Smart Tax Plays for January

Advisors can help clients make moves to maximize their tax health in the new year.

BY ROBERT GORDON

The new year is here, and it’s time for advisors to help their clients kick off a financially successful 2016. Tax optimization in particular can be tied to the calendar months.

Here are some January action items that may make a big difference in clients’ after-tax returns.

1. Fund Early
Contributions can be made to a tax-favored retirement account as early as Jan. 1 this year, or as late as April 15 next year. It seems obvious that, the sooner you get your clients’ money behind the tax shield, the more money there will be for them to use in retirement.

However, research from Vanguard shows that many people are inefficient at funding their retirement plans. Vanguard examined the IRA contributions of its clients for the years 2007 to 2012. Only 10% of the contributions were made at the optimum point in January; over 20% were funded in the very last month possible.

Clients can significantly improve their after-tax returns by being more diligent when putting money away for retirement. Vanguard modeled the “procrastination penalty” to be over 10% of the ending value of the investment when comparing one who funds on Jan. 1 to one who waits until the last moment to make a contribution for the previous calendar year.

2. Exercise
Sure, many of us make New Year’s resolutions to exercise. For clients holding incentive stock options, following through with that pledge can be critical in managing their possible Alternative Minimum Tax liability.

When clients exercise such options, there are AMT implications only if they continue to hold the shares they received past year’s end. The AMT is levied on the difference between the option exercise price and the market price at the time of exercise.

If the shares are at $100 and the option lets clients buy the shares at $20, there is $80 of income subject to the AMT, no matter what price the shares are sold for. Many ISO holders keep their shares after exercising, hoping to age them to long-term holding status. If the shares are sold for $100 after more than one year has elapsed, the $80 would be taxed as a long-term capital gain.

If the shares are disposed of in less than one year, then any gain above $20 is taxed as ordinary income. Unfortunately, many employees have watched their shares plunge in price and wound up paying an AMT on these near worthless shares. This is why the rules allow employees to avoid the AMT hit as long as they dispose of the shares before the year of exercise ends.

The rules do not grant clients 12 months to see how the stock does; they give the employee only until the end of the year of exercise to sell the shares and have no AMT implications. The gov-
Estate Planning for Tax-Deferred Investments

Advisors can choose from several different approaches to preserve their clients’ IRAs.

BY ALEXANDRA SMYSER

Many clients hold a tremendous percentage of their wealth in retirement plans, so it is crucial that advisors carefully consider how to help them transfer these assets to beneficiaries—particularly because retirement plans are subject to different rules than other financial accounts. Here are some approaches advisors can offer.

If a surviving spouse is named as beneficiary of an IRA, the spouse can roll over the IRA into his or her own name. The rollover allows the surviving spouse all the protections and privileges provided to the original owner. A straight rollover is perfect for the long-term married couple who are approximately the same age. The surviving spouse is considered the owner of the rollover plan, so any withdrawal before the age of 59½ will carry a penalty.

Another option would be to inherit the IRA as a non-spouse beneficiary, which allows the beneficiary to take a required minimum distribution annually from the IRA and let the remainder grow tax-deferred. This option may be a better choice if the surviving spouse is younger and may want to access the funds in the IRA before she reaches 59½.

There is no penalty (other than income tax owed) for taking out the annual distribution or a greater amount. The downside is that the full balance of the IRA is not growing tax-deferred for the surviving spouse’s retirement.

Naming a surviving spouse as a primary beneficiary is wise, as long as the couple agrees on who should inherit the IRA after the surviving spouse passes away. If, for example, the original owner wants to secure the remainder for his children after the surviving spouse passes away, it may be prudent to provide the added protection of naming a trust as the beneficiary of the IRA.

If the original owner wants more control over the IRA asset, then the client should name the trust as the beneficiary of the IRA; however, disaster can result if the trust is not drafted properly. The stretch-out works only if the trust qualifies as a “designated beneficiary” under the IRS code. Also, it is wise to name a trust as the beneficiary on behalf of a minor, a person with special needs or an irresponsible spendthrift.

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