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Tax Time Comes With Many Changes to Tax Code

Retirement Accounts Hot Topic

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Tax time is always the most hectic time of the year for accountants and tax preparation professionals, but this year stands to be even crazier as people try to make sense of the Taxpayer Reform Act of 2012.

"For the majority of people, they're going to bring the same forms in," said Jeffrey T. Cutter, founder and president of Cutter Financial Group, as well as a member of the Falmouth Road Race board of directors, but this year higher income earners, beneficiaries of inheritances, retirees, and those planning for retirement are going to make their accountants earn their fee.

Mr. Cutter, a CPA, Personal Financial Specialist, and Wealth Manager, was recently interviewed by **The Wall Street Journal** about certain provisions in the Taxpayer Reform Act, elements of which he said he was very familiar with thanks to his earlier career as a certified public accountant.

That familiarity led him to draft a letter that is going out to his clients explaining some of the key elements of the Taxpayer Reform Act, the extension of certain parts of the so-called Bush Tax Cuts approved on December 31, 2012.

"There's 157 pages (to the law) and gosh, if you read through it, your head starts bobbing. This is boring stuff," he joked, "so I went through it, and it was amazing how favorable it is to 98 percent of our taxpayers. Really, there's not going to be much change."

That favorability is due in part to the greater level of certainty as to the act's future impacts on taxes because it was not passed with a "sunset clause"—an expiration date that would require further Congressional action in order to remain in effect.

Additionally, the law does not change tax brackets for most earners; the tax rate for those who make more than $400,000 a year if a single filer or $450,000 a year for married couples filing jointly will be 39.6 percent, up from 35 percent, but other rates will not change.

However, Mr. Cutter said despite the static tax rates for most earners, the amount paid in taxes could increase through changes elsewhere due to payroll tax increases, the phasing out of personal exemptions, and the "Pease phase-out"—a "3 percent haircut" on itemized deductions—for those making more than $250,000 a year (single filers) and $300,000 a year (married filing jointly).

"It'll hit the mortgage deduction, it'll hit any type of medical insurance expense, anything on a Schedule A," he said of the Pease phase-out. "Your itemized deductions go down, which means your taxes go up."

Those who exceed the $250,000/$300,000 income threshold will also be subject to the 3.8 percent Affordable Healthcare Act surtax; wages exceeding those thresholds will be subject to a 0.9 percent surtax.

One change that could affect workers' retirement plans, according to Mr. Cutter, "has been the hottest topic in our industry right now."

The lesser-known provision affects workers with 401(k) retirement plans thinking about moving those plans into a "Roth account," a type of individual retirement account. Normally a worker can convert a 401(k) to an IRA "and there's no tax consequences," Mr. Cutter said. "It's just a paper transaction."

There are, however, potential consequences for converting a standard 401(k) to a Roth 401(k), which people typically do to avoid paying higher taxes; money invested in a standard 401(k) is tax-deferred, meaning the account holder will pay taxes on money received through the account after retirement and would be taxed at the going rate. Roth 401(k) accounts allow account holders to pay the taxes up-front at the current, and in theory lower, rate.

"The beautiful part of the Roth is that you pay taxes on it now, so when you pull the money out later in life, it's all tax-free," he said.

Under the old law, converting to a Roth 401(k) required the account holder to be eligible to take a "distribution"—having the ability to take money out of the account—"but now you no longer have to do a distribution" and can do a direct conversion from one account type to the other, assuming the employer offers the Roth 401(k) option.

Mr. Cutter warned that the conversion, while potentially beneficial, comes with some caveats: once converted to a Roth 401(k), the account holder must be able to pay the tax amount at the time of conversion, and that tax bill could be considerable. The example he cited in The Wall Street Journal story: a client converted $500,000 from an IRA to a Roth 401(k) and got hit with a tax bill of $165,000.

"That piece is huge," he said, and once the trigger is pulled on the conversion, "there's very few ways to get out of paying the taxman," including filing for bankruptcy.

Also, the account holder cannot "recharacterize" the account, meaning "if the value of the account drops before you file your tax return, you're paying tax on whatever the account was" prior to the conversion rather than its current value, whereas standard IRAs allow for recharacterization to avoid an inflated tax payment.

Another change affecting IRAs: the return of the "Qualified Charitable Distribution" exemptions, which allow retirees taking distributions (payments) from their IRAs to direct those payments directly to qualifying charitable organizations in exchange for a tax break.

The other major change was to the estate tax exemption, which was made permanent in the new law. The $5 million threshold on the estate tax instated through the Bush Tax Cuts was set to expire at the end of 2012 but has been made permanent and indexed to account for inflation to $5.2 million.

This means that up to $5.2 million in assets transferred from a deceased spouse to the surviving spouse is tax-exempt, and if one spouse dies without using all of his or her $5.2 million exemption, the remainder may be transferred over to the surviving spouse.

Mr. Cutter stressed that any spouse hoping to take advantage of this benefit needs to fill out the proper form, Form 706. "This is where a lot of people mess up," he said, and without that form "you lose that portability portion."