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Q&A

Navigating the Shifting Tax Landscape

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THIS is the year of tax uncertainty, and what might seem like temporary tax benefits could turn into tax traps.

Retirement accounts, charitable gifts and taxes that older, high-income Americans face on Medicare are all in dispute on Capitol Hill. As long as Washington dithers on tax policy, higher-income individuals and people with most forms of investment income will find it difficult to plan their economic lives.

Here is a look at the changing tax landscape, starting with little-known levies that can fall hard on higher-income retirees.

MEDICARE A retired couple can easily spend and be taxed more for their health care than what it costs an employer to provide health insurance for one worker and a spouse.

One couple — a husband and wife who both worked as professionals and delayed retirement past age 70 — will spend about $21,100 out of pocket this year under Medicare, before counting co-pays. That is roughly double the amount an employer typically would pay for one employee and a spouse in a group insurance plan.

(The husband, a retired insurance executive, provided a detailed breakdown of his and his wife's medical expenses, including official notices from Medicare, on the condition they not be identified.)

For starters, the Medicare Part B premium for all retirees is deducted from Social Security checks. The cost this year is $2,652 for a married couple, up almost 17 percent from the $2,270 cost last year. Congress makes higher-income couples pay an extra premium if their income is more than $170,000. This couple's extra charge this year is $5,834.

The retired executive and his wife then pay more than $3,300 for a Medicare supplement, an option they chose because they travel extensively, and this option allows them to see any doctor. (Other supplements, with no extra cost, place limits on which doctors can be seen, except in emergencies.)

"If you travel or want a surgeon or specialist outside your area because he has some expertise, then you want to pay for this supplemental," the retired executive said.

Then there is the Medicare Part D drug plan, with its so-called doughnut hole. The plan covers some drugs, then makes people pay a large amount (the hole) and then picks up all drug costs. The executive and his wife said that they would spend the $9,000 maximum this year.

All that comes to about $21,100 for the year, in addition to deductibles and co-pays for medical care and lab tests.

Beyond the medical costs, the couple is taxed on 85 percent of their Social Security benefits, which come to almost $58,000. For couples in the top bracket, that tax will amount to more than $17,000 this year, bringing their total medical and benefits tax close to $40,000.

This former executive said he expected costs to be much higher in the future. Medical advances, and especially drugs, are driving up costs, he said, particularly new biologics that can cost tens of thousands of dollars a year.

As a result, “fatal illnesses, often of short duration, have become chronic diseases,” he said, and “continued expensive care over a long period of time is costly.”

ROTHS This year, people whose income level denied them access to a Roth I.R.A., where investment gains are free of tax, can create them. They can also convert tax-deferred individual retirement plans into Roths by paying the taxes.

The net income from a pretax I.R.A. and the after-tax contribution to a Roth are the same (assuming tax rates remain unchanged over time). But a Roth offers an advantage: it does not require withdrawals for those older than age 70 1/2, as a traditional I.R.A. does.

Those who convert this year can pay the income taxes over two years. However, that may be a costly strategy for high-income taxpayers. At year-end, the temporary tax cuts sponsored by President George W. Bush in 2001 expire. Next year, the two top rates are scheduled to revert to the higher rates of 2000.

Someone in the top bracket would pay $35,000 this year to convert a $100,000 I.R.A. into a Roth, but would most likely pay $39,600 if they took advantage of the pay-later option.

ROTH GIFT-GIVING Those converting to a Roth may want to combine it with a charitable gift annuity, getting some immediate tax savings, tax-favored income and leaving money to both heirs and a favorite cause, said Robert F. Sharpe, a fund-raising consultant in Memphis.

A 71-year-old single man in the top tax bracket who converts a $100,000 I.R.A. and puts 60 percent into a Roth and 40 percent into a charitable gift annuity can save 16 percent of the $35,000 tax cost, said Nelson Wittenmyer, vice chairman at the Cleveland Clinic Foundation.

With 6 percent annual investment returns, the donor would get almost $76,000 of tax-favored income during his expected lifetime, give heirs almost $74,000 after-tax and leave a charitable bequest of almost $42,000.

“You are never going to make yourself better off or whole this way,” he said, “because you are making a charitable gift.” But for those inclined to leave money to a charity, combining a Roth conversion with a charitable gift annuity results in significantly less income tax than a straight conversion to a Roth.

HEIRS Converting to a Roth that you expect to go to children or grandchildren may not make sense if their income tax rates are lower than yours, said Bob D. Scharin, a senior tax analyst with the tax and accounting business of Thomson Reuters.

Say you are in the 35 percent bracket and convert a $100,000 traditional I.R.A. into a Roth. The cost will be $35,000 in taxes today, diminishing your estate by that amount. But if your life expectancy is relatively short and your heirs are taxed at the 15 percent tax rate, the most common bracket, or the 28 percent rate, they would pay less in taxes without the Roth conversion.

An inheritor who is a young adult and no longer listed on her parents' tax return could be in the 10 percent bracket. A student supporting himself with college loans and tax-free gifts from parents owes no income tax. Such a student could take withdrawals of $9,350 this year from an inherited I.R.A. before owing federal income tax, provided that it is the student's only source of taxable income.

"In leaving a Roth to heirs you need to think about the tax rate of your children or grandchildren," Mr. Scharin said.

TAXING GIVING Some taxpayers get a subsidy on charitable gifts, but President Obama has proposed taxing gifts by some high-income Americans.

Today donors deduct charitable gifts at their marginal tax rate. Some of those giving stocks and other property that is worth more than they paid for it get a subsidy because they avoid a 15 percent capital gains tax and can deduct the gift against wage income taxed at the 35 percent rate.

Mr. Obama wants Congress to limit the deduction to 28 percent, the top rate for the alternative minimum tax. Someone making a cash gift that is subject to the 39.6 percent top tax rate on wages scheduled to be in effect next year would effectively be taxed 11.6 percentage points on the donation.

Speeding up donations, such as making those planned for the next several years during this year, would result in getting the full tax deduction and, in some cases, a tax subsidy of up to 20 percentage points.

I.R.A. GIFTS Congress has not extended the law that last year let people give up to $100,000 to charity from their traditional tax-deferred retirement accounts (with no tax deduction, because those accounts hold untaxed dollars). However, it may do so.

If Congress reinstates the policy, people with plenty of income would benefit, because these gifts from retirement accounts count in determining the minimum annual withdrawals for those age 70 1/2.

ESTATES Congress is expected to take action this year on the estate tax, which was repealed for 2010 but is scheduled to return in 2011. Both supporters and foes of the tax have an interest in Congress enacting a new law, because otherwise the estate tax exemption, which was $3.5 million last year, reverts to the $1 million level and rates rise by 10 percentage points next Jan. 1. Congress can also retroactively impose an estate tax for this year.