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## The Federal Tax Law Is An Uncertain Mess. Here's How To Plan Anyway.

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**The tax law is maddeningly uncertain. But there's still much a rational taxpayer can do now.**

Congress has headed home for elections, leaving the tax code an unstable mess. Under current law, come Jan. 1, 2011 income tax rates will rise for the middle class and wealthy alike, while the estate tax, defunct for 2010, will spring back to life, grabbing 55% of any assets over $1 million not left to a spouse or charity. To make matters worse, dozens of tax provisions that expired at the end of 2009, including one that would protect 24 million families from the alternative minimum tax for 2010, have yet to be renewed. (It's widely expected most will be, probably in December.) "You would have thought we would have had some certainty by this point, but as we get closer to Dec. 31 the uncertainty seems to be getting greater," sighs Mitchell Drossman, national director of wealth-planning strategies with U.S. Trust. If President Obama has his way, the Bush tax cuts will be extended for the middle class but not for incomes above $250,000; the top tax rate on ordinary income will increase from 35% in 2010 to 39.6% in 2011, while the top tax on long-term capital gains and ordinary dividends will climb from 15% to 20%. (If nothing is done, the dividends tax will revert to 39.6%.)

So what's a rational taxpayer to do? It's certainly tempting to put off planning and hope for a quick resolution after Nov. 2. Don't. It likely won't be quick. There's a chance that the 2011 income tax rates won't be known by the end of 2010 and an even greater risk an estate tax deal won't get done this year. After all, congressional gridlock allowed the estate tax to expire for 2010.

So think about three categories of tax moves: those you should do now, because they make sense regardless; those you can tee up to do in December; and Roth conversions, which you can do now and then undo with hindsight. Gregory Rosica, a partner with Ernst & Young in Tampa, Fla., has been creating two sets of plans for clients, with the idea that they'll "pull the trigger" on one or the other in December. Why not just wait? "It's going to be a frantic end of the year," he warns.

## DO-IT-NOW MOVES

### Max Out Your 401(k)

You can contribute $16,500 in 2010 to a 401(k) and an additional $5,500 if you'll be 50 by the end of this year. Contributions must be made by year-end but don't have to be made evenly all year. Call payroll and raise your contributions for the last two months.

Aren't tax-deferred retirement accounts a trap if rates rise? If your employer offers a Roth 401(k) option, you can contribute already taxed money to that account and all withdrawals in retirement will be tax free--a good hedge against higher future tax rates, particularly if you're young and expect your salary (and tax bracket) to rise. What if you don't have a Roth option or prefer putting pretax money away to get the current tax break? The benefits of long-term tax deferral will often outweigh a higher rate in the future, says Drossman.

### Take Gains on Taxable Bonds

With interest rates scraping bottom, you may have corporate bonds you bought years ago that pay higher interest rates and now sell above par. If one of those bonds matures next year, sell it now and book the long-term capital gain, suggests Robert Gordon, president of Twenty-First Securities Corp. This converts 2011 interest income, taxed at 35% or 39.6%, into 2010 capital gains taxed at 15%. "We always advise this. If rates rise, that makes it unbelievable," says Gordon.

## Make Annual Gifts

Anyone can give anyone else $13,000 a year without worrying about gift tax. So a couple can give $26,000 to each child or $52,000 to a child and his spouse. If you have the money, annual gifts are always a good idea, but even more so now with the estate tax about to make a comeback. Consider putting the $13,000 for a grandchild in a 529 state college-savings plan, where money for higher education can grow tax free.

## Set Up GRATs

If you've got substantial wealth, now is the time to set up grantor retained annuity trusts to transfer assets to your kids or grandkids. Congress is considering changes that will make GRATs less attractive, but those changes aren't likely to be retroactive. Plus, a key IRS interest rate is at an alltime low of 2% for GRATs set up in October. That means if assets in a GRAT grow more than 2% a year, the excess return will go to your beneficiaries gift-tax free.

## TEE-IT-UP MOVES

## Set Up Taxable Gifts

**If you've used up your $1 million lifetime gift-tax exemption (that's in addition to $13,000 annual gifts), consider making taxable gifts this year, particularly to grandchildren. The gift tax this year is only 35%, and the generation-skipping tax (an extra tax on gifts made to grandkids) lapsed for 2010 along with the estate tax. James Cundiff, an estate lawyer with McDermott, Will & Emery in Chicago, is now doing the paperwork for a 94-year-old man who plans to give $10 million to his grandkids the last week in December--if Congress hasn't reinstated the GST retroactively for 2010 by then.**

## Identify (But Delay) Big Deductions

The traditional advice is to accelerate your deductions (and hence tax savings) by making charitable contributions and paying state and local taxes due the following January before Dec. 31. But the possibility of a higher tax rate next year could turn that on its head. "If you assume tax rates will go up, then it pays to accelerate income and defer deductions," notes Robert Meighan, a vice president at **Intuit** ( INTU - news - people )'s TurboTax unit. (Do-it-yourselfer alert: When TurboTax's 2010 program comes out around Thanksgiving, its planning function will assume the continuation of 2010 tax rates in 2011; you'll have to download an update to calculate the impact of whatever Congress decides.)

## Look for Income to Accelerate

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Identify ordinary income you might accelerate into 2010, and find out the date you must act by. If it looks like rates will rise, you might, for example, be able to move a January bonus forward. You'll also want to exercise in 2010 any in-the-money nonqualified stock options that are going to expire in 2011 anyway, says Bernard Kent, a managing director of Telemus Wealth Advisors in Southfield, Mich. (That's assuming you have a neutral outlook on the stock.) If you have deferred compensation earned and vested before 2005 (when strict new rules were put in), consider pulling it out and paying taxes at 2010 rates, says Mark Bokert, an executive comp lawyer at Davis & Gilbert in New York City. (That's assuming you would be taking it out in the next few years anyway and not enjoying years of extra tax deferral.)

What about accelerating capital gains? Review your taxable portfolio for highly appreciated stocks you might want to sell before year's end. But remember to factor in state and local capital gains taxes.

# THE ROTH DO-UNDO

This year, for the first time, all taxpayers, including those with incomes above $100,000, can take money from a pretax individual retirement account, pay tax on it and deposit it in a Roth IRA, where it can grow tax free. Doing a Roth conversion usually requires professional help and isn't a project to undertake in late December. But if you convert now, you have until Oct. 15 2011 to make two key decisions. First, you can undo the conversion, which you might want to do if, for example, the securities you put in the Roth have tanked. Second, you have until then to decide whether to pay taxes on the conversion on your 2010 return or to split the income between your 2011 and 2012 returns. With Congress putting so many key tax decisions off, 20-20 hindsight could come in handy.