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Mid-Year Reality Check: Covering Your Bases in Uncertain Times

Imagine playing a complicated game, but the rules of the game are changing, and the new rules have yet to be announced. That's what income tax planning is like this year. In fact, if there was ever a year to spend some quality time with your financial professional, this is it. Here are a few items to discuss.

How will higher rates next year affect you?

Federal income tax rates are scheduled to jump in 2013, with the bottom (10%) rate disappearing, and the top rate increasing from 35% to 39.6%. Starting in 2013, high wage earners--those with wages exceeding $200,000 ($250,000 for married couples filing jointly and $125,000 for married individuals filing separately)--will also have to pay an additional 0.9% in the hospital insurance (HI) portion of their payroll tax, commonly referred to as the Medicare portion.

Could the current federal income tax rates be extended again? Of course, but it's far from a certain bet, and the odds are that any action would not take place until after the presidential election. That means any financial plan you put in place has to account for this uncertainty. And the uncertainty extends beyond just tax rates, because a number of popular tax breaks are also scheduled to expire at the end of the year, while others have already expired. So, any potential moves have to be considered in the context of several "what if" scenarios. For example, if you have the opportunity to defer compensation to next year, you have to really think about whether that makes sense, or if you would be better off paying tax on the income at this year's rates.

Potential investment moves

In addition to increased tax rates on earnings, the rates that apply to long-term capital gain and qualifying dividends are scheduled to increase in 2013. The maximum rate on long-term capital gain will jump from 15% to 20%. And while qualifying dividends currently benefit from being taxed at the rates that apply to long-term capital gain, in 2013 they'll be taxed at ordinary income tax rates. Also beginning in 2013, a new 3.8% Medicare contribution tax will be imposed on the net investment income of individuals with modified adjusted gross income that exceeds $200,000 ($250,000 for married couples filing jointly and $125,000 for married individuals filing separately). That means someone in the top tax bracket could potentially end up paying tax on some investment income at a total rate of 43.4%.

Potentially higher rates in 2013 could be a motivating factor in your investment strategy. For example, you might want to consider selling investments that have appreciated in value to recognize long-term capital gain in 2012, before the maximum rate is scheduled to increase. Alternatively, you might consider timing the sale of an investment to postpone the recognition of a capital loss until 2013, when it could be more valuable.

Roth conversions--is this the year?

If you've been on the fence about converting traditional IRA funds or pretax 401(k) contributions to a Roth account, you ought to give the matter one last hard look before the year ends. That's because when you convert a traditional IRA to a Roth IRA, or pretax dollars in a 401(k) plan to a Roth account, the converted funds are subject to federal income tax (to the extent the funds represent investment earnings, tax-deductible IRA contributions, or pretax 401(k) contributions) in the year that you make the conversion.

If tax rates go up next year, so will the effective cost of doing a Roth conversion. Additionally, qualified distributions from Roth IRAs and Roth 401(k)s are free from federal income tax. That could make a big difference in retirement if you're paying tax at a higher rate at the time. Whether a Roth conversion is right for you depends on a number of factors. If it makes sense for you, though, it might pay to think about acting now, rather than later.

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