Tax Relief
by John Burns
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On December 17, Americans received an 11th-hour extension of the Bush tax cuts when President Obama signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 into law. Essentially, it maintains the status quo for income tax rates, putting off a return to higher rates until 2013. Investors will benefit from an extension of long-term capital gains and qualified dividend tax rates as well, which will also remain at current levels through the end of 2012.

The Act does, however, enact several new changes that will affect personal financial planning decisions. Estate and gift tax exemption levels were expanded generously, and the rate at which the remainder of transferred assets can be taxed was lowered. This presents a great, albeit unexpected, planning opportunity for many higher net worth individuals and families to consider before 2013 begins and the extension expires.

It is important to note the current extension is more likely a stay-of-execution rather than a step toward making current rates permanent, particularly for the top income tax brackets. Though making investment decisions based on speculation over future tax rates is not ideal, it is reasonable to expect the federal government's continued spending levels will eventually lead to higher levels of taxation. This should be considered when structuring an investment management strategy.

The Roth IRA conversion option for 2011 and 2012 increased in appeal with the income tax rate extension. It should never have received the broad endorsement for all investors that was echoed by the marketing departments of major banks last year, but it does make sense for some of those who make too much to qualify for direct Roth IRA contributions. The general rule for the next two years should be: The younger the investor, the longer the time horizon available to compensate for the upfront tax implications of making the conversion. If higher income tax rates can be expected in 2013, then this is worth considering now.

The extension of capital gains and dividend tax rates enables investors to delay moving into tax deferred products like annuities. This benefits investors as a group because, although annuities offer tax deferred growth, their payouts are taxed at normal income rates, which tend to be higher than the long-term capital gains rate.

It is interesting to note annuities could gain in appeal down the road if the capital gains rate rises, closing the gap on normal income tax rates. Moving the bond component of a portfolio into an inexpensive annuity could make sense, since the investment proceeds are already held to income tax rates and would benefit from the annuity's tax deferral. But for higher growth assets like stocks, investors could be forfeiting the opportunity to capitalize on lower future tax rates. There is no easy way to get out of an annuity once it is purchased, so those who make the switch will miss the benefit of any lower tax rates on long-term capital gains and dividends.

Investors can be certain about at least one point: The tax landscape will continue to evolve over the next several years, so it is essential to have a strong understanding of how current rates impact an investment strategy and even more important to have a financial plan addressing the implications.