Revisit Roth IRA Strategies for 2012

By Arthur M. Seltzer, CPA

The traditional approach to year-end tax planning, and the primary reason why it might not apply in a specific year, was aptly summarized by Rich Petrofsky in his September 2010 *ASSET* column:

"It is commonly said that the three most important tax planning rules are: defer, defer and defer. This is because it is *generally* (emphasis added) better to pay taxes later rather than sooner...This generally sound advice may have an exception for the right type of taxpayer in 2010."

The same rationale applies for 2012. The following is a review of this principle in connection with Roth IRA conversion strategies for 2012.

Basic Principles

There are two primary reasons why a person would want to accelerate tax liability by establishing a Roth IRA or performing a conversion:

- The expectation that the tax bracket after retirement will be higher than at present, and, more significantly,
- The expectation that the investments in the Roth IRA will increase substantially in value over time, generating tax-free future growth.

Pluses

The possibility of higher income tax rates in future years can reasonably be anticipated in the event that the Bush tax cuts are not extended and/or the new Obamacare income taxes go into effect. This provides an extra incentive to consider a Roth conversion in 2012, despite the additional current tax burden that would necessarily be incurred.

The significant stock market correction that occurred last year suggests there may be significant appreciation potential, particularly for stocks and investment sectors that were hit hard during the correction.

Conversion strategies should be focused on specific investments that have maximum potential to appreciate. Conversions can be timed to occur throughout the year when the overall stock market is down and/or the prices of the specific investments under consideration are depressed.

The opportunity to recharacterize investments that underperform, which can be deferred to as late as Oct. 15, 2013, by extending the Form 1040, provides scope for retroactive planning and fine-tuning. (Review of the fine points of this strategy are beyond the scope of this article.) Therefore, before the decision on recharacterization needs to be finalized, the investor will be able to take into consideration the outcome of the November elections and the early actions of the next Congress and administration.

Minuses

Where multiple assets are involved and the recharacterization only covers assets that have decreased in value, the "anti-cherry picking rules" do not permit the taxpayer to completely restore the status quo as if no conversion had been made.

One downside, which might be remote but can't be discounted, is the possibility of a statutory change in the tax treatment of Roth IRAs. The history of bipartisan expansion of the Roth vehicle (including the institution of Roth 401(k)s), which has historically been considered a revenue raiser by the Congressional budget gurus, and the extensive commitment to Roth vehicles by the public generate a significant constituency to oppose such a change.

Another possibility is that the emphasis on a total overhaul of the tax system could, as some advocate, result in the income tax system being replaced by a flat tax, a national sales tax or a value-added tax. Such a change would retroactively render the decision to convert costly, as the cost of the conversion will have already been incurred but the benefits might not materialize.

Conclusion

There is a possibility of significantly higher income tax rates and/or reconstruction of the taxing system. Another concern is the uncertain outlook faced by the national and international economies over the next few years. These considerations suggest you should be paying especially close attention to your clients' tax planning in 2012, and the rules that have likely guided your thinking in the past need to be reconsidered in view of these developments. Consideration of Roth IRA contribution and conversion strategies ought to be an integral part of that process.

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