Boulder County Business Report

Section A | Nov. 12-25, 2010

Financial moves for 2011, before the sunset

Barring action by a lame-duck session of Congress, federal tax rates are set to rise sharply in 2011 for all income levels, as the Bush tax cuts sunset back to their pre-2001 levels.

GUEST OPINION

Robert J. Pyle

The top tax bracket is scheduled to go up from 35 percent to 39.6 percent. Qualified dividends will revert to being taxed as ordinary income, which means they could be taxed as high as 39.6 percent. Long-term capital gains will be taxed at 20 percent instead of 15 percent and short-term capital gains will be taxed at your marginal rates as before, but the rates likely will be higher than in 2010.

If you haven't reviewed your investment portfolio to best allocate your assets to minimize your expected tax burden, now would be the right time to do so. For example, if you have taxable bond funds in your taxable account and stock funds in your IRA you should sell the bonds funds and buy stocks funds.

You should simultaneously sell stock funds in your IRA and buy bond funds. REIT mutual funds should be located in your tax deferred accounts too. Be aware of the wash sale rule, which disallows claiming any loss on those stock sales if you repurchase the stocks within 30 days.

Conversion opportunities

There is a special opportunity in 2010 by which you can convert your IRA/401(k)/SEP/Simple IRA regardless of income to a Roth IRA. Previously, only people with an adjusted gross income of less than $100,000 could convert. This restriction is lifted in 2010 and beyond. The special circumstances related to 2010 are that you can spread out the income from the conversion over 2011 and 2012 or recognize it all in 2010.

CONVERTING IS A HEDGE against higher tax rates in the future. If you think your tax rate will be higher when you retire, then it is beneficial to convert.

Converting is a hedge against higher tax rates in the future. If you think your tax rate will be higher when you retire, then it is beneficial to convert. You can pay taxes on the conversion in 2010, or spread out the income over 2011 and 2012. One of the beauties of the Roth IRA conversion process is the opportunity for a do-over. If you extend your 2010 tax return until Oct. 15, 2011 then you have until then to unconvert and return to the previous setup.

One great candidate for a Roth conversion is a high-net-worth family who would like to pass on their asset to their heirs. If the family has the ability to pay the taxes upfront, no need to use the minimum IRA distributions, and they are in the highest tax bracket, a conversion is likely a good move in the long run. The conversion amount would face a one-time tax, but eliminate future required taxable minimum distributions from the IRA and shift the funds to a tax-free environment for you and your heirs. It would lower future estate tax rates which could be as high as 55 percent.

Also, in 2013 portfolio income will be subject to a 3.8 percent tax if you are over a certain threshold. The conversion will reduce your overall income and possibly make you less likely to be subject to this tax.

Another opportunity would be to max out your Roth 401(k) to take advantage of the lower current rates. By maxing out your contributions in 2010 you are taking advantage of paying tax on income at a lower rate now.

When to take gains

Higher taxes ahead are leading many investors to ask whether they should they take capital gains now and pay at the 15 percent rate, and reset their basis to a higher number in anticipation of higher capital gains rates in the future?

The decision depends on a number of factors such as expected holding period of the current asset and the expected future rate of return of the asset. This situation takes some analysis, but in general if you plan to hold the asset only for a short time, then it may be better to sell now and pay at the lower rate.

Decisions are also to be made as whether to realize short-term gains, or exercise non-qualified stock options now or in the future when marginal rates likely will be higher.

All of these decisions require some careful analysis by a trained professional who fully understands your financial goals, values, wishes and your unique personal situation.

Robert J. Pyle is president of Boulder-based Diversified Asset Management Inc., an investment adviser registered with the Securities and Exchange Commission. This column reflects the writer's views and is not a recommendation to buy or sell any investment. He can be reached at 303-440-2906 or via e-mail at rpyle@diversifiedassetmanagement.com.