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HOME

PLANNER RESOURCES

SHOULD YOU CHANGE YOUR RETIREMENT PLANNING IN LIGHT OF THE NEW TAX ACT?

Should you change your retirement planning in light of the new tax act?

The Jobs and Growth Tax Relief Reconciliation Act of 2003 raises several questions regarding retirement planning. Should you reduce your contributions to tax-deferred retirement accounts in favor of taxable accounts? Should you change what types of investments to put into taxable accounts versus retirement accounts? Does the act affect investing for retirees differently than it does those still saving for retirement?

Although the new act doesn't directly change the rules of tax-qualified retirement accounts, the lowering of ordinary income-tax rates and the rates on dividends and long-term capital gains is forcing a rethinking of some retirement planning strategies, say many experts.

One of the first debates is whether you should still try to fully fund your tax-qualified retirement accounts such as 401(k) plans or individual retirement accounts. The argument for relying less heavily on tax-deductible retirement accounts and more on taxable accounts is that many taxable investment earnings are subject to a lower tax rate than before. The act temporarily drops the maximum capital gains rate from 20 percent to 15 percent, and from 10 percent to a mere 5 percent for the lowest-income taxpayers (zero percent in 2008). In the most dramatic change, the rates on most stock dividends will equal the capital gains rates instead of being taxed as ordinary income.

Why not take advantage of these low rates by investing in taxable accounts, argue some, instead of letting capital gains and dividends grow inside retirement accounts where they generally will be taxed at higher ordinary income-tax rates upon withdrawal?

Because you'll miss out on the benefit of the tax-deductible contributions necessary to earn those capital gains and dividends, counter critics. In short, you'll have less money available to earn the reduced rates, thus offsetting the advantages. Moreover, if you belong to a retirement plan at work you could miss out on the "free" money offered when your employer makes matching contributions.

Page 2/New Tax Act Retirement Planning

Also, workers are less likely to tap a retirement account than a taxable account because if they do, they'll probably have to pay ordinary income taxes and early-withdrawal penalties.

There's more agreement among experts that the new act does change what type of assets are best to put into taxable versus nontaxable investment accounts for those still saving for retirement. Assuming you have fully funded your retirement account contributions, and are saving for retirement in taxable

accounts, the consensus is to put individual stocks, dividend-paying stocks, and index or tax-managed stock mutual funds in your taxable account and put investments that generate annual income that's subject to ordinary income-tax rates in your retirement accounts. These would include taxable bonds, real estate investment trusts and stock funds with high annual turnovers.

The tax cuts on investment income may also help retirees. Retirees typically rely on income-generating investments such as certificates of deposit, bonds and REITs whose payouts are still subject to ordinary income taxes. Some experts recommend that retirees decrease their allocation to interest-paying investments and increase their allocation in dividend-paying stocks and stocks that generate capital gains, though such investments traditionally carry higher risk.

The lower capital gains rates also make more advantageous a less-well-known tax strategy known as net unrealized appreciation. Workers who have accumulated loads of company stock in the company's tax-deferred retirement plan often roll all of their stock into an IRA when they leave the company in order to keep deferring taxes. But it can be more advantageous to withdraw the company stock and not roll it over to the IRA. The employee will pay ordinary income taxes on the stock—but only on the value of the shares when they were acquired, not what they're worth now. The difference between the basis and the current market price, which could be substantial, would be taxed at the new lower capital gains rates if the stock were immediately sold. The lower rates also will apply to new earnings from the stock as long as the stock is held at least a year.

The challenge for making any of these changes to your retirement investments is that all these tax-rate changes for investments expire by the start of 2009 unless Congress votes to extend them or make them permanent.

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