CHIEF INVESTMENT OFFICE

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Beginning of Year Tax Planning

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INTRODUCTION

Tax planning and tax decisions are not, and should not be, exclusive to the final weeks of the calendar year. Year-end does offer an opportunity to assess one's tax situation with a nearly complete set of facts. But by then it may be too late to plan and make timely decisions.

Beginning-of-the-year tax planning should not be overlooked and in some instances may be even more important than year-end planning. As we begin a new year, we want to draw your attention to some important tax items that should be considered early in the year, not only because they have the potential to maximize savings and minimize taxes, but also because some are time sensitive. The following is a non-exclusive list of items to be considered by taxpayers early in the year, some time-sensitive, some based on common sense.

TAX CONSIDERATIONS FOR THE BEGINNING OF THE YEAR

What if?

It is said that "an ounce of prevention is worth a pound of cure." Upfront tax planning can prevent unpleasant future surprises and, more importantly, potentially result in tax savings as well. An early-in-the-year assessment of projected income can lead to better and more informed decision making.

Rather than waiting for the end of the year, taxpayers should look at their prospective tax planning early in the year. If compensation or investment earnings have increased from the prior year, various tax benefits could be lost as income exceeds certain thresholds or phase-out ranges. For instance, an increase of $50,000 of investment income could cause the qualified business income deduction to be fully phased-out for some taxpayers. In such case, would it be better for investment income to be tax-exempt to preserve the deduction? Alternatively, consider whether increasing taxable interest income would result in a charitable gift being more tax-efficient by the charitable deduction offsetting ordinary income otherwise taxed at 37% versus long-term gains or dividends taxed at 20%. It may make sense to allocate investments to taxable bonds to generate a possible higher yield and gain greater tax efficiency from making a charitable gift.

Of course, a taxpayer could consider these tax decisions at year end, but by then the taxpayer would not be in a position to alter the character of income previously recognized during the year or rearrange investments to generate taxable or non-taxable income. Taxpayers could be well served by running base-case, best-case, and worst-case financial and tax projection scenarios at the beginning of each tax year, with periodic updates throughout the year.

FUNDING RETIREMENT PLANS

Annual Retirement Plan Contributions. Contributions to retirement accounts, such as a 401(k) or IRA, can be made throughout the calendar year, or in the case of an IRA (and solo 401(k) plans for the first plan year) even in the following tax year, if made on or before April 15 of such following year (the un-extended due date for filing a tax return). However, in a rising investment market, funding a retirement account early in the year has the benefit of permitting those funds to grow tax deferred for a longer period of time. A taxpayer who funds an IRA in January of 2024 rather than April of 2025, will enable those funds to potentially grow and compound for an extra 15 months. However, for an employer sponsored plan such as a 401(k), if your employer offers a match to your contributions you will want to consider the implications of fully funding your account early in the year. In some instances, if your contributions stop, the company's match will stop or be delayed.

529 Plan Rollovers to Roth IRAs. Beginning in 2024, 529 plan beneficiaries have the option of rolling a portion of their plan into a Roth IRA. This benefit, authorized under the SECURE 2.0 Act, allows a lifetime maximum of $35,000 to be moved from an individual's 529 plan to a Roth IRA, with certain restrictions.

To be eligible, the 529 plan must be open for over 15 years, and only contributions that have been in the plan for at least five years may be rolled over. Assuming these timing requirements are met, a beneficiary is limited to rolling over no more than the maximum annual IRA contribution for a single year. For 2024 this is the lesser of: $7,000 or the beneficiary's earned income, minus any other IRA contributions made by the beneficiary for the current year. Therefore, it's important to coordinate this rollover with any other planned Roth or Traditional IRA contributions. Also, be aware that this tax benefit may not apply to state income taxes, in which case, a 529 plan rollover to a Roth IRA could be subject to a recapture of any state income tax benefit attributable to the assets distributed from the 529 plan.

RETIREMENT PLAN & IRA DISTRIBUTIONS

New Commencement Age for RMDs. In the final days of 2022 Congress passed the SECURE 2.0 Act, making many changes to retirement plan rules, some taking effect immediately while others being phased in over time. One provision of the Act increased the commencement age for Required Minimum Distributions (RMDs) from 72 to 73 beginning in 2023. As a result, individuals turning 73 in 2024 will have until April 1, 2025 to take their first RMD.

While one might be inclined to delay their RMD as long as possible and continue deferring income taxes on any potential growth, taking an RMD early in the year may also have its benefits. For example, taxpayers planning to complete a Roth IRA conversion in 2024 must first take their RMD, if applicable, prior to converting traditional IRA assets to a Roth. Additionally, taxpayers might also consider the difference between their marginal ordinary income and capital gain tax rates when deciding when to take an RMD. While distributions from traditional IRAs are generally taxable at ordinary income tax rates of up to 37%, assets invested in taxable accounts may qualify for more favorable long-term capital gain rates topping out at 20% plus a 3.8% surtax on net investment income (if applicable). In some cases, taking an RMD earlier in the year may result in a tax savings if future growth will be taxed at lower rates outside the IRA.

The pros and cons of different RMD timing strategies are discussed in our Wealth Strategy Report: *RMDs: Should You Take Your RMD Earlier or Later in the Year?*

Qualified Charitable Distributions For 2024. IRA owners over the age of 70.5 may direct up to $105,000 per year to be distributed directly from their IRA to a charity as a Qualified Charitable Distribution (QCD). Such distributions are not taxable to the account owner. Additionally, a QCD may be used to offset a taxpayer's required minimum distribution for the year. Note that these charitable distributions have been permitted since 2006; however, the SECURE 2.0 Act of 2022 added that the permitted amount would be adjusted for inflation annually, with the first adjustment occurring in 2024.

When a taxpayer who is subject to RMDs takes funds from an IRA, any amount withdrawn is first assumed to satisfy the RMD. Therefore, an IRA owner who is considering making a QCD for the year may want to do this earlier in the year to satisfy their RMD using the QCD before making any other distributions from the account. This not only includes distributions directly to the account owner, but also rollovers and Roth conversions. Otherwise, the account owner may generate a tax liability that could have been avoided simply by doing transactions in a different order.

Inherited IRAs. A major change initiated under the 2019 SECURE Act was the requirement that most IRA beneficiaries completely withdraw inherited IRA assets by December 31 of the year of the 10th anniversary of the original owner's death (with exceptions for certain beneficiaries such as spouses, minor children and disabled beneficiaries). Prior to this change, individual IRA beneficiaries could "stretch" distributions based on their life expectancy. The new "10-year rule" applies to beneficiaries inheriting IRAs beginning in 2020. In addition to the ten-year requirement, the IRS has indicated that beneficiaries inheriting accounts after the original owner began taking RMDs are also required to take annual life-expectancy based distributions, although relief from this requirement has been provided through 2023.

While many beneficiaries may seek to delay distributions (and the associated income tax) as long as possible by waiting for the tenth year to withdraw most or all of the account, this may have negative tax and financial consequences. A large taxable event in a single year could result in the income being taxed at higher federal and state rates, cause certain tax benefits to phase-out, increase Medicare premiums and even impact a college-aged dependent's eligibility for financial aid. As part of annual cash flow and tax planning projections, beneficiaries who are subject to the 10-year rule should consider whether taking a distribution from the inherited account, even if not required, will provide a better financial outcome by smoothing the increased taxable income over several years.

CORPORATE TRANSPARENCY ACT

The Corporate Transparency Act (CTA), enacted under the 2021 National Defense Authorization Act, was designed to combat financial crimes by requiring business entities (corporations, LLCs, partnerships, etc.) to provide certain information about the entity and its owners and individuals who control it. Reporting requirements took effect on January 1, 2024. Note that while this will impact many if not most business entities, there are exceptions to the reporting requirements for companies that are highly regulated such as public companies, financial services companies, tax-exempt entities, and large operating companies.

CTA reporting is completed using the FinCEN Beneficial Ownership Information Report (BOIR) which can be filed electronically from the FinCEN website. All individuals owning or controlling 25% or more of an entity or exercising substantial control over the entity must provide the required identifying information on the FinCEN report. For each entity, the report will require:

1. Reporting company information:
   - Full legal name and any DBA name;
   - Street address of the principal place of business;
   - State of jurisdiction or formation;
   - Taxpayer or employer ID number.
2. Individual information for beneficial owners and the company applicant (i.e. the person involved in organizing the entity):
   - Full legal name;
   - Date of birth;
   - Residential address;
   - Identification number from a passport, state ID or driver's license and an image of the identification.

Although these reporting requirements went into effect on January 1, 2024 the deadlines for submitting a report will vary based on when the entity was formed:

- For existing entities (formed prior to January 1, 2024), an initial report must be submitted by January 1, 2025.
- For entities formed on or after January 1, 2024 but prior to January 1, 2025, the report must be filed within 90 days.
- For entities formed on or after January 1, 2025 the report must be filed within 30 days.

Additionally any changes in an entity's beneficial ownership information will require an updated report to be filed within 30 days.

DECLINING INTEREST RATES

Beginning in early 2022, interest rates rose steadily as the Fed proceeded to hike their target rate eleven times before holding steady for the final months of 2023. In an effort to control inflation, these hikes effectively reversed a multi-year trend of extremely low interest rates.

The effectiveness of many tax planning strategies is directly influenced by interest rates, and last year's trend of higher rates has benefited certain strategies that had been out of favor during the prior era of low interest rates. Rates have fallen from their recent highs and there are further expectations for declining rates in the second half of 2024. If rates were to continue on this downward trend, executing certain strategies early in 2024 may be beneficial. Some examples of these strategies include:

Qualified Personal Residence Trusts (QPRT): With a QPRT, one makes a gift to family members (typically children) of a personal residence. The gift is made by the donor transferring the residence to a trust while retaining the right to live there for a term of years. After the expiration of the QPRT term, the house either passes to the trust's remainder beneficiaries outright, or it can remain in trust for their benefit.

When the QPRT is established a gift is being made to the remainder beneficiaries; however, they will not receive any benefit during the term of the QPRT since the donor retains the right to live in the residence. The valuation of the gift must account for this, and appropriately discount its value. The assumed interest rate at the time of the gift is a key component of this calculation. Higher interest rates will provide a larger discount which in turn lowers the value of the gift when calculating the amount of gift exemption used or tax payable.

Charitable Remainder Trusts (CRTs): Charitable Remainder Trusts are a tax planning strategy that involves a charitable gift of a future interest and a retained present interest by the donor. With a CRT, the donor contributes assets to a trust and retains a stream of payments from the trust either for a term years or for life. Assets remaining in the CRT at the end of the term then pass to a charitable organization.

Although generally not the motivating factor for establishing a CRT, in the year of funding the donor will receive a charitable income tax deduction equal to the value that the charity may expect to receive at the end of the term. A larger remainder value for the charity means a larger tax deduction. Factors that determine this remainder value include: the length of the CRT term, the amount of the payments to the donor, and what the expected return of the assets will be during the term.

Generally, higher interest rates represent a higher expected return, which in turn means more would be left for charity at the end of the term. So for any given term and payout amount, a higher interest rate will produce a larger charitable remainder and deduction. For individuals considering this strategy, funding a CRT while rates are higher may be beneficial by providing a larger income tax deduction.

TIMING MATTERS

A host of tax decisions and elections are time-sensitive and must be considered within the first few months of the year, if not sooner. Some decisions have a retroactive effect and could affect taxes for the prior calendar year, and yet others are prospective in nature.

Trust/Estate Distribution Planning. One important tax planning decision must be made by early March. That decision allows a trustee to elect to treat trust distributions made during the first 65 days of the current tax year as distributions made during the immediately preceding tax year. This decision could save significant income taxes by pulling income away from a trust (which is subject to top ordinary and capital gains tax rates at income levels as low as about $15,000) and pushing that income into the hands of individual beneficiaries who may be in much lower tax brackets (the 2024 top income tax bracket for married taxpayers begins at approximately $730,000). While the trustee must make the distribution soon after year end, the election to treat the distribution as occurring in the preceding tax year is made on the trust's income tax return. An executor may make a similar election on the estate's income tax return for income distributed during the first 65 days of the estate's current tax year.

Pass-Through Entity Taxes. Another important tax election relates to the new pass-through entity ("PTE") taxes enacted by a majority of states within the last several years. In many states, this is an optional tax that allows partnerships (including LLCs) or S-corporations to annually elect to pay state income tax on certain income at the entity level rather than at the partner or member level. The intent of this tax is to indirectly provide the individual with an unlimited federal income tax deduction for state and local taxes paid. Generally, if a partnership or S-corporation elects to pay an entity level tax, the partners, members, or shareholders of the electing entity which is subject to the tax may be eligible for a tax credit on their state income tax returns and reduce the amount of income that passes through to them at the federal level.

The rules for electing this treatment vary among states. New York, for instance, permits the annual PTE tax election to be made on or after January 1 but no later than March 15. New Jersey and California permit the PTE annual election to be made on an original, timely filed tax return, while North Carolina and Minnesota permit the PTE annual election to be made on the due date of the return, including extensions.

For those operating as a sole proprietorship or single member LLC, consideration should be given to incorporating as an S-corporation or adding another member to avail themselves of the benefits of state PTE rules.

Federal Elections: S-Corporations. For taxpayers who have converted a C-corporation into an S-corporation, the change in tax status will be recognized for federal tax purposes retroactive to the beginning of 2024 only if the taxpayer makes a timely election. That election must be made by March 15, 2024 (with limited exceptions), otherwise the S-corporation status will be prospective in nature, taking effect in the following tax year.

Gift Tax Returns. With the scheduled decrease in the federal estate and gift tax exemption set to take effect in 2026, many taxpayers have sought to take advantage of the temporarily increased exemption by making large lifetime gifts. Taxpayers who made gifts in 2023 will need to file a federal gift tax return by April 15, 2024. Taxpayers can request an automatic six-month extension of time to file a federal gift tax return in two ways, provided they take timely action. First, a taxpayer can request an automatic extension to file a gift tax return by also applying for an extension of time to file their federal income tax return. Second, if a taxpayer is not requesting an extension to file their income tax return, then a separate request to extend the time to file a gift tax return should be made on IRS Form 8892.

In some instances, taxpayers may want to avoid extending the deadline to file their return. For situations in which the value of gifted assets has declined, donors who wish to allocate Generation Skipping Transfer (GST) exemption may benefit from a late allocation of their exemption rather than a timely allocation on their 2023 gift tax return. The potential benefit is that the amount of GST exemption required to shelter the gift will be based on the value of the assets at the time the late allocation is made instead of the value at the time of the gift. In this case, an extension could delay the ability to make a late allocation. If asset values subsequently recover during the period of the extension the late allocation opportunity may be diminished or lost.

INCENTIVE STOCK OPTIONS

Exercising incentive stock options early in the year can provide tax benefits and flexibility not otherwise available for late-year exercises. Incentive Stock Options (ISOs) have special tax benefits which can result in long-term capital gains treatment if you exercise your options and then hold the underlying stock for more than one year. While the exercise of ISOs is not a taxable event for regular federal income tax purposes, the gain upon exercise is considered income for Alternative Minimum Tax purposes. If the underlying shares are sold within one year of exercise, then it results in a disqualifying disposition, and options are treated as non-qualified stock options: the gain at the date of exercise is taxable as compensation income (and there is no resulting AMT income).

Exercising ISOs early in the year provides significant flexibility because it gives you almost a full year to determine if the resulting shares should be sold: If the stock prices goes up, a taxpayer should continue to hold the underlying stock to attain long-term capital gain treatment; however, if the stock price goes down the taxpayer should consider disposing of the shares (in the same calendar year as the exercise) to negate the AMT income and turn the tax treatment into non-qualified options.

For example, assume an incentive stock option is exercised on January 23, 2024 with a strike price of $10 and the underlying stock is valued at $25. If the stock is then held for over a year, there will be no ordinary income tax due on the $15 difference between the $10 strike price and the $25 stock value at the time of exercise. A future sale of the stock at a price above the $10 strike will result in a long-term capital gain. For the purpose of calculating the potential AMT, the $15 will be considered income for 2024 regardless of what happens to the price of the stock for the remainder of 2024 if the stock continues to be held by the taxpayer through year end.

Now assume that 11 months after exercising the option (December 23, 2024) the share price declines to $10 and, without expecting a near-term recovery of the share price, the taxpayer decides to sell the shares thereby disqualifying the option from the special tax treatment permitted for ISOs. For ordinary income tax purposes, this would result in taxable income being due based on the difference between the strike price and the lower of the price on the date of exercise or the price on the date of sale of the shares. In this case, with the sale price equal to the $10 strike price, there would be no ordinary income tax due.

However, for AMT remember that the tax would be calculated and due for the calendar year of the option exercise. If the disqualifying disposition occurs in 2024 (the same calendar year as the ISO exercise) there would not be any AMT income resulting from the exercise. However, if the taxpayer delayed the sale by two weeks and the disqualifying disposition occurs in 2025, the taxpayer would have already calculated their AMT due for 2024 based on the difference between the strike and the exercise price. A sale occurring in 2025 would not change that. This could leave the taxpayer with a large AMT liability bill for 2024 based on the $25 price at the time of exercise, despite the current $10 stock price. The bottom line is that exercising earlier in the year would give the taxpayer more time to decide whether to disqualify shares acquired through an ISO exercise prior to year-end and avoid a potential 2024 AMT liability based on a higher price if the stock price declines.

ESTATE PLANNING

Annual exclusion gifts. Like contributions to retirement plans, there are benefits to making annual exclusion gifts early in the tax year. An early gift gives the recipient more time to invest the funds, which will hopefully appreciate in the recipient's hands, rather than in the donor's estate. For 2024, the annual exclusion is $18,000 per recipient.

Exemption gifts. While there has been much talk about the possibility of the estate, gift and GST exemption going down, it has steadily been going up each year due to the inflation adjustment. In 2023, the exemption was $12,920,000 per donor. In 2024, the exemption went up to $13,610,000—an increase of $690,000, or $1,380,000 for a couple. Just as with annual exclusion gifts, a gift of the full amount of the exemption gives the recipient more time to invest the funds, which will result in a greater amount of property removed from the donor's estate. By making a full exemption gift now, it would presumably lock-in not only appreciation, but also the full exemption amount as well. This could be beneficial if the estate exemption is reduced as scheduled in 2026.

Taxable gifts. When gifts exceed the annual exclusion amount and the lifetime exemption amount, it could result in the payment of gift taxes. Those gifts have an effective federal tax rate of 28.6%, if the donor survives for three years after the gift is made, otherwise the effective rate jumps to 40%. The earlier such a taxable gift is made, the more likely the donor will survive the three years and the less likely the gift will be taxed at 40%. By way of comparison to the estate tax, the top estate tax bracket is 40%.

INFLATION AND TAXES

High Inflation can be mixed news for taxpayers. Inflation is often viewed as an additional figurative "tax" since it decreases purchasing power. However, it can also have a real impact on actual tax payments at the federal and state levels.

The good news is that federal tax brackets and many federal tax benefits are adjusted for inflation. For instance, thresholds for determining ordinary income and capital gains brackets all increased in 2024, and the standard deduction, IRA contribution limits, and retirement contribution caps were all adjusted upwards. But that adjustment, itself, did not keep pace with the inflation taxpayers feel. Due to a 2017 change to the tax code's formula for inflation adjustments, the increase generally will not be reflective of the actual change in the Consumer Price Index.

There are also many tax items which are not adjusted for inflation, which can result in an increase in actual taxes paid. That is the dark side of inflation. For instance, the threshold for determining if a taxpayer is subject to the 3.8% net investment income surtax is set at $250,000 ($200,000 for single taxpayers) and not adjusted for inflation. With interest income pushed up by higher yields, more taxpayers and more income could be subject to the surtax. Consideration should be given to any additional taxes when determining the appropriate amount of estimated tax payments for 2024.

CONCLUSION

Tax planning and tax decisions are not, and should not be, exclusive to the final weeks of the calendar year. Beginning-of-the-year tax planning should not be overlooked and in some instances may be even more important than year-end planning. This may be especially true with respect to opportunities that can change tax consequences on a retroactive basis since they are generally elective in nature and time sensitive to early in the calendar year.

As we look to November, and the 2024 presidential election, there appears to be a low likelihood of significant tax legislation being passed this year, as much of Washington shifts its focus to campaigning for state primaries and the general election. However, the outcome of the election will determine the course for 2026 and beyond, when many of the current individual tax provisions expire. This potentially calm legislative period may provide the opportunity to prepare and plan for any potential changes down the road, with ample time to make informed and well-thought-out decisions. Tax planning is always a year-round endeavor, with particular emphasis on not only year-end planning but on beginning-of-year planning, too.

—National Wealth Strategies, Chief Investment Office

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