IRA UPDATE: MARCH 2013

With the American Taxpayer Relief Act that was passed in 2013, there are some new tax considerations to be aware of.

NUA planning with ATRA

NUA or Net Unrealized Appreciation has to do with employer stock within a 401k plan. NUA allows the plan participant to take the employer stock out of the plan in-kind and transfer to a taxable brokerage account while only realizing ordinary income on the original cost of the shares. The gains, or NUA is taxed at long-term capital gains (LTCG) rates but only when the shares are actually sold. See http://portnofffinancial.com/blogc57.php?postID=46&article=Net-Unrealized-Appreciation-%28NUA%29-tax-break for more details on NUA.

Previous to 2013, the difference between the top rate of 35% and the LTCG rate of 15% meant a 20% potential tax savings when using the NUA strategy. With the new top rate of 39.6% and 20% top capital gains rate; difference is 19.6% which is close however one must consider the 3.8% surtax on net investment income. The surtax would be applied on the income generated from the sale of shares after the distribution and thus the tax would be 23.8% which is 8.8% higher than in 2012. In other words the potential tax savings is reduced to 15.8% from 19.6%.

As an aside, almost no one will actually pay 20% capital gains because if your income is high enough to be in the 20% capital gain territory, you are probably also subject to the 3.8% surtax which is why you would pay 23.8%.

It is important to look at the potential tax savings but also important to consider that any future growth of distributed stock would no longer have the protective shell of tax deferral. Once the stock is sold, the capital gain would be realized. Any future income derived from the stock such as dividends would be taxable in the year received. Also the stretch IRA for beneficiaries would no longer be applicable to distributed NUA stock.

A key consideration: Is there significant appreciation on NUA stock and when will you need the NUA funds? If the gain on NUA is not significant, the benefit is less because it may cost a lot in having realized the ordinary income to get the NUA out at ordinary rates if there is a relatively small amount of NUA that would get the LTCG treatment. However if you are going to use the funds soon after distribution, the benefit is high because some of the money that would have been taxed at ordinary rates gets the long-term capital gains treatment instead. If holding for a long time before selling the shares, you have to evaluate whether it makes sense or not.

Roth Conversion Strategies

Roth conversion strategies need to be review and revised in light of the new tax rates. Taxpayers who are subject to the return of the 39.6% bracket obviously pay more tax and need to consider whether they want to convert at this rate. Since the Bush tax cuts for most taxpayers were made "permanent," those who converted into higher tax brackets in

2012 may want to revisit and determine if they should recharacterize and begin to reconvert over a longer period to keep their marginal tax rate lower.

Even with higher rates for high income, taxable assets are still subject to the 3.8% surtax and thus Roth conversion will help to reduce taxation on those types of funds if you were to use those funds to pay the tax on conversions. There certainly is no guarantee that congress won't come back and raise tax rates even more which is already being discussed and this should be factored into your decision to what income tax bracket you will convert to.

Planning with new estate tax threshold

With the estate tax being set at $5 million with portability and inflation adjustments means only the wealthiest will pay estate taxes, that is unless and until this level is brought back down. The Generation Skipping Tax (GST) exemption is set at $5.25 million instead of going back to $1 million. The estate tax rate went up to 40% from 35% but this is only on the amounts about the exemption.

Wealthy IRA owners may want to consider naming grandchildren as beneficiaries of IRAs to take advantage of the $5.25 million GST exemption and the stretch for the younger generation. Trusts may be necessary for grandchildren so watch the wording and the type of trust used so as to not affect the stretch and force small amounts of income to trust and estate tax rates which hit the highest bracket very quickly.

If the estate is potentially large enough, strategies to reduce the estate size such as gifting, Roth conversions, and life insurance via ILITs (Irrevocable Life Insurance Trust) should be considered. You must also consider even though there is a large federal exemption amount, some states still have their own estate tax with different thresholds such as NJ which sits at a $675,000 exemption amount.

Gifts can be given to family members who may be in lower tax brackets to help them convert their own IRAs to Roth IRAs. This can also mean gifts to parents who are in lower tax brackets. Helping a parent or even a grandparent convert their IRA to Roth means that Required Minimum Distributions cease and when you inherit, you can get a tax free stretch, or if you don't need it, have the younger generation named as beneficiaries so that they get lifetime tax free distributions.

Misc Tax Planning

- Itemized deductions begin to phase-out at $300,000 for Married filing joint ($250,000 for single filers) up to $422,500 ($372,500 for single filers).
- AMT exemption amount has been permanently indexed to inflation. For 2013 the amount is $80,800 ($51,900 for single filers).
- Qualified Charitable Distributions temporarily extended for 2013.
- In-plan Roth conversion rules have expanded.
- Top trust tax rates starts at $11,950 which means that distributions from inherited IRAs to discretionary trusts that can retain those distributions hit the 39.6% tax rate very quickly.
- Salary deferrals for 401k, 403b, etc, can reduce the MAGI for the 3.8% surtax however cannot reduce income for purposes of the 0.9% Medicare surtax.

As always, please consult with a qualified tax professional and financial advisor to determine if these strategies are right for you.

Sincerely,

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