46 PEAKS
INVESTMENT ADVISORY GROUP

It's Always Tax Season.

ERIK MOSHOLT, CFP®
Chief Investment Officer

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April 15th is right around the corner - taxpayers and their accountants across the country are keenly aware that we are in the middle of what's often called "tax season". But is there really a tax "season"? A prudent manager of wealth would argue the answer is "*No. Tax season is all year*. *Every year*"

It's easy to overlook the fact that taxes are likely your number one expense over your lifetime, investment or otherwise, and it's probably not even close. Since they're so significant, and since there are several tactics to reduce our taxes, we need to be both knowledgeable and diligent in how we approach taxes throughout our lifetimes.

As the saying goes, paying taxes is one of the few certainties in life. But tax rates and policies themselves are far from certain – the Government makes significant changes from time to time. Just over the last few years, The Tax Cuts and Jobs Act (TCJA) of 2017 made the largest changes to our tax code in 30 years. Then the SECURE Act 1.0 in 2020 changed several important retirement planning considerations. And late last year, the SECURE 2.0 further tweaked many tax policies even more.

Each year we publish a two-page summary of **Key Financial Data** including tax rates, retirement plan contribution limits, and more. You can access a PDF copy of it HERE. There's a lot of information on it and to make it easier for you, we've highlighted what we think are some of the most relevant and important figures.

As far as planning considerations, we obviously cannot cover all the details and nuances of tax planning in a brief bulletin like this, but we think there are **a handful of very important considerations that you should be aware of**.

Let's start with the tax tables. Two of the most important income tax figures that you should know today, and throughout your lifetime, are your **Effective Tax Rate** and your **Marginal Tax Rate**. Your Effective Tax Rate on income is what your total tax rate is. For example, if someone earned $100,000 and paid $20,000 in total income taxes, her effective rate is 20%. If the same person earned $110,000, and paid $3,000 more in taxes, then her marginal tax rate on the $10,000 of earnings over $100,000 was 30%.

Now, let's make it a little more personal. Forbes.com has a great tax calculator that you can access online HERE. You simply plug in your income, filing status, state of residence, and any retirement plan contributions. It assumes you take the standard deduction and tells you your Federal and State tax liabilities in both dollar and percentage terms, including your Effective Tax and Marginal Tax rates. You really should go do this now. It takes a minute or two. I'll wait. (*NJ residents note that the Forbes calculator is not accurate on income over $750k*.)

KEY FINANCIAL DATA
2023

OK. Now that you're back and you have your own Effective and Marginal Federal and State tax rates, or if you didn't bother to go get your own numbers, this table provides a quick perspective at different income levels across a selection of states:

	2023 Tax Rates/Cost for Married Filing Jointly with Standard Deduction and No Retirement Plan Contributions											
	Federal		NY		NJ		PA		NC		SC	
	Effective	Marginal	Effective	Marginal	Effective	Marginal	Effective	Marginal	Effective	Marginal	Effective	Marginal
$100,000	8.5%	12.0%	4.5%	5.9%	2.6%	5.5%	3.1%	3.1%	3.7%	5.0%	4.6%	7.0%
	$8,500		$4,500		$2,600		$3,100		$3,700		$4,600	
$175,000	13.7%	22.0%	5.1%	5.9%	4.0%	6.4%	3.1%	3.1%	4.3%	5.0%	5.7%	7.0%
	$24,000		$8,900		$7,000		$5,400		$7,500		$9,900	
$250,000	16.6%	24.0%	5.4%	6.3%	4.7%	6.4%	3.1%	3.1%	4.5%	5.0%	6.1%	7.0%
	$41,500		$13,500		$11,800		$7,700		$11,200		$15,100	
$350,000	18.7%	24.0%	5.7%	6.9%	5.2%	6.4%	3.1%	3.1%	4.6%	5.0%	6.3%	7.0%
	$65,500		$19,900		$18,100		$10,700		$16,200		$22,100	
$500,000	22.7%	35.0%	6.0%	6.9%	5.5%	6.4%	3.1%	3.1%	4.7%	5.0%	6.5%	7.0%
	$113,400		$30,100		$27,700		$15,400		$23,700		$32,600	
$750,000	27.0%	37.0%	6.3%	6.9%	6.7%	9.0%	3.1%	3.1%	4.8%	5.0%	6.7%	7.0%
	$202,500		$47,300		$50,100		$23,000		$36,200		$50,100	
$1,000,000	29.5%	37.0%	6.4%	6.9%	7.3%	10.8%	3.1%	3.1%	4.9%	5.0%	6.8%	7.0%
	$295,000		$64,400		$72,500		$30,700		$48,600		$67,600	
$2,500,000	34.0%	37.0%	7.1%	9.7%	9.4%	10.8%	3.1%	3.1%	4.9%	5.0%	6.9%	7.0%
	$850,000		$176,300		$233,700		$76,800		$123,478		$172,600	

When you look at these figures, it's important to **keep in mind what you do not see**. You do not see Florida, Texas, Tennessee, or Nevada listed, as they all have **zero state income tax** (along with five other states). You also do not see **local taxes** like those in New York City, which range between 3.08% and 3.9%, depending on income.

You also don't see taxes on qualified dividends and capital gains, which are **only 15%** on married couples with income between $89,250 (the tax rate is 0% under this amount) and $553,850 (the tax rate is 20% over this amount). On the plus side, the rates in this table do not reflect any tax-deductible retirement plan contributions (but you can put them in yourself on the Forbes.com calculator).

Importantly, you do not see Federal Taxes for **Social Security** and **Medicare**. For W2 employees, Social Security taxes are 6.2% on income up to $160,200. Medicare taxes are 1.45% up to $250,000 (joint) and 2.35% on income over $250,000 (joint). So, in addition to the taxes in the table above, employees pay **7.65% toward FICA** (Social Security + Medicare) on their first $160,200 of earnings and keep paying Medicare taxes with no income limits. For the self-employed, who pay both employee and employer halves of Social Security and Medicare, these taxes are double. Ouch.

To us, a few things jump off this table. For one, how **relatively LOW Federal Income tax rates are** at some income levels. (Part of the reason for this is the TCJA, but another part is inflation – tax bracket income levels rose 10% the last two years due to high inflation.) For example, a couple earning $100,000 per year only pays $8,500 in Federal Income Taxes. This may not sound like a high income to you, but roughly 67% of American households make less than $100,000. Even at $350,000 per year, the total (effective) Federal Tax rate is only 18.7% and the marginal rate is only 24%. Of course, if that couple is dual income, and live in a high tax state, total effective and marginal taxes can exceed 30% when you add in 7.65% of FICA and 5-7% of State taxes.

At a state level, it's "interesting" how quickly New York, New Jersey, and South Carolina get to high rates (no break for the middle class), while compared to many of its neighbors, Pennsylvania has a low and flat rate. You may also notice how New York and New Jersey tax rates reach 9.0% or higher at higher income levels. It's no wonder more and more professional athletes factor state taxes into their decisions of what teams to play for. Finally, since percentages can be slippery to appreciate, we included dollar amounts in the table and in that context, the taxes paid by taxpayers with seven figure incomes are startling.

So, **what can you do about it**? With the TCJA limiting the deductibility of State and Local Taxes to $10,000, and raising the standard deduction, fewer taxpayers itemize deductions today. The good news is that the standard deduction is now pretty high - $13,850 for individuals and $27,700 for married couples filing jointly. So, in one important way, the Tax Code got a lot simpler – yeah!

The other good news is that it's easier now than ever before to reduce current taxes by deferring income into retirement plans. For 2023, the annual limit for contributions to 401(k) and similar plans is $22,500. And if you are over 50 years old, you can defer another $7,500,

for a total of $30,000 each year. That's significant. The limit on SIMPLE plans is $15,500 (plus $3,500 catch up). Self-employed individuals can contribute 25% of their compensation, up to $66,000 in 2023. For those seeking to reduce taxes and/or save toward retirement, there are real opportunities today!

But we don't want you myopically focused on minimizing taxes each year. We want you to think about taxes in the context of the arc of your lifetime, as well as current and potential future policy. These are hard questions to answer with confidence, but besides asking "*What's my marginal tax bracket?*", you also should contemplate… "*Am I likely to be living in a lower or higher tax state when I retire?*" and "*Are Federal tax rates likely to be higher or lower when I retire?*" You also need to consider your beneficiaries, as unpredictable as that may be.

Broadly speaking, from a planning perspective, we worry that **Federal tax rates are going to go UP** in the future. As a result, if you are in a marginal tax bracket of 25% or less, we think you should not overemphasize minimizing your current taxable income and thus taxes paid today. However, if you are in a high total tax bracket, let's say your total combined marginal tax rate is 35% or more, then deferring income and minimizing taxes today should be a priority. For the group in the middle, with marginal total income tax rates between 25-35%, we think it's a tougher decision.

When it comes to Financial and Retirement planning, we think there are **two areas where conventional wisdom may be sub-optimal**. The first is the default assumption to maximize your 401(k) contribution throughout your life and the second is to limit withdrawals from your IRA to the Required Minimum Distributions (RMDs).

Someone who diligently maxes out their 401(k) contributions throughout their career and postpones IRA withdrawals until they are required, can certainly accumulate $2.5 million in an IRA by the age of 73. At that point, using today's RMD tables, his RMD would be about $95,000. Hypothetically, if that person took only the Required Minimum Distributions over the next 17 years, and earned 6% returns, at age 90, his RMD would be $227,000.

And that's for one person. A couple who both save diligently and limit their IRA withdrawals to the bare minimum, could have even larger combined IRAs and Required Minimum Distributions. Here is another wrinkle that is **very important and often overlooked**…while they are both alive, they would pay taxes on their IRA withdrawals based on the married/joint tax schedule. But once one of them crosses over the rainbow bridge, the surviving spouse would pay taxes based on the Single filer tax schedule – reaching higher tax rates much more quickly. And since SECURE 1.0 eliminated the stretch IRA tactic, once the second spouse passes, their beneficiaries, who may still be working and in high tax brackets themselves, or living in higher tax states, will have to evacuate their inherited IRAs within ten years.

Having a large IRA sounds like a worthwhile goal, and it is, but it could result in unnecessarily large taxes for you, your spouse, and your IRA beneficiaries. Once again, **what to do?** For one, investors must understand and consider the usefulness of ROTH 401(k)s and ROTH IRAs. Unlike contributions to other retirement plan accounts like IRAs and 401(k)s, contributions to ROTH 401(k)s and ROTH IRAs are not tax deductible. Similarly to 401(k)s, asset growth is not taxed while in a ROTH account. But the important difference is that unlike withdrawals from regular 401(k)s and IRAs that are taxed as current income, withdrawals from ROTH accounts are not taxed. So, while we think investors should always contribute to a 401(k) up to the threshold of any employer match (since the employer match is "free money"), if available, they should consider allocating to a ROTH 401(k) instead IF their marginal tax rate is not that high (25% or less, in our opinion).

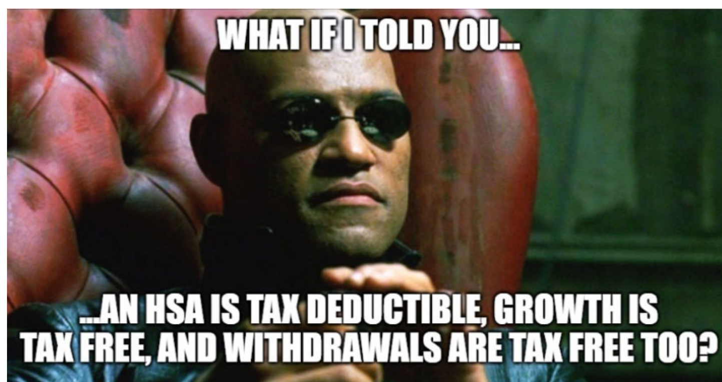
Besides being mindful of contributions, investors who have already accumulated 401(k) and IRA balances should strongly consider converting some of them to a ROTH IRA if they are in a lower tax bracket, perhaps even when they are retired. Finally, don't obsess about taking only the required minimum distribution - You can start before they are required, and you can take more than the minimum. The math and planning dynamics of this decision are beyond the scope of this article, but getting assets into a ROTH 401(k) or ROTH IRA, and managing your IRA withdrawals, maybe even to help you defer and maximize your Social Security benefits, are tactics that you should strongly consider throughout your investing lifetime. Pro Tip – Don't just consider how this applies to the IRAs of you and your spouse. If you have a parent with an IRA, it

may apply to you too.

Another underappreciated and often overlooked opportunity to reduce taxes (and expenses) is in **Healthcare**. Yes, Healthcare. Your choices here depend on several factors, including your family size, your expected healthcare expenses, and how much of your health insurance is paid by your employer. All else being equal, if your employer pays for a large percentage (say 75% or more) of your health insurance premiums, then you probably don't have too much to think about – you probably should take what most people think of is the "best" plan – the most coverage, the lowest deductible, the lowest co-payments. Why? Because your employer is footing the bill, or most of it.

But if your employer is paying less than 75% of the premiums, and especially if you are self-employed, or if you and your family rarely use healthcare services, you should consider the tradeoffs of going with a high deductible plan (which will have lower premiums). In our experience, depending on your circumstances, it's often better to pay less in Health Insurance premiums and have a larger deductible, than to pay large, guaranteed premiums per year and have a small deductible.

Having a large health insurance deductible opens a tax saving and financial planning opportunity – **Health Savings Accounts (HSAs)**. HSAs are available to anyone with a family health plan deductible of $3,000 or more. There are no income limits. And HSAs offer **THE BEST TAX TREATMENT** of any investment vehicle. They are treated like a ROTH (tax free growth and tax-free withdrawals as long as withdrawals are used for qualified medical expenses) but BETTER – Contributions to HSAs are tax-deductible (like contributions to IRAs and 401(k)s). The HSA contribution limit for 2023 is **$7,750** for family coverage. Those 55 and older can contribute an additional $1,000. While this is a relatively modest contribution cap, 10-15 years of HSA contributions, invested, and then left alone until you are in your 70's or 80's, can really add up. This is **the most tax-advantaged savings vehicle that we are aware of** and in the right circumstances, could be a very important part of many Americans' tax (and retirement) planning.



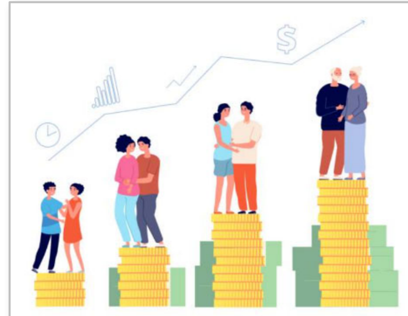
Another opportunity to reduce taxes is via **Charitable Giving**. The increased Standard Deduction and the $10,000 cap on SALT deductions makes it harder for many Americans to itemize deductions, but for those charitably inclined, there remain opportunities. One often recommended tactic for those who are close to the standard deduction but don't reach it, is to bunch your annual charitable contributions into every other year - You would itemize one year (when you make charitable contributions) and not the next (when you don't).

Another important charitable giving tactic would be to gift appreciated securities to avoid paying capital gains on them. Additionally, investors older than 70.5 can make charitable donations directly from their IRAs by making **Qualified Charitable Donations (QCD's)**. Unlike other IRA withdrawals, these QCD's are **non-taxable**. They can satisfy Required Minimum Distributions, and importantly, allow investors to achieve a tax benefit for their charitable donation <u>without itemizing</u>.

Obviously, tax management is not just about income taxes - taxes are an important consideration in portfolio design and portfolio management. There are a few important tactics that we employ to help reduce taxes for our clients:

a. We seek to harvest tax-losses when available, to offset realized taxable gains.
b. For portfolios with both taxable and tax-advantaged accounts, we strive to place tax-inefficient investments (like Private Credit) in tax-advantaged accounts and tax-efficient assets (like Stocks and Real Estate) in taxable accounts.
c. When realizing gains, we strive to ensure they are long-term in nature (held more than 12 months) so they are subject to (typically lower) long-term capital gains taxes instead of potentially higher current income rates.

As mentioned earlier, tax planning is not just about minimizing taxes today, it's about minimizing taxes over the course of your life. Therefore, planning involves at least some element of prediction. For you, that means, *how much will you make? At what age? Where will you live in retirement? How long do you think you'll live*? But for all of us, it also involves some prediction about future tax policy.



With that in mind, it's important to remember that 2017's **TCJA will effectively expire, or "sunset" at the end of 2025**. If it sunsets and Congress does nothing, then many elements of the Tax Code will revert to 2017 policies, and many tax rates will go up. With a split Congress today, we don't expect any meaningful changes over the next two years, so there's a real possibility that today's low Federal tax rates will expire at the end of 2025 and many taxpayers will be paying more in 2026.

A few other considerations. After TCJA expires or gets renegotiated, we do think there's a good chance that today's low ($10,000) cap on State and Local Tax deductibility will either go up (to $20,000 or $25,000) or be removed entirely (but that would bring the AMT tax back into the conversation.) We also think it's inevitable that Social Security and Medicare Taxes will be going up. The form of that increase is impossible to predict and may be limited to higher income taxpayers. Additionally, we think an asset-based tax on "large" IRA assets will be implemented at some point in the next 5-10-15 years. What will be the definition of "large"? We don't know, but President Biden's most recent proposal (which is unlikely to get passed) set the bar at $10 million. It could be more or less than that.

So, our overall message is that investors need to be diligent throughout their lives in planning their finances around current and expected tax policy. Beware the potential pitfalls of conventional wisdom. If you are in a high marginal tax bracket (Federal + State), by all means seek to defer income and minimize taxes. But 401(k) contributions, RMDs, and Health Insurance should be viewed under a critical eye with ROTH (contributions and conversions) and HSA accounts given strong consideration. We also think investors should realize that many tax rates, including those on capital gains, are **relatively low today with the potential to go up in the future**, so paying some taxes now might payoff in the long run (as painful as that might be in the short run).

One final message – **getting this right is not easy**. It requires knowledge and expertise, a long-term perspective, and importantly, both full transparency and trust between investors, their accountants, and their financial planners. The stakes are high and so are the potential savings, so it's worth the effort - winter, spring, summer or fall.

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