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# *New tax law requires careful reading and planning*

John Schooler

Beginning in 2010, millions of tax filers will be able to ensure greater tax-free savings at retirement. This is because of the Tax Increase Prevention and Reconciliation Act of 2005 recently signed into law by President Bush.

The law allows conversion of traditional Individual Retirement Accounts to Roth IRAs for investors who are currently ineligible to do so because of income restrictions. The current $100,000 income limit will be eliminated in 2010.

You can begin taking steps now to prepare for this opportunity.

With a Roth IRA, withdrawals are tax-free. Also, the IRA owner, as opposed to the inheritor, effectively prepays the taxes owed. This lowers the estate tax and provides tax-free income to heirs that can be distributed throughout their lifetime.

Some people may become hesitant to convert because of the immediate tax ramifications during the year of conversion. However, if the conversion occurs in 2010, the tax can be paid over the following two years. More importantly, the long-term benefits will outweigh these immediate taxes. The Urban-Brookings Tax Policy Center estimates that $1 converted is worth $1.30 in present value.

Starting to put money aside now to pay the taxes would be prudent. Even if tax laws change, you will have saved money for retirement you might otherwise have failed to put aside.

You can prepare now by opening a nondeductible IRA. Contribution limits are $8,000 for married couples filing jointly and $4,000 for single filers. For those older than 50, the limits are $10,000 and $5,000, respectively.

One needs to be careful if planning to convert these funds.

“Assume that in 2010, your nondeductible IRA is worth $100,000 and you have a $40,000 basis,” said Barry Picker of Picker & Weinberg. “In addition, you have another IRA worth $900,000 from a 401(k) rollover. If you plan to convert the $100,000 IRA thinking your basis is $40,000, you’re wrong. In reality, it is not based on $100,000, but the total of all IRAs, $1 million.”

The new law states a person must take into account all IRAs, and then calculate the basis by dividing the nondeductible contributions by the total worth of all IRAs. In this case, that’s 4 percent or $40,000 divided by $1 million. Therefore $96,000 of the nondeductible IRA funds will be taxable and only $4,000 is a return of basis.

Picker believes this will trip up many people, and they will not find out until filing their tax returns. Someone who was going to retire in 2010 may want to wait before rolling over a 401(k) to an IRA if plans are to convert to a Roth IRA.

Part of the new tax law, pertaining to custodial accounts governed by the Uniform Gifts to Minors Act and Uniform Transfers to Minors Act, took effect in 2006. Previously, custodial accounts for children between 14 and 18 years old were not taxed on the first $850 in gains, and any capital gain beyond that was taxed at the child's reduced rate. Now any gains above $1,700 are subject to the kiddie tax, and are taxed at the parents' rate until the child is older than 18. So how does one save for college without being subjected to these higher tax rates?

The safest bet would be Coverdell accounts, otherwise known as 529 plans. However, Coverdell accounts are subject to income restrictions and have a maximum yearly contribution rate of $2,000. Both accounts are tax-free when the money is withdrawn to pay for an accredited university.

This law does not make these accounts completely worthless. After age 18, these custodial accounts are again taxed at the child's individual rate. They can be very practical for saving money for a major expense, such as purchasing a house.

Another advantage in this law is the extension of reduced rates on capital gains. In 2008, the rate at which capital gains are taxed will be reduced to zero for taxpayers in the 10 percent and 15 percent brackets. For all other brackets, the 15 percent current rate set to expire in 2008 was extended to 2010.

John Schooler can be reached at (858) 677-0477 or *john@wfpsecurities.com*.