The Financial Navigator - January Newsletter

Happy 2010, in this issue we wanted to update you on some recent tax developments, or lack thereof, courtesy of our over-worked Congress. In addition, we touch on a great opportunity available in 2010 to convert retirement assets such as IRAs to Roth IRAs and pay the taxes over 2011-2012. This opportunity is available to all tax payers regardless of income levels. The chance to pay any income tax due because of the Roth IRA conversion over a two year period is only available in 2010, so this may be an once in a lifetime opportunity.

2010 Tax Developments

Recently in the *Wall Street Journal*, Stephen Moore wrote an article titled "The New Year Brings Tax Chaos." If you missed it I thought I would summarize some of the more salient points, although the first line of the article says it all: "Happy New Year. Your tax bill just went way up."

Basically when 2010 dawned many new taxes on the middle class and small businesses went into effect as many deductions and tax breaks expired due to Congress's inaction. According to Congressional leaders it will enact new tax laws to reinstate many of the tax breaks that expired; however, to do so it will have to come up with billions of dollars. This is perhaps a daunting prospect since the administration has suddenly caught the fiscal responsibility bug. According to Mr. Moore some 70 'new taxes' went into effect as of January 1, some of the more widely known tax breaks that have expired are:

- The alternative minimum tax (AMT) so called 'patch' expired, so 25 million middle class citizens earning as little as $75,000 will get hit with it. The AMT was originally designed in the late 60s to hit the 155 richest Americans, but Congress forgot to index it to inflation and has constantly tinkered with it, so each year it pulls in more middle income tax payers. And each year the geniuses in DC pass only a temporary fix, or 'patch', as even they know that teachers and firefighters weren't the original targets of this tax. Maybe they will fix it again, but the cost will be some $63 billion, so maybe they won't. Perhaps Bill Gate's CPA has some good tips on how to avoid the AMT since now many of us are 'rich' even though we don't feel it.
- The tax deduction for state and local taxes is gone for 2010.
- Ditto for the federal tax deduction for college tuition and fees.
- Small businesses, the ones that are being counted on to grow and hire many of the unemployed, lose the 50% write off for capital purchases. Result is more money for Uncle Sam, less for investments in equipment and capital, that should fix the economy.
- Finally, the one that takes the cake, the estate tax fell to zero for 2010, and it then comes back in 2011 at 55%. As it stands today, you could pass $1 billion, or any amount, to heirs in 2010 tax free. However, in 2011 the estate tax comes back with a vengeance and will hit anyone trying to pass more than $1 million to heirs excluding their spouse, or $2 million for a married couple as long as they have a proper estate plan. $1 to $2 million sounds like a lot, but if you consider the value of your home, life insurance, and investments those limits can be hit pretty easily. Just an FYI, in 2009 you were able to pass $3.5 million per person untaxed to your heirs, or $7 million per couple, so in essence we are going backwards as the tax will hit smaller estates. In 2001 Congress created this mess and had nine years to fix it, as everyone in the financial field expected they would, instead they punted. Look for a spike in the death rates of wealthy Americans this year.

Now as stated, Congress may pass new tax laws to reinstate many of the tax deductions and credits that have expired, but I wouldn't bet on all of them coming back due to budget deficits. The take-away from these developments, or lack thereof are: 1. As you are doing your 2009 taxes speak with your CPA about 2010 and plan around the above changes, and on possibly an increased tax bill for 2010; 2. If you don't have an estate plan (wills, family trust, living will) get one from an attorney (not online), or think about the consequences, starting next year, if half your wealth goes to Uncle Sam instead of your heirs.

I will end this section with the last few lines of Mr. Moore's article as they succinctly drive home the ridiculous situation Congress has placed us in.

"*What no one in Congress seems to understand is that there is a very real economic cost to constantly tinkering with the tax laws. Uncertainty is the enemy of investment. Do businesses want to make major investment decisions based on congressional promises of a future tax break? Likely not. So right now millions of businesses and tens of millions of individual tax filers are stranded in tax purgatory... Congress's failure to settle the tax laws for 2010 is an unforgivable dereliction of duty. The federal government isn't so understanding when American citizens are late paying their taxes: The IRS imposes strict civil fines and even criminal penalties. We should hold Congress to the same standards.*"

Stephen Moore, "The New Year Brings Tax Chaos", The Wall Street Journal, 8 January 2010, p. A15.

Roth IRA Conversions

The Taxpayer Relief Act of 1997 created a type of IRA known as the Roth IRA. Contributions made to a Roth IRAs are not tax deductible in the year they are made; however, contributions and earnings grow tax deferred until needed in retirement, and withdrawals are tax-free once you are in retirement. Roth IRAs are not subject to required minimum distributions at age 70½ like most retirement plans, the funds do not have to be withdrawn until they are needed. These provisions can allow for significant tax-free growth of assets and make Roth IRAs very attractive, especially with the uncertainty of future tax rates. However, income limits ($167,000-married or $105,000-single) for Roth contributions have limited access to this retirement vehicle for many high income tax payers.

The "Tax Increase Prevention and Reconciliation Act of 2005" (TIPRA) created an opportunity for converting existing IRA accounts to Roth IRA accounts. Until 2010, your modified adjusted gross income had to be under $100,000 (single or married) to be eligible to convert a traditional IRA to a Roth IRA. TIPRA removed the income restrictions for conversions that take place after December 31, 2009. An additional advantage to a conversion in 2010 is that TIPRA allows for any taxes owed on the conversion in that year to be delayed and spread ratably over the two-year period of 2011 and 2012. If you have an existing traditional IRA, this may be the year to consider converting it to a Roth IRA especially if your future income will limit any future contributions. Tax free income in retirement could be invaluable as future tax rates will likely be higher than current tax rates. Of course first consult with your CPA or financial planner to determine the pros-cons of doing a conversion and the related tax strategies.

If you have any questions on this topics, or need some help with other financial issues you are facing give me a call at (603) 373-8793.