InvestmentNews
The Leading Information Source for Financial Advisers

THE TAX-CONSCIOUS ADVISER

Robert N. Gordon

Beginning of the year tax strategies

Timing is important when looking for ways to help clients reduce taxes and save more for retirement

By Robert N. Gordon | Dec 16, 2014 - 12:01 am EST

When is the best time for clients to fund their retirement plans? One has until April 15, 2015 to contribute to their retirement plan for 2014, but is that optimal? A report from the Vanguard Group Inc. sheds new light on the issue.

Vanguard found that 10% of all the money contributed into the company's individual retirement accounts from 2007 to 2012 was invested in January, the first month it was possible to contribute. Unfortunately, double that amount, or 20% of all funds put into Vanguard IRAs, went in at the last possible moment, just before the April 15 deadline.

Of those who made single annual contributions to their IRA as opposed to multiple contributions, Vanguard found that 30% of IRA dollars were contributed in April, at the last possible minute. More than half of the dollars from this group were contributed after the taxable year had closed.

Vanguard calculated the cost of delay — they called it the “procrastination penalty” — of waiting as a decrease in the after-tax earnings of a little more 10%. The takeway: Why wouldn't someone want their funds invested in a tax-favored vehicle as soon as they could?

INCENTIVE STOCK OPTIONS

Employees who have incentive stock options that they want to exercise should make sure they do so in January or risk paying loads of alternative minimum tax on profits they never realized. The AMT is only applied if an employee holds the shares received from an ISO past Dec. 31. It does not apply if you dispose of ISO-generated shares in the same year you exercise. It might make more sense if the time period was 12 months from exercise but it is not.

If you exercise in Jan. 1, you have 364 days to decide to hold and be liable for the AMT or not. If you exercise on Dec. 1 you have only 30 days; why wouldn't anyone want to optimize this choice? Because the exercise of an ISO starts a new holding period, many employees try to hold the shares for at least 12 months after exercise in order to get a long-term gain instead of a short-term gain. But, in order to do that, you would have to hold through year-end, exposing oneself to the AMT.

The perfect plan for ISOs should be to exercise on Jan. 2, then if you still hold the shares on Dec. 31, measure the gain or loss that will be recognized upon sale. If there is a decent-sized long-term gain to be realized, then wait until the next year to sell, even though you will be liable for the AMT. If the gain isn't so large — or if it is a loss — then maybe you should sell before the end of the year. The goal is to not pay an AMT unless you know there's a good reason to hold over year-end.

When one converts to a Roth, the taxpayer has until they file a final tax return to observe the value of the Roth in order to decide to keep the Roth or to recharacterize the Roth back into an IRA. You get a chance for a do-over.

21 MONTHS TO DECIDE

This option can last as long as 21 months if you convert to a Roth on Jan. 1 or as little as nine months if you convert at the very end of the year. Utilizing multiple Roths would further optimize the ability to Roth, recharacterize and then re-Roth again the following January.

The government doesn't give us many choices. But when it does, you owe it to yourself to optimize them.

Robert N. Gordon (bob@twenty-first.com) is the chief executive of Twenty-First Securities Corp. and an adjunct professor at New York University's Leonard N. Stern School of Business.