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Strategies to use if taxes rise next year

Deferring deductions and accelerating income may make sense in bizarre world of hiked rates

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There are multiple strategies that can be employed once we know what will happen with taxes in 2011.

In my last column, I discussed selling taxable bonds late in the year to realize the accrued interest this year versus next. I also explored exercising non-qualified options that give rise to ordinary income.

Here I will go deeper and suggest a few more possibilities.

Why would you accelerate income into 2010 and pay tax in April 2011 when you could have done nothing and paid in April 2012? You wouldn't, unless we were facing the prospect of higher tax rates.

In the bizarre world of increasing tax rates, normal tax planning is turned upside down. Deferring deductions and accelerating income makes sense only in this “mirrored” world.

As an example, cash basis taxpayers can pay their state taxes in January. Likewise, leveraged individual investors can defer interest expense deductions by deciding to hold off paying their interest expense until January.

Normally, I advise investors to avoid purchasing mutual funds that are about to pay a sizable long-term-gain distribution. The conventional wisdom is that it is a bad idea to pay taxes on someone else's gains.

If capital gains taxes were going up and I knew an investor were going to have capital gains in 2011, I would suggest funds about to pay sizable long-term-gains distributions.

The investor would receive a distribution taxed at 15% this year, and by holding until January, any capital loss from the sale of the fund would be realized in 2011.

This 2011 loss could wind up sheltering 2011 gains either from the 20% long-term-gains tax or maybe even the 39.6% tax due for short-term gains.

Let's explore the choice afforded an investor who converts his or her individual retirement account into a Roth this year. Those who convert for tax year 2010 are given the choice to take all the income in 2010 or, alternatively, to take half the income in 2011 and the other half in 2012.

If taxes weren't changing, almost anyone would benefit by electing to spread the tax out to future years. The question is, would you rather pay 35 cents in April 2011 or 39.6 cents in April 2012?

In order for deferral to make sense, the investor would have to make 4.6 cents in after-tax return on the 35 cents that he or she was allowed to keep for the 12 months between April 2011 and April 2012. To make that 4.6 cents, the 35 cents would need to earn over 13% after-tax — not a reasonable expectation.

The two-year deferral demands a 6.5% after-tax return. Bottom line: Don't take the deferral option unless tax rates are to continue at this year's levels.

I heard from some who would like to explore further the wisdom of exercising non-qualified options this year, rather than at their expiration. It is clear that an option that will expire in January 2011 should be exercised if tax rates are scheduled to increase.

Why pay taxes at the higher rate expected to be in place next year?

However, it has been pointed out that by exercising early, the employee is accelerating income equal to the intrinsic value of the option at the cost of throwing away time premium. If the option had years to go before its scheduled expiration, this could be a costly direction to take.

As an example, a non-qualified option to buy employer stock at $20 is intrinsically worth $15 when the underlying stock is at $35. If the option were to expire in one day, its value would equate to the intrinsic value, but if the option were to expire in two years, the value of the option could be $21: $15 of intrinsic value and $6 of time value.

Early exercise “throws away” the $6.

Alternatively, I would suggest selling an exchange-traded call option with the same strike price and expiration as the non-qualified option. The investor would realize the $21 in the example, rather than only the $15 of intrinsic value.

We are advised that by selling a comparable traded option, the employee would be forced to realize the income this year under the constructive-sale rules of Internal Revenue Code Section 1259.

There are myriad possibilities once you begin to contemplate the upside-down world of tax planning in the face of increasing tax rates.

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