3.8% Medicare tax becomes effective.

Let's start with a fairly simple example using only the variables of investment return and length of holding period. Assume you hold a stock that you acquired prior to December 31, 2000, that is now worth $100,000 in which you have a zero tax basis. You expect the stock to continue to appreciate at 8% per year for two more years at which point you believe it will have reached its potential and should likely be sold. Should you sell the stock in 2010 to capture the 15% tax rate and then immediately re-purchase it to capture what you expect to be 8% growth for an additional two years? If you live in a state with no income tax the answer is yes. The $100,000 gain resulting from a sale today would be subject to federal tax of 15%, leaving you with $85,000 to re-invest. If you then re-purchase the same stock to hold for two more years and it appreciates at 8% per year, in two years it will be worth $99,144. When you sell it again, you will have additional gain of $14,144, now taxed at 20%, or $2,829. This leaves you with after tax proceeds of $96,315. If you simply continue to hold your original position in the stock for two more years, its current value of $100,000 will grow to $116,640. Your tax at 20% will be $23,328, leaving you $93,312 after taxes, so you would have been better off to sell in 2010 and then immediately re-purchase the position.

If you believe you would hold the investment for more than two years, beginning on January 1, 2013, the federal tax rate on long-term capital gain will be 23.8%, due to the 3.8% Medicare tax on investment income that takes effect. Note that the 18% rate would not apply here because we have assumed that you acquired the investment before December 31, 2000. It will take even longer for the holding strategy to catch up with selling before the end of 2010 and re-investing your proceeds in the same stock. Assume you sell your position today, pay the $15,000 capital gain tax and then re-purchase the same stock and hold it for seven more years during which time it appreciates at 8% per year. Your stock would be worth $145,675 and your additional gain would be $60,675, taxed at 21.8% or $13,227. Because you re-purchased the position after December 31, 2000, and then held it more than five years, your capital gain tax rate is 18%, which becomes 21.8% with the Medicare tax. Your after tax proceeds would be $132,448. If you held the original $100,000 for seven more years, it would be worth $171,382, all of which would be subject to tax at 23.8%. Because the original position was acquired before December 31, 2000, it does not qualify for the 18% tax rate. Your tax would be $40,789 and your after-tax proceeds would be $130,593, just slightly less than you would have if you sold the position in 2010 and re-invested your after-tax proceeds. At eight years, the two approaches produce about the same result.

If you expected appreciation of 15% per year, the break even holding period would be about four years. The rate of return and holding period are inversely correlated. That is, the higher the rate of return, the less time it takes for the strategy of simply holding your original position until you believe the stock should be sold to catch up to the strategy of selling in 2010, paying tax on your current gain at the 15% rate and re-investing the after-tax proceeds.

The analysis changes if you are also subject to state income taxes on capital gains. Because you lose more of your current principal to taxes when you sell, the strategy of simply holding the current position and paying a higher tax rate on all of your gain will catch up even faster. Let's assume you live in a high tax state like California where you might pay a 10% state income tax. If you sell your position in 2010, your total tax rate is 25% compared to 33.8% beginning January 1, 2013. Instead of taking eight years to reach break even at an 8% appreciation rate, you would now reach break even in only about five and one-half years. The more initial tax you have to pay, the faster the strategy of simply holding the original investment will catch up.

The difficulty of this analysis is accurately predicting the variables. How rapidly will the investment appreciate in the future? When will you want to sell it? Will the tax rates be changed again before you sell? For most, the best approach is simply to observe a few simple rules of thumb. Investments you intend to hold indefinitely into the future should be held. You should not sell these investments, pay tax on your current gain at 15% and then re-invest the after tax proceeds, even in the same asset. For investments you are fairly sure you will sell in the near future, you might save some taxes by selling now and re-investing, even if in the same asset. However, the savings may be fairly minimal and may not offset the additional brokerage costs of selling your position a second time. Also, people experiencing rapid deterioration of their health should generally not sell appreciated assets. It is expected that beginning in 2011, the tax basis of a decedent's assets will once again be stepped-up to fair market value. By simply holding appreciated assets until your death, all tax gain can be eliminated and the difference in rates will not be relevant.

Ordinary Income Tax Rates Increase from a Maximum of 35% to 39.6%

Beginning in 2011, the maximum federal tax rate on ordinary income will increase from 35% to 39.6%, with a further 3.8% increase in the tax rate for investment income beginning in 2013 due to the Medicare tax. This raises the question whether you should attempt to accelerate ordinary income into 2010 (assuming you have the ability to do so)? If you have a chance to receive an income item in December instead of January, it may be advantageous to do so.

The tax on income you receive in December may be paid earlier than if you received the payment in January, although with the estimated tax payment requirements, it may not be paid all that much earlier. Even if you assume that in the best case you could defer the tax for a full year by receiving the payment in January, in what will you invest that has virtually no risk of loss and will return nearly 5% over one year? If you have something, please let us know.

Not everyone will have the ability to accelerate their receipt of income. You must also take into account other possible implications to your tax picture. For example, having more income in 2010 means a higher threshold before medical expenses are deductible and a higher threshold before miscellaneous itemized deductions are allowed. Unless your numbers are very large, the difference is probably too small to spend much time analyzing.

Tax Rate on Dividends Increases from 15% to 39.6%

One of the most dramatic changes will be to the tax rate imposed on dividend income. It is presently scheduled to increase from 15% to 39.6% on January 1, 2011, and to 43.4% on January 1, 2013. Even President Obama has indicated that he believes the top rate on dividends should be 20%, but Congress will have to agree to legislation to make that happen. If the rate does go to 39.6%, it may be necessary to re-evaluate your investments in dividend paying stocks, compared to other asset classes. Let's assume that with state taxes added, your effective tax rate on dividend income will become 45%. If a stock has a 4% dividend yield, your after-tax yield will be 2.2%. You might find a tax-free state or municipal bond that you like providing a similar or better yield.

Of course, there are many other considerations to be taken into account, with respect to which you should consult your financial advisor. Some have expressed concern that the prices of stocks of companies that pay large dividends may drop if this dramatic increase in the tax rate on dividends takes effect. However, if selling your high dividend paying stocks results in a gain, you will have a smaller sum to re-invest after you pay your income tax. This is also a subject worth raising with your financial advisor.

Should you defer deductions and losses?

Itemized deductions and other deductions from ordinary income will have greater potential value in 2011 than in 2010 due to the higher income tax rate (39.6% in 2011 vs. 35% in 2010). You do not have complete control over the year in which you have to pay many of your deductible expenses, but for some you do. Charitable contributions are a good example. You could make your donation in December or January. January may be better because each dollar donated can reduce your federal income tax bill by 39.6 cents compared to 35 cents if you write the check in December. It may also be beneficial to defer capital losses until 2011 or even 2013, when the tax rate on long-term capital gain may be higher. The benefit of deferring deductions and losses is reduced somewhat by time value of money considerations since the tax savings from the deduction will come at a later time.

You do need to remember that for 2010 only, there is no phase-out of itemized deductions. Beginning in 2011, the original phase-out provision returns. Your allowed itemized deductions will be reduced by the lesser of: i) 3% of your adjusted gross income in excess of an inflation adjusted amount; or, ii) 80% of your itemized deductions. Only medical expenses, investment interest and casualty and theft losses are not subject to this limitation. All other itemized deductions are subject to this limit. For 2009, the inflation adjusted amount was $166,800. The amount for 2011 will be announced soon. If you do not expect your itemized deductions in 2011 to exceed your phase-out amount, it may make sense to move any deductions you can into 2010 when there is no phase-out.

Roth IRA Conversion in 2010

Beginning in 2010, there is no longer an adjusted gross income limitation to be able to effect a Roth IRA conversion. For prior years, you could not convert a regular IRA to a Roth IRA if your adjusted gross income was in excess of $100,000. There continues to be an income limit on making new contributions to a Roth IRA.

If you convert a regular IRA to a Roth IRA, you must pay income tax on any previously untaxed amounts in the account. The taxable amount is ordinary income and cannot be offset by capital losses. Thereafter, the amount in the Roth account will continue to accumulate tax-free and there will also be no tax when you withdraw amounts from the Roth account, provided they have been in the Roth account for at least five years. A further benefit is that with a Roth account, you do not have to begin taking withdrawals from the account when you reach age 70 ½, as you do with a regular IRA.

While you can convert your regular IRA to a Roth IRA in 2010 or any later year, there is an extra benefit to doing so in 2010. For conversions made in 2010, you do not have to pay tax on the converted amount in the 2010 tax year but instead pay tax on one-half of the amount as part of your 2011 and 2012 taxes. Your tax will be determined based on the rates actually in effect for those years. If you prefer to pay all of the tax for the 2010 tax year (due to higher rates in 2011 and 2012 or other factors), you may elect to do so.

Another beneficial feature of converting is that you can un-do the conversion any time up to the due date with extensions for your federal income tax return for the year of the conversion. For most, this will be October 15 of the following year. Some reasons why you may want to reverse the conversion would be if your investments in the account drop sharply after you convert, or if your income for the year you convert turns out to be higher than you expected.

Whether conversion is advantageous is somewhat difficult to analyze. It depends on many variables that are difficult to forecast. In general, you should meet two key criteria to consider converting an IRA to a Roth IRA: i) you should be able to pay the tax on the converted amount from funds outside of your IRA in order to maximize the amount that will continue to accumulate tax-free in the Roth IRA; and, ii) you should expect that you will not need to withdraw amounts from the Roth IRA until you are substantially older than age 70 ½. The longer you can leave the funds in your Roth account, the greater the potential benefit of converting. Your financial advisor and accountant can assist you with this analysis.

Please do not hesitate to contact us for additional information if you believe that any of the issues discussed above may be relevant to your particular circumstances.

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