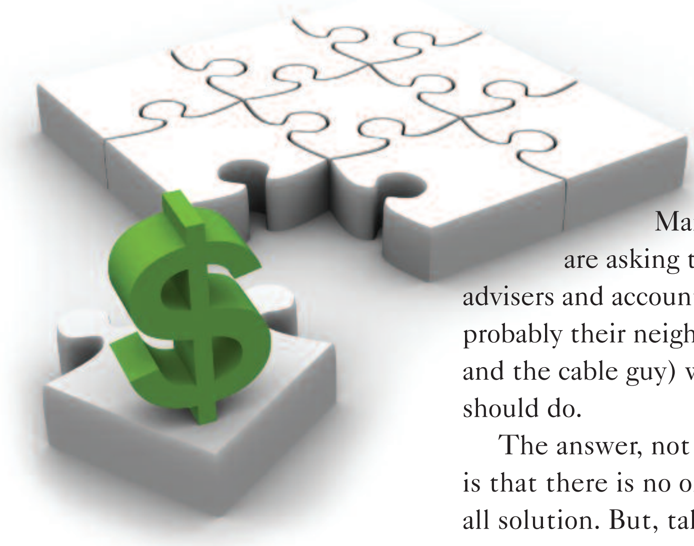
Tough Choices for Investors: Tax Strategies for Uncertain Times

By David Gray, CFP®



The year-end deadline for taking advantage of a rare opportunity to transfer retirement savings from a traditional IRA to a Roth IRA, without limitation due to income, is fast approaching.

Many taxpayers are asking their financial advisers and accountants (and probably their neighbors, barbers, and the cable guy) what they should do.

The answer, not surprisingly, is that there is no one-size-fits-all solution. But, take heart, the

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path toward figuring out what is right for you runs through a familiar strategy: diversification. Just as investors diversify their assets to maximize investment returns and reduce risk, taxpayers need to think about diversity in terms of tax orientation. That means considering how much you have in regular taxable accounts; tax-deferred retirement accounts like traditional IRAs, 401(k)s and 403(b)s); and nontaxable accounts such as Roth IRAs and Roth 401(k)s.

This year's Big Question hinges on the difference between the tax-deferred accounts and the nontaxable Roths. One of the advantages of tax-deferred accounts is that they are funded with *pre*-tax dollars, meaning that when you withdraw the money later (typically in retirement, when income and taxes often are lower) you will pay income tax on both the original investment and the growth on that investment. Roth accounts are funded with *after*-tax dollars, so you won't have to pay any income or capital-gains taxes when you take funds out.

Until this year, there had been an income limit that precluded anyone with modified adjusted gross income of more than $100,000 from converting traditional, pre-tax IRA funds to Roth IRA funds. Those rules have been temporarily lifted (through the end of the year), allowing anyone at any income level to convert some or all of their traditional IRA funds to a Roth.

The catch is that any traditional IRA money, on which taxes have not been paid, that is rolled over into a ROTH IRA, will be treated as regular income and taxed accordingly. You can pay all the taxes with your 2010 return or you can opt to pay the taxes as if you had converted half the money in 2011 and half again in 2012.

As the rules exist today—note the use of the word 'today'—Roth IRA funds will grow tax-free and the funds will not be taxed when withdrawn, assuming the Roth has been open for at least five years and you are at least age 59½. Importantly, Roth IRAs can be useful in estate planning because they don't require minimum distributions at age 70½: The money can continue to grow tax-free.

The traditional answer to the question of 'what should I do?' would be that if you think you are going to be in a higher tax bracket when you retire, and if you think that your money has some years to grow, a Roth IRA would be beneficial. Alternatively, if you are likely to have lower income and a lower tax rate when you are retired, a traditional IRA might make more sense. A lot of calculating and predicting is involved: If you pay the taxes now on the money rolled over into a Roth IRA, how long and at what rate of return will you need to invest in order recoup the portion lost to taxes? What *assumptions* must be made about your taxable income in retirement and about your post-retirement tax rate if you keep your traditional IRA?

For many taxpayers confronting the question, the sticking point is the word 'assumptions.' Although economists, financial planners and tax preparers try to predict the future, none can do it with confidence. Changes in income- and estate-tax rates are likely to be hotly debated for years to come, both in Washington and in state capitals. Can anyone be confident that tax rates and treatment of the various tax and investment options won't change? Current government deficit spending argues for the idea that taxes will be higher in the future. But whose taxes? Which taxes? Does anyone know?

The top federal income tax rate has ranged from as little as 7% to as much as 94% during the past 100 years. Of course, not everyone is exposed to the highest rate, but it is interesting to note that the highest rate changed, on average, every 2½ years. The longest period during which the top rate held steady was 10 years. Can you really be confident in projecting any particular tax rate into the future?

Even if the tax rates don't change, the rules might. Millions of people found out that their deductions for state and local income taxes and real estate taxes were no longer reducing their tax bills. How? Not because anyone said, "Your local taxes will no longer be deductible on Schedule A of Form 1040." They found out when they became subject to the Alternative Minimum Tax (AMT).

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If people had known that they might become ensnared in the AMT, would they have made different decisions about where they live and work?

These changes are not always the work of one political party or another. Substantive changes may not even require passage of any legislation. It used to be that Social Security retirement benefits were not taxed. Then an administrative rule change under President Reagan in 1983 made 50% of benefits taxable. That amount was increased under President Clinton.

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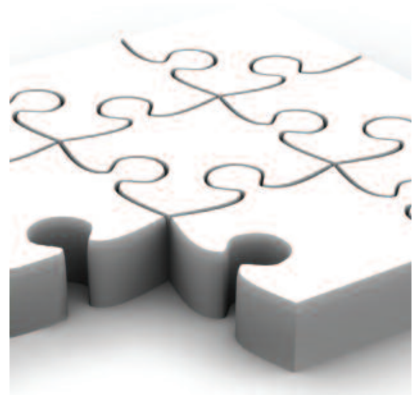

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