# AFTER-TAX WEALTH

## 2024 ADVISOR HANDBOOK

THIS MATERIAL IS FOR FINANCIAL PROFESSIONAL USE ONLY AND NOT FOR DISTRIBUTION TO CURRENT OR POTENTIAL INVESTORS.

Plan and prepare – that's the theme for 2024. This is a major election year, and while we believe there is a minimal chance of any meaningful tax legislation occurring this year, now is the time to prepare for 2025. Government spending has increased substantially this decade, with both national debt and the budget deficit running at high levels. Come 2025, much debate will occur about taxes with the sunsetting of the 2017 Tax Cuts and Jobs Act (TCJA). We believe the probability of tax rates and tax bills going down from here is not high. Prepare, plan and if needed take action today.

We have partnered with Deloitte to offer insight on a host of tax topics, ranging from helpful tax planning techniques to wealth transfer information, as well as important tax facts and figures. We have also included expert insight into tax-smart investing, leveraging more than 35 years of experience. You can put all this information to work today.

Tax-smart investing is a great way for advisors to differentiate themselves and deliver additional value to client relationships and portfolios.

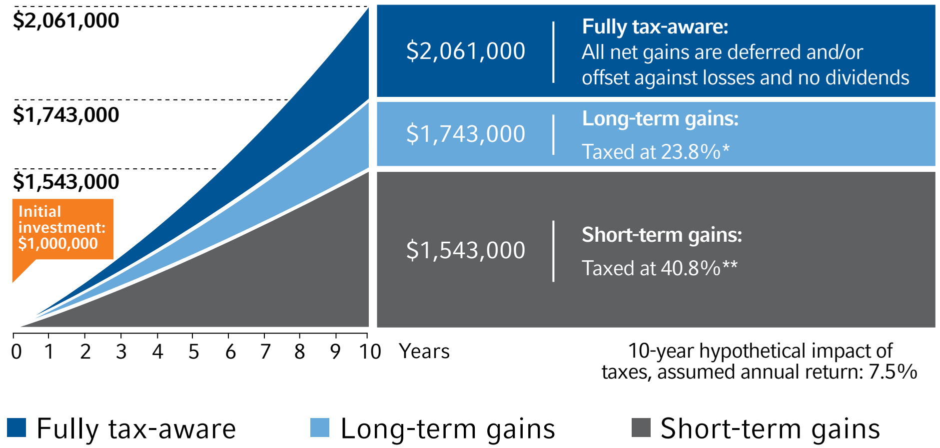
Contact our team at 800-787-7354 or service@russellinvestments.com if you have any questions or are interested in discussing solutions that could potentially benefit your tax-sensitive clients.

Rob Kuharic, CFA®
Director
Tax Managed Solutions



# Understanding the impact of taxes on client portfolios

**Hypothetical impact of taxes on growth of $1,000,000 over 10 years**




* Long-term cap gain rate of 20% + 3.8% net investment income tax (NIIT)

** 40.8% tax rate: Top marginal rate of 37% + 3.8% NIIT.

This example does not reflect the deduction of state income taxes. If it had, returns would have been lower.

This is a hypothetical illustration and not meant to represent an actual investment strategy.

Taxes may be due at some point in the future and tax rates may be different when they are.

The information, analyses and opinions set forth herein are subject to change, and intended to serve as general information only and should not be relied upon by any individual or entity as advice or recommendations specific to that individual entity. Anyone using this material should consult with their own attorney, accountant, financial or tax advisor or consultants on whom they rely for investment advice specific to their own circumstances.

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Russell Investments

SECTION 1

SECTION 1

## FOCUSING ON AFTER-TAX RETURNS YEAR-ROUND

Taxes have the ability to seriously erode investment returns. Focusing on after-tax returns is an opportunity for advisors to differentiate themselves to their high net-worth investors.

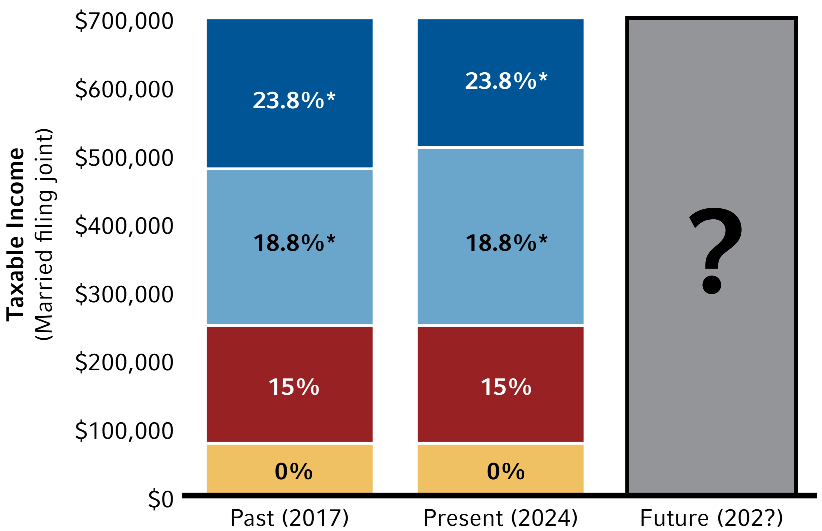
**In this section:**

- Tax-smart investing still matters
- The 4 A's of preparing for tax season
- How to calculate after-tax returns
- Investment taxes can be a factor in positive or negative return years
- Understanding your client's tax-sensitivity level
- Here's an easy way to understand the impact capital gains taxes can have on an investment portfolio

# Tax-smart investing still matters

While the 2017 Tax Act made dramatic changes to much of the tax code, the tax rates and income thresholds for taxes around many investments were virtually unchanged from 2017 to present. The tax rates and income thresholds generally were lowered for wages, interest income and short-term capital gains (STCG), but they barely moved for long-term capital gains (LTCG) and qualified dividends. These are the income sources that many advisors have the most impact on for their taxable clients. Being tax-smart around dividends and LTCG continue to be just as important as with the prior tax code or may be even more important given the limitations on deductions for many taxpayers.

**Long-Term Capital Gains/Qualified Dividends**




Rates unchanged / thresholds adjusted for inflation

* 3.8% Net Investment Income Tax applies to Modified Adjusted Gross Income over $250,000 for filing status MFJ Source: Internal Revenue Service.

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Consider a hypothetical $1,000,000 taxable investment by an investor in the highest federal tax bracket. Let's assume it is a diversified portfolio with 50% invested in stocks and 50% in bonds. A 4.9% capital gain distribution and 1.5% in dividends on the stock investments would generate $24,500 and $7,500 in income, respectively, and would be taxed at the long-term capital gains (LTCG) rate. Additionally, 4.5% in interest income from the bond investments would generate $22,500 in income taxed at the ordinary income tax rate. As you see in the table below, this would result in a tax bill of $16,796 for that portfolio, even if the income is reinvested.

| | |
|---|---|
| Assumed taxable investment*: | $1,000,000 (50% stocks, 50% bonds) |
| Capital gain distribution: | $24,500 |
| Dividends: | $7,500 |
| Interest: | $22,500 |
| Federal tax due**: | $16,796 |

**A tax bill of this magnitude can be an eye-opener for investors.** Given strong equity returns since 2009, it's hard to see the issue getting easier for taxable investors.

### Potential long-term benefits of tax-smart investing

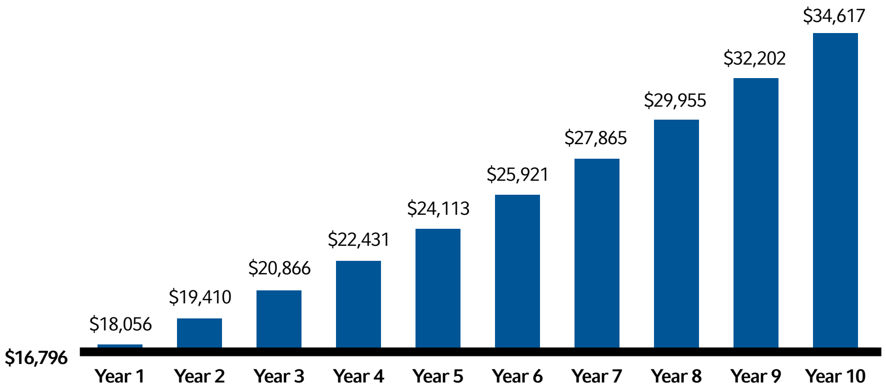
Five-figure tax bills aside, continually facing large taxable distributions, such as those seen in recent years, can have a material impact on the long-term wealth of investors. We at Russell Investments believe taxes can be managed—through active tax-loss harvesting year-round (not just at year-end) to limit taxable distributions, minimizing wash sales, managing holding periods, and focusing on qualified versus non-qualified dividend distributions. These tools can help lower tax liabilities today and allow for additional portfolio growth over the long run.

* Assumes an investment of $500,000 in stock funds, with a 4.9% capital gain distribution and 1.5% in dividends; and $500,000 in bonds with 4.5% in taxable interest income.

** Federal tax due calculation assumes the capital gain distribution and dividends are taxed at 23.8% (20.0% LTCG + 3.8% NIIT) and interest is taxed at 40.8% (37% ordinary income tax rate + 3.8% NIIT).

Let's consider our first scenario once again, where instead of paying a tax bill of $16,796, we invest that amount in a portfolio that averages a 7.5% annual return. Assuming no taxes are paid along the way, that investment would almost double over a 10-year time horizon to $34,617. (Of course taxes would be due when shares are eventually sold, but there can be major benefits to deferring gain recognition.)

**Hypothetical growth of a reinvested—rather than paid—tax bill**




Imagine what this additional potential money could do for your client's investment goals: Could it help fund their child's education? A down-payment on a home? Help them remain comfortable in retirement?

Taxes aren't simply percentages and unpleasant conversation topics to survive once per year. They can be actively managed to help your clients reach their goals—and to help you reach yours.

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# The 4 A's of preparing for tax season


## Summary

Advisors can consider taking these four steps to help prepare for anticipated taxes on their client portfolios.


Tax proposals and changes to the tax code are frequently in the news. We all know what that means: Client questions and conversations about what may, or may not, happen to tax rates-and more importantly-the potential impact on their portfolios, and what steps can be taken today to help manage that potential impact.

While investors wait for clarity on uncertain tax rates, there are actions advisors can take now to prepare for the certainty of capital gains and related taxable distributions. After all, fall/winter is the time of year when most mutual funds post their estimates for capital gains distributions and related taxable events. And it is not just capital gains that erode after-tax returns. Dividends and interest payments also reduce after-tax return of both passive and active strategies and they are paid throughout the year.

So, how can you prepare for these taxable events? Think of these four A's:

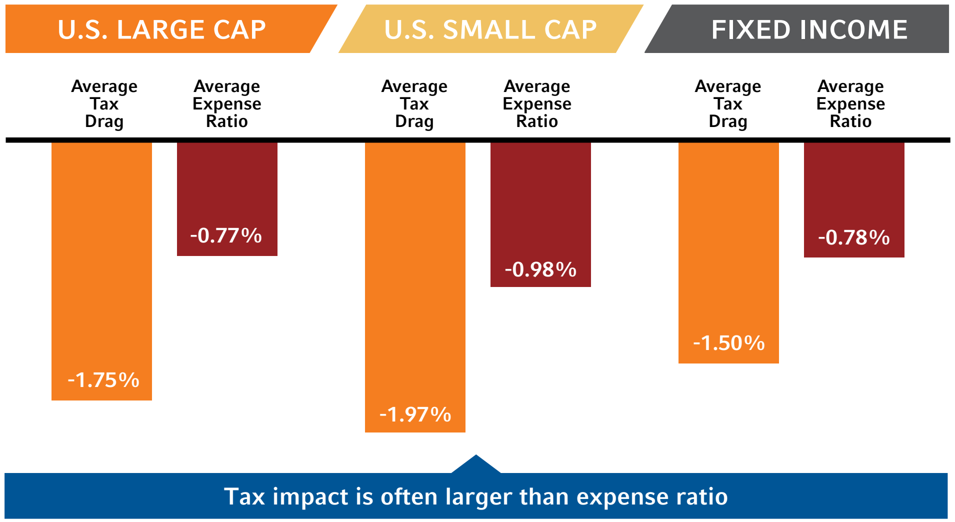
**Four A's of preparing for tax season**

| | | | |
|---|---|---|---|
| Awareness | Assessment | Action | Advocate |

## 1. Awareness

How big of a problem is tax drag? Looking at data across all investment products (active mutual funds, index funds and ETFs) reveals that the return lost to taxes is typically higher than the average net expense ratio. Another way to think of these lost returns is that they have been subjected to a *government expense ratio*. Awareness of the size of the tax drag can open your eyes to its pervasiveness across your clients' accounts. We believe reducing this tax drag is one of the best ways to justify the fee you charge and demonstrate your value in working to improve after-tax outcomes.

### Return lost to taxes vs. fund fees – three years ending Dec 2023




Source: Morningstar. U.S. Large Cap: Morningstar U.S. Large Blend Universes average, U.S. Small Cap: Morningstar U.S. Small Blend Universes average, Fixed Income: Morningstar Taxable Bond Universes average. Tax Drag: Morningstar Tax Cost Ratio. See appendix for methodology.

Morningstar's tax cost ratio assumes the highest possible applicable tax rates, including the 3.8% net investment income tax. Many investors are not subject to the highest rates. Note that tax drag calculations only apply to taxable accounts.



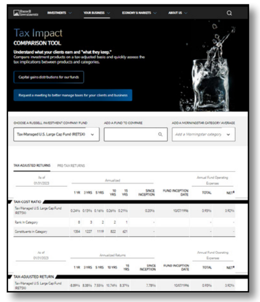


## 2. Assessment

History may not repeat itself, but when it comes to investment returns lost to taxes, it sure is indicative of past tax efficiency.

Reading about tax slippage is one thing, but seeing specific tax drag and after-tax return by product really helps in the Assessment. Our Tax Impact Comparison Tool, which uses Morningstar data, is a great way to assess the impact taxes have on investment returns to help make informed decisions for taxable accounts. This tool shows the amount of return lost to taxes (tax-cost ratio), after-tax return, and pre-tax return, and also shows their percentile rank within a peer universe.

### Russell Investments Tax Impact Comparison Tool



Try the tool now and get a comparison across multiple selections showing cost tax cost ratio, after-tax and pre-tax return for thousands of mutual funds and ETFs. Updated monthly.

**russellinvestments.com/us-interactive-tools**

## 3. Action

Once you have the awareness and an accurate assessment of tax drag across your portfolios, it is time to take Action. Consider the following client scenarios:

- **Cash or new money to invest?**
  With proper awareness and assessment, you should be well-positioned to make informed choices on after-tax return and tax drag for different investment options and the best tax-smart offerings.

- **Invested in a security or fund that is tax-inefficient or in which the client has lost conviction?**
  Russell Investments can help you conduct a break-even analysis to understand the possible tax impact of selling the asset and the potential return improvement of transitioning to a more tax-efficient alternative. The analysis can also help make an informed decision about whether executing the transition over time or “ripping off the band-aid” may make more sense. This may guide those considering pulling gains forward in advance of potential tax rate increases.

At least for current investments that are tax-inefficient, consider turning off the automatic reinvestment of capital gains, dividends, and income. No reason to put new money into the same tax-inferior alternative.

We believe tax-managed funds are a natural recipient of these scenarios.

### 4. Advocacy

In our annual Value of an Advisor Study, helping clients reduce the impact of taxes is one of the greatest value-adds advisors may bring to the client relationship. Tell your clients what you are doing to improve after-tax outcomes.

Demonstrate Advocacy to clients and prospects by helping them understand how you work to improve their after-tax investment outcomes. Be sure to avoid using jargon, like *basis points* and *percentage returns*. Talk about dollars and cents when showing clients the difference between tax-smart and tax-agnostic investment options. That will resonate much more clearly with them. Your efforts to protect their investments from the impact of taxes have the potential to go a long way toward strengthening the relationship. Advocate for the great work you do on their behalf.



**The bottom line:** *Don’t miss this opportunity to turn the headlines and debates about federal tax legislation into a productive relationship and business-building strategy focused on what you and your clients can control right now. At Russell Investments, we have series of tools, analysis, subject matter experts and dedicated sales/service teams to help you be successful in this space.*

## How to calculate after-tax returns

Calculating after-tax returns may seem onerous at first, but if you don’t know the portfolio’s after-tax return and some basic information about your clients’ tax status, how do you know if you are helping them grow their after-tax wealth?

To properly calculate your clients’ after-tax return, you need to consider the distributions/income coming from the underlying investments. For simplicity’s sake, we’ll limit this discussion to mutual funds, individual stocks and bonds.

### Identify the distribution

We’ve heard from several advisors that say they apply their clients’ marginal tax rate to the investment return. That’s not necessarily correct. The after-tax return should focus on the actual distribution and/or realized gain for that year—not the rate of return. Remember that not all return is equal in the consideration of taxes. Return through unrealized capital appreciation may be preferable to income or capital gain distributions for taxable investors.

### Do the prep

The list below is not intended to be all-inclusive or specific for all of your clients, but identifying the following numbers can be a beneficial step in preparing to calculate a client's after-tax return. Ask yourself:

- What is the amount of your client's actual distribution during the calendar year?
- What is the character of the distribution?
    - Was it interest income?
    - Qualified or non-qualified dividends?
    - Long-term capital gains (LTCG)?
    - Short-term capital gains (STCG)?
- What is your client's specific tax rate? Be sure to consider:
    - Marginal federal and state tax rates (the tax on the next dollar earned) for gains taxed as ordinary income. STCG and gains from other assets are taxed at the marginal rate.
    - The 3.8% net investment income tax (NIIT), if applicable. This is tied to investment income (interest, dividends, capital gain distributions) for clients with modified adjusted gross income high enough to cross the threshold.
- Does the client have capital losses outside the portfolio you managed or a capital loss carryforward to offset against distributed gains? If so, these may be able to be used to offset the current distribution.





### Do the math

Once you've done your prep work, it's a reasonably straight-forward calculation to determine after-tax return. Just follow these steps:

1. Apply the correct tax rate to the calendar-year distribution. Use the top marginal rate for STCG, taxable interest, non-qualified dividends or other items treated as ordinary income. Use the LTCG rate for qualified dividends and capital gains held greater than one year.
2. Do the calculation: [(ending market value – tax paid) – (beginning market value)] / (beginning market value)

The result is an approximation of the client's after-tax return. Note that if the taxpayer qualifies for the alternative minimum tax, results will vary.

## Example

It may help to look at an example. In this case, gains are treated as short term (taxed as ordinary income).

| | |
|---|---|
| **Assumptions:** | |
| Top marginal federal tax rate | 37.0% |
| NIIT on unearned income | 3.8% |
| Rate applied to STCG | 40.8% |
| Fund beginning market value | $100 |
| Assumed market return during year (annual return) | 5.0% |
| Fund ending market value | $105.00 |
| Assume fund had distribution at year end (% of NAV) | 10.0% |
| Taxable distribution (end market value x distribution %) | $10.50 |
| Tax rate (assume taxed as STCG + NIIT) | 40.8% |
| Federal tax due | $4.28 |
| Ending market value (net of tax paid) | $100.72 |
| Pre-tax return | 5.0%<br>($105-$100)/($100) |
| After-tax return (assuming no liquidation of shares)* | 0.7%<br>($100.72-$100)/($100) |

* If shares are sold at year-end, taxes would be due on the appreciation of shares and would reduce after-tax return.

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# Investment taxes can be a factor in positive or negative return years

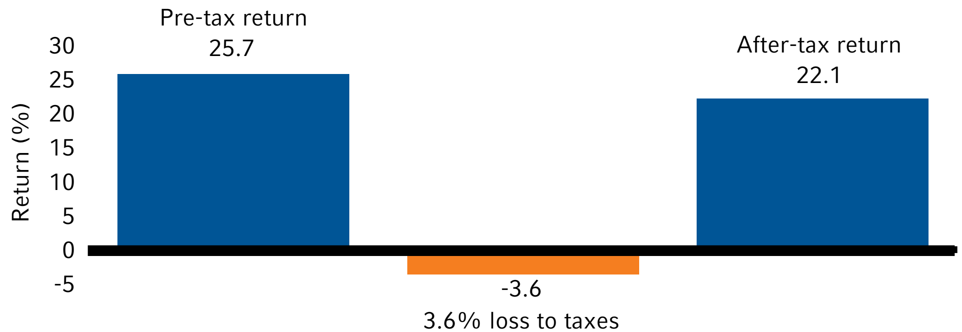
Investors may feel that taxes are only really a consideration in up markets. The charts that follow illustrate that taxes impact returns in both positive return years, like 2021, and negative years, like 2022.

- In 2021, assuming the average 12% distribution is taxed at 23.8% (20% LTCG + 3.8% NIIT), the return falls from 25.7% to 22.1%
- In 2022, assuming the average 7% distribution is also taxed at 23.8%, the after-tax return falls further from -19.2% to -20.5% for the year.

Note the overall tax burden is similar in both years; however, investor impact feels vastly different. The power of tax-managed investing lies in dialing down tax drag in up, down and flat markets. Reducing the tax liability—through thoughtful portfolio turnover, active tax-loss harvesting throughout the year, awareness of holding periods (STCG vs. LTCG), and awareness of yield—is how you can materially improve the odds of success for taxable clients.

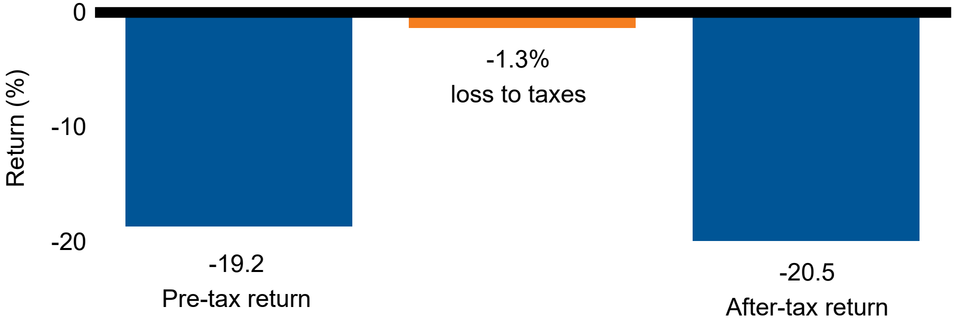
### 2021: $100,000 U.S. equity portfolio

- Market return: 25.7%
- Avg. 2021 fund taxable distribution: 12%
- Federal tax due: $3,590
- After-tax return: 22.1%



### 2022: $100,000 U.S. equity portfolio

- Market return: -19.2%
- Avg. 2022 fund taxable distribution: 7%
- Federal tax due: $1,346
- After-tax return: -20.5%




Market Return: Russell 3000® Index. Average taxable distribution includes average capital gain distribution for all Morningstar U.S. equity categories for listed year (no ETFs). Distribution is assumed to be made at last day of year and reinvested. Tax rate is 23.8% (Max LTCG 20% + NIIT 3.8%). Percent lost to taxes is the estimated taxes due divided by $100k.

Index returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment. Indexes are unmanaged and cannot be invested in directly.

### How can there be a tax owed when an investment goes down?

Mutual funds are required to payout 98.2% of realized capital gains back to shareholders within their fiscal year. If the mutual fund has unused losses from prior years (capital loss carryforwards), it may be able to offset some—or all—of the gain depending on size or availability of the loss carryforward. If hardly any U.S. equity funds have any available losses to use against recognized gains, the offset isn't possible.

In addition, selling pressures, due to investors' concerns about high valuations and/or moves to passive investing, can cause many portfolio managers to sell low basis securities at record levels. These sales then trigger short-term capital gains (STCG), which come with materially higher tax rates—depending on one's income tax bracket.

To summarize, the aforementioned selling pressure generates a positive payout, but in a year when equity markets are down.

# Understanding your client's tax-sensitivity level

## Finding clues in investor Form 1040

This section describes some of the ways to forensically go through the Form 1040. Note that none of the items highlighted suggest something is "good" or "bad" in regards to investment choices on Form 1040, but it does highlight where the investor is seeing taxable income resulting from their investment decisions. We find that investors (and many advisors) don't appreciate how much tax they are paying that is directly tied to their investments.

## Form 1040

Looking through an investor's Form 1040 can yield good insights in regard to investment-related taxable income. There are many other schedules and tax forms related to investment activities (Schedule 1, Schedule B, Schedule D, Schedule E, etc.), but at some point, all of these flow through Form 1040. Note that Form 1040-A and 1040-EZ have been discontinued.

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Form **1040** Department of the Treasury—Internal Revenue Service
**U.S. Individual Income Tax Return** **2023** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2023, or other tax year beginning , 2023, ending , 20 See separate instructions.

Your first name and middle initial | Last name | **Your social security number**

If joint return, spouse's first name and middle initial | Last name | **Spouse's social security number**

Home address (number and street). If you have a P.O. box, see instructions. | Apt. no.

City, town, or post office. If you have a foreign address, also complete spaces below. | State | ZIP code

Foreign country name | Foreign province/state/county | Foreign postal code

**Presidential Election Campaign** Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ **You** ☐ **Spouse**

**Filing Status** Check only one box.
☐ Single
☐ Married filing jointly (even if only one had income)
☐ Married filing separately (MFS)
☐ Head of household (HOH)
☐ Qualifying surviving spouse (QSS)
If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QSS box, enter the child's name if the qualifying person is a child but not your dependent:

**Digital Assets** At any time during 2023, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.) ☐ **Yes** ☐ **No**

**Standard Deduction** **Someone can claim:** ☐ You as a dependent ☐ Your spouse as a dependent
☐ Spouse itemizes on a separate return or you were a dual-status alien

**Age/Blindness** **You:** ☐ Were born before January 2, 1959 ☐ Are blind **Spouse:** ☐ Was born before January 2, 1959 ☐ Is blind

**Dependents** (see instructions): If more than four dependents, see instructions and check here ☐

| (1) First name Last name | (2) Social security number | (3) Relationship to you | (4) Check the box if qualifies for (see instructions): Child tax credit | Credit for other dependents |
|---|---|---|---|---|
| | | | ☐ | ☐ |
| | | | ☐ | ☐ |
| | | | ☐ | ☐ |
| | | | ☐ | ☐ |

**Income**

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.
If you did not get a Form W-2, see instructions.

| | | |
|---|---|---|
| 1a | Total amount from Form(s) W-2, box 1 (see instructions) | 1a |
| b | Household employee wages not reported on Form(s) W-2 | 1b |
| c | Tip income not reported on line 1a (see instructions) | 1c |
| d | Medicaid waiver payments not reported on Form(s) W-2 (see instructions) | 1d |
| e | Taxable dependent care benefits from Form 2441, line 26 | 1e |
| f | Employer-provided adoption benefits from Form 8839, line 29 | 1f |
| g | Wages from Form 8919, line 6 | 1g |
| h | Other earned income (see instructions) | 1h |
| i | Nontaxable combat pay election (see instructions) 1i | |
| z | Add lines 1a through 1h | 1z |

Attach Sch. B if required.

| | | | | |
|---|---|---|---|---|
| 2a | Tax-exempt interest | 2a | b Taxable interest | 2b |
| 3a | Qualified dividends | 3a | b Ordinary dividends | 3b |
| 4a | IRA distributions | 4a | b Taxable amount | 4b |
| 5a | Pensions and annuities | 5a | b Taxable amount | 5b |
| 6a | Social security benefits | 6a | b Taxable amount | 6b |
| c | If you elect to use the lump-sum election method, check here (see instructions) ☐ | | | |
| 7 | Capital gain or (loss). Attach Schedule D if required. If not required, check here ☐ | | | 7 |
| 8 | Additional income from Schedule 1, line 10 | | | 8 |
| 9 | Add lines 1z, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your **total income** | | | 9 |
| 10 | Adjustments to income from Schedule 1, line 26 | | | 10 |
| 11 | Subtract line 10 from line 9. This is your **adjusted gross income** | | | 11 |
| 12 | **Standard deduction or itemized deductions** (from Schedule A) | | | 12 |
| 13 | Qualified business income deduction from Form 8995 or Form 8995-A | | | 13 |
| 14 | Add lines 12 and 13 | | | 14 |
| 15 | Subtract line 14 from line 11. If zero or less, enter -0-. This is your **taxable income** | | | 15 |

**Standard Deduction for—**
- Single or Married filing separately, $13,850
- Married filing jointly or Qualifying surviving spouse, $27,700
- Head of household, $20,800
- If you checked any box under *Standard Deduction*, see instructions.

**For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions.** Cat. No. 11320B Form **1040** (2023)

For illustrative purposes only.

## Interest:

### Line 2a: Tax-exempt interest income

- Interest income from municipal bonds and municipal bond funds is reported here. This interest is generally tax-free at the federal level.

### Line 2b: Taxable interest

- If you have an investor with more than $1,500 in dividends or interest, they will likely file a Schedule B to itemize their interest and dividends.
- Line 2b equals the total received from taxable interest income. This will include interest-paying vehicles like savings account interest, CD's and interest earned from taxable bonds and taxable bond funds.
- Note that taxable interest is taxed as ordinary income and at the highest marginal tax rate for taxpayers.
- What is the after-tax yield on this interest income? Is this amount in line with helping to meet long-term financial goals?

$$\text{After-tax yield} = \text{pre-tax yield} \times (1 - \text{marginal rate})$$

**Tax check:** *Does the client understand the amount of taxes being paid on the interest? Perhaps consider municipal bond funds as either a replacement or complement to the current interest-paying accounts.*





## Dividends:

### Line 3a: Qualified dividends

- Line 3a equals the total amount of dividends that are considered as "qualified dividends" received from individual stocks and mutual funds. This designation is found in Box 1b in Form 1099-DIV. For dividends, recall there are two types to evaluate, and the difference can be material, in regards to taxes.
  - Qualified dividends: Generally, dividends paid from U.S. companies structured as corporations are considered qualified. Foreign dividends can be considered qualified as well if the issuer is a tax resident in a country that has a tax treaty with the U.S.
  - Non-qualified dividends: This category includes pretty much all other dividends. Examples include dividends from entities that include real estate investment trusts (REITs), master limited partnerships (MLPs), dividends paid on employee stock options, dividends paid by tax-exempt companies, and dividends paid on savings or money market accounts.

### Line 3b: Ordinary dividends

- Again, if you have an investor with more than $1,500 in dividends or interest, they will likely file a Schedule B to itemize their interest and dividends.
- Line 3b equals the total amount of dividends received and is generally found in Box 1a on Form 1099-DIV.

### Tax check: Why does it matter?

*Qualified dividends are treated as LTCG and currently taxed at 20% for those in the top tax bracket. Add in the 3.8% NIIT and the top rate is 23.8%.*

*Non-qualified dividends are taxed as ordinary income and will be taxed at the investors top marginal tax rate. For those in the top bracket, that is 37% + 3.8% NIIT for a total of 40.8%.*

- *Non-qualified dividends are taxed 71% higher than qualified dividends for those in the top bracket. This difference can greatly impact the after-tax return.*

**Capital gains:**

- **Line 7 of Form 1040:** Reports capital gains from Schedule D.
- **Line 13 of Schedule D:** This schedule feeds line 7 on Form 1040 and broadly covers the sale of capital assets during the year (broken out as short term and long term) and the reporting of capital loss carryforwards.

**Tax check:** *Is there an inordinate amount of buying and selling securities/funds relative to the size of the account? This higher turnover may be leading to increased taxes. A more thoughtful tax-managed approach may provide an improved after-tax return.*

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## Forensic review of Form 1099-DIV

### Look for:

- Difference between 1a and 1b. Too much non-qualified dividends?
- Does the client need dividend income?

**Box 1a: Total Ordinary Dividends**

- Includes qualified dividends
- Includes non-qualified dividends
- Includes net short-term capital gain distributions from mutual funds and/or real estate investment trusts (REITs)
- Includes taxable interest income from mutual funds (not just dividends)

**Box 1b: Qualified Dividends**

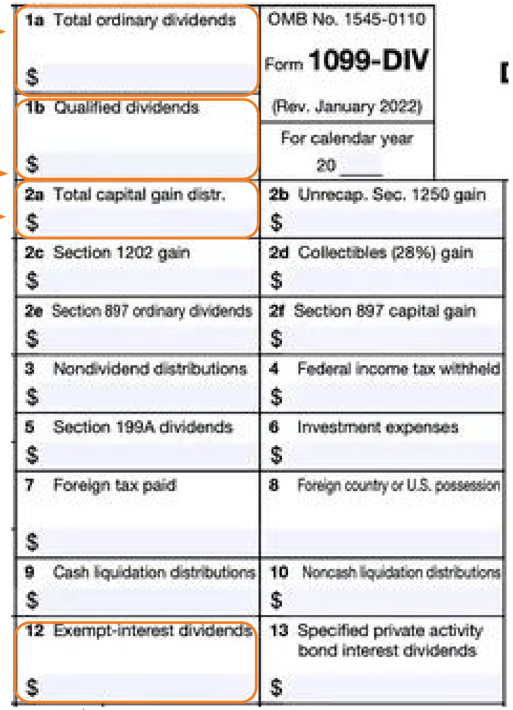
- Dividends paid by a U.S. company or qualifying foreign company
- Not all foreign dividends are qualified
- Generally, lower tax rate for qualified dividends

**Box 1a minus Box 1b = Non-Qualified Dividends**

- Includes interest income
- Includes dividends from REITs
- Taxed as ordinary income and often a higher corresponding tax rate

**Box 2a: Total Capital Gain Distribution**

- Net long-term capital gain distributions from mutual funds or REITs


1a Total ordinary dividends $
OMB No. 1545-0110
Form 1099-DIV
(Rev. January 2022)
For calendar year 20 ____
1b Qualified dividends $
2a Total capital gain distr. $
2b Unrecap. Sec. 1250 gain $
2c Section 1202 gain $
2d Collectibles (28%) gain $
2e Section 897 ordinary dividends $
2f Section 897 capital gain $
3 Nondividend distributions $
4 Federal income tax withheld $
5 Section 199A dividends $
6 Investment expenses $
7 Foreign tax paid $
8 Foreign country or U.S. possession
9 Cash liquidation distributions $
10 Noncash liquidation distributions $
12 Exempt-interest dividends $
13 Specified private activity bond interest dividends $

**Box 12: Exempt-Interest Dividends**
Interest income from municipal bond funds. Generally, tax-tree at the federal level. Know client's tax rate and tax-equivalent yield.

For illustrative purposes only.

### Summary

Your clients' tax forms can provide a great deal of information about investment-related taxes. In advance of tax day, use your clients' 1099-DIV forms to assess the general tax efficiency of their investments. After tax day, review their Form 1040 to see the actual impact of investment-related activities on their final tax bill.

Russell Investments’ 1099 Guide helps you determine what to look for along with insights, implications, and actions that can be taken to improve the tax efficiency of your clients' investments.

Access our 1099 Guide and other useful resources at:
**russellinvestments.com/us-tax-resources**






# Here’s an easy way to understand the impact capital gains taxes can have on an investment portfolio


### Summary

Taxes are complicated, but they don’t have to be. Here’s an easy way to understand the impact of capital gains distributions on a client’s annual tax bill.


Let’s be honest-taxes are complicated. Trying to make sense of it all can be quite frustrating for many investors. Whether it’s the forms you need to fill out, the information you need to gather to fill in those forms, the many different tax rates that exist, what actions trigger different tax rates... it’s almost as if you need a master’s degree in tax policy just to understand how to pay your taxes.

Regardless, we all need to understand how taxes work. Because taxes have an impact on our income, our wealth, our lives and our ability to have a comfortable retirement. And even more than understanding taxes, we need to know what to do about them.

### Taxes on investments: fees of no value

For many people, their investment portfolio will be the primary source of income in retirement. When it comes to the taxable part of the investment portfolio (often referred to as non-qualified accounts) what is the impact of taxes on this key source of retirement income?

Let’s take a look at how taxes play out and the impact they can have on investment outcomes. The focus here will be on capital gains distributions. These are annual distributions that come out of many mutual funds. While many investors think of them as a dividend, they are actually a return of capital. Investors often do not understand the deep impact these distributions can have on their long-term wealth.

## The Impact of capital gains distributions

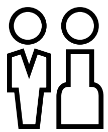
We'll start by looking at the experience of a traditional investor couple. At the end of 2023, they have a balance of $500,000 in their taxable accounts.

The average capital gains distribution in 2023 was 5%. This number by itself doesn't mean much to most people; but when you do the math, that results in a $25,000 taxable distribution on the couple's Form 1099-DIV as shown in our hypothetical illustration below. This is the number that they are going to have to pay capital gains taxes on.

For the sake of simplicity, let's use a 23.8% tax rate in this example. This is the 20% top long-term capital gains tax rate at the federal level plus the 3.8% investment tax surcharge.

Let's add it up: 23.8% of a $25,000 distribution means that this traditional investor couple will receive a $5,950 tax bill. This is not a small amount!

### How much might the IRS take from this Traditional Taxpayer?



| | Traditional Taxpayer |
|---|---|
| **Year End Balance** | **$500,000** |
| Capital Gain Distribution | 5.0%** |
| 1099 | $25,000 |
| Assumed Tax Rate* | 23.8% |
| Tax Due | $5,950 |

A hypothetical illustration.

*23.8%: Represents the 20% top long-term cap gains rate plus 3.8% Net Investment Income Tax.

**5%: Represents 2023 average capital gain distribution % of Morningstar broad category 'U.S. Equity, which includes mutual funds and ETFs.

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## A better outcome

Is there a better way?

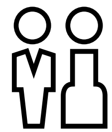
Yes, there is, by focusing on active tax management. By using a more hands-on and intensive approach to managing taxes and minimizing capital gain distributions, a better result may be achieved.

Let's look at another example using a different couple – Tax-Aware Taxpayers. For comparison's sake, we will use the same year-end $500,000 balance.

While a traditional investor last year may have experienced the 5% capital gain distribution mentioned earlier, a tax-aware investor's portfolio taking full advantage of active tax-managed solutions could have had a 0% distribution. A distribution of 0% means their money stays right where they intended-in their portfolio!

Let's keep working through the math and still assume that same 23.8% tax rate. When you get to calculating the final figure, remember what we learned back in elementary school about multiplying anything times a zero-the outcome is zero. That's the tax bill for our Tax-Aware Taxpayers.

### How about a tax-aware investor?



| | Tax-Aware Taxpayer |
|---|---|
| **Year End Balance** | **$500,000** |
| Capital Gain Distribution | 0.0% |
| 1099 | $0 |
| Assumed Tax Rate* | 23.8% |
| Tax Due | $0 |

A hypothetical illustration.

*23.8%: Represents the 20% top long-term cap gains rate plus 3.8% Net Investment Income Tax.

## Adding it up

Let's look at these two examples now side by side.

Look at the difference in these tax bills.

Which one of these two tax bills do you think your clients would rather pay?

## The power of taxes

**How much are yearly taxes costing your clients?**

| | Traditional Taxpayer | Tax-Aware Taxpayer |
|---|---|---|
| **Year End Balance** | **$500,000** | **$500,000** |
| Capital Gain Distribution | 5.0%** | 0.0% |
| 1099 | $25,000 | $0 |
| Assumed Tax Rate* | 23.8% | 23.8% |
| Tax Due | $5,950 | $0 |

**A weight lifted.**
**It's not only about December 31st. April 15th is key.**

A hypothetical illustration.

*23.8%: Represents the 20% top long-term cap gains rate plus 3.8% Net Investment Income Tax.

**5%: Represents 2023 average capital gain distribution % of Morningstar broad category 'U.S. Equity, which includes mutual funds and ETFs.

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**The bottom line:** *While taxes may by complicated and confusing, they are important. The thing is, you don't need to be an expert in taxes to address the problem they create for your clients.*

*An active tax-managed investing approach can lead to a much better after-tax outcome. Tax drag is not only a burden that weighs on returns over time, but also an indicator that portfolios are not deploying proper solutions. Russell Investments can help shine the light on both the problem as well as the solution.*

*We're not only leaders in active tax management, we're also pioneers, having spent the past 35 years sharpening an approach tailored to remove complexity, solve problems and save time. Tax management is our specialty, and we are here to serve advisors looking to unlock true return by helping their tax-sensitive clients keep more of what they earn.*

# SECTION 2

SECTION 2

## A REVIEW OF THE 2017 TAX CUTS AND JOBS ACT

While most parts of the Tax Cuts and Jobs Act (TCJA) went into effect in 2018, it is still worth reviewing the major changes to the tax code. Parts of the bill will sunset after 2025, but the TCJA remains the largest change to the tax code since 1985.

**In this section:**

- 2022 tax law changes: The Inflation Reduction Act and SECURE 2.0 Act
- Tax rate modifications
- Alternative minimum tax
- Itemized deductions
- Other deductions, exclusions, and credits
- Miscellaneous provisions
- Estate, gift, and generation-skipping transfer tax
- Tax reform summary

**This section contains content sourced from the *2019, 2020, 2021 & 2023 Essential Tax and Wealth Planning Guide* published by Deloitte. Deloitte provides industry-leading audit, consulting, tax, and advisory services to many of the world's most admired brands.**

# 2022 tax law changes

### The Inflation Reduction Act

The tax provisions in the Inflation Reduction Act focus heavily on the corporate side of the tax code but the measures include roughly $80 billion in new funds that will be available to the Internal Revenue Service over 10 years, with much of that amount set to be allocated to strengthening tax collection and enforcement efforts focused on wealthy individuals and large corporations as part of the Service's overarching goal of narrowing the "tax gap"—the difference between the amount of taxes owed to the federal government and the amount paid and collected on a timely basis. The new funding is expected to be directed largely to modernizing information technology, improving data analytic approaches, and hiring and training agents dedicated to auditing highly complex returns involving sophisticated tax transactions.

### SECURE 2.0

Building on the SECURE Act of 2019, the SECURE 2.0 Act creates several new provisions related to retirement savings. Key provisions increase the limits for certain catch-up contributions, increase the age for required minimum distributions, and expand options for certain tax- and penalty-free withdrawals and rollovers. The provisions expand the universe of workers that participate in employer-sponsored retirement plans, creating certain automatic enrollment requirements, expanding options for employer matching contributions, and reducing requirements for part-time employee participation.

See the **Tax reform summary** at the end of this section for a quick guide to the primary changes.

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# Tax rate modifications

### Ordinary income tax rates

The 2017 Tax Act maintains seven individual income tax brackets, which are typically adjusted each year for inflation. Through 2025, the marriage penalty will only apply to married-filing-jointly taxpayers whose combined taxable income falls in the 37% tax bracket. These rates are set to expire after 2025.

### Pass-through tax rates

Pass-through income continues to be taxed at a taxpayer's individual rate, however, for individuals and fiduciaries, the 2017 Tax Act includes a 20% deduction against domestic qualified business income from a partnership, S corporation, or sole proprietorship. (Details on the deduction are further discussed in Section 3: Tax Rates, Section 199A deduction (pass-through activities) of this publication.)

### Corporate tax rates

The 2017 Tax Act changed the top corporate rate from 35% to one flat rate of 21%. This rate was effective for corporations whose tax year begins after January 1, 2018 and unlike the individual rates cuts which are set to expire after 2025, this rate cut is a permanent change to the tax code.

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# Alternative minimum tax

Alternative minimum tax (AMT) applies to individual and fiduciary income taxpayers. Exemption amounts and phaseout thresholds are typically adjusted each year for inflation. The four historic pillars of AMT were eliminated or reduced by the 2017 Tax Act, including personal exemptions, miscellaneous itemized deductions, state and local taxes, and net operation loss limits. As a result of these changes, the "old AMT" has essentially become the new regular tax. Moreover, for those with pre-2018 AMT credit carryforwards, these and other changes may assist such taxpayers with realizing such carryforwards.

# Itemized deductions

Taxpayers may choose to either itemize their deductions or use the standard deduction and the 2017 Tax Act nearly doubled the standard deduction. The standard deduction will allow many individuals to avoid itemizing their deductions. However, for those individuals who will itemize, there are several notable items:

### Mortgage interest deduction

The mortgage interest is deductible on new loans up to $750,000 ($375,000 for married taxpayers filing separately) for acquisition debt which includes debt used to substantially improve the collateralized home. Mortgages existing on or before December 15, 2017 are grandfathered under the prior-law $1 million threshold even if refinanced, but not above the current balance. There is no interest deduction for home-equity indebtedness, except to the extent the home-equity loan is used to buy, build or substantially improve the taxpayer's home that secures the loan or deductible under interest tracing rules.





### Miscellaneous itemized deductions

Miscellaneous deductions subject to the 2% of the adjusted gross income (AGI) floor under prior law are unavailable through 2025. This includes a variety of expenses, including deductions for investment expenses, trustee fees, tax preparation fees, unreimbursed employee expenses and dues and subscriptions. The 2017 Tax Act clarified that trusts and estates will continue to be allowed to deduct their administrative expenses.

### State and local tax

The 2017 Tax Act capped the deduction for the aggregate of non-business (1) state and local income taxes, and (2) state and local property taxes at $10,000 ($5,000 for married taxpayers filing separately). The $10,000 limitation is not indexed for inflation. Non-business foreign real property taxes are not deductible.

In response to the 2017 Tax Act, many states have either enacted or proposed workarounds that provide a mechanism for state and local taxes (SALT) to be deducted at the pass-through entity level rather than at the partner or shareholder level where such owners are typically subject to the state and local income tax deduction limitation. Thus, through the passthrough entity, the owners receive a deduction for federal purposes that would have been limited if the SALT were paid by the owner directly. This is commonly referred to as a pass-through entity tax, or "PET". See Section 3 for a deeper dive on PET.

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## Charitable contributions

Under the 2017 Tax Act, a charitable deduction is no longer available for payments made in exchange for college athletic event seating rights. When it comes to the AGI limitations on cash contributions to public charities, the 2017 Tax Act increased the AGI limit for cash contributed to public charities and certain other organizations from 50% to 60%. All other limits based on AGI remain unchanged. If you make charitable contributions in excess of the applicable AGI limit, including the new 60% limitation, you are still able to carry the excess amount forward for up to five years.

*One note of caution:* As shown in the following example, non-cash contributions may impact a taxpayer's ability to fully utilize the new 60% AGI limitation on cash contributions. This is because charitable contributions of non-cash property to public charities are only allowed to the extent the aggregate of those contributions does not exceed the lesser of (1) 30% of the taxpayer's contribution base (generally, the taxpayer's AGI) or (2) the excess of 50% of the taxpayer's contribution base over the allowed amount of cash gifted to public charities. There has been commentary indicating that this issue may be addressed via a technical corrections bill, but when or if such a legislative change will occur is uncertain.

## Don't forget about substantiation!

Charitable deductions are always dependent on meeting strict substantiation requirements. Take great care with non-cash gifts, as final regulations issued in 2018 impose new substantiation requirements, including more exacting rules for qualified appraisals.

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### Example

**Facts**

| $10M | $4M | $4M |
|---|---|---|
| AGI | cash gift to public charity | stock gift to public charity |

**Result**

| | |
|---|---|
| Full deduction for **$4M** cash donation, but only **$1M** of the stock donation is allowed as a deduction. Carryforward of **$3M** | Non-cash contribution deduction is the lesser of: **30% x $10M = $3M** or **(50% x $10M) - $4M cash gift = $1M** |

## Pease limitation

For high-income taxpayers who itemize their deductions, the Pease limitations previously capped or phased out certain deductions. There are no Pease limitations through 2025.

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# Other deductions, exclusions, and credits

### Personal exemption

There are no personal exemption deductions allowed for the current tax year. The personal exemption amount was set to zero under the 2017 Tax Act and is repealed through 2025.

### Alimony

Alimony payments are neither taxable to the recipient nor deductible by the payer for any divorce or separation maintenance payments executed after December 31, 2018. Alimony payments under divorce or separation agreements in effect before December 31, 2018 are not affected by the 2017 Tax Act rules. The treatment of child support was not changed.

### Child tax credit

The child tax credit is $2,000 per qualifying child; of which $1,700 per qualifying child is refundable. The credit begins to phase out for married-filing-jointly taxpayers with adjusted gross income in excess of $400,000. The phase outs will not be indexed for inflation. A $500 non-refundable credit is available for qualifying dependents other than children, intended to account for the fact that taxpayers no longer have the ability to claim other dependents, such as parents, on their tax returns as personal exemptions since those have been eliminated.

### Moving expenses

The 2017 Tax Act repealed the exclusion from gross income and wages for qualified moving expense reimbursements and repealed the moving expense deduction other than for members of the U.S. Armed Forces moving on military orders.





# Miscellaneous provisions

### Net operating losses (NOL)

The 2017 Tax Act eliminated the NOL carryback period and makes the carryforward period indefinite. The amount of the NOL deduction allowed is limited to 80% of taxable income. These provisions apply to NOLs that occur after December 31, 2017.

### Like-kind exchanges

The 2017 Tax Act limited the scope of like-kind exchange non-recognition treatment to real property that is not held primarily for sale. Personal property that previously qualified for non-recognition treatment no longer qualifies under the 2017 Tax Act.

### Carried interest

A three-year holding period is required to obtain long-term capital gain treatment with respect to carried interests. There is no grandfathering for investments held prior to enactment.

### Section 529 plans

Section 529 plan funds can be used for elementary or secondary public, private, or religious school tuition and eligible expenses. In addition, the named beneficiary of the 529 plan and each sibling can each withdraw up to $10,000 to repay student loans. These distributions are on a per-student basis.

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### Individual (health insurance) mandate

There is no penalty for individuals who do not maintain qualifying health insurance coverage under the Patient Protection and Affordable Care Act (the "individual mandate"). The reduced penalty is effective for months beginning after December 31, 2018. Unlike other individual provisions in the 2017 Tax Act, this does not sunset after the end of 2025.

## Estate, gift and generation-skipping transfer tax

The applicable exclusion amount (the amount that each citizen is entitled to transfer either during life or, if otherwise unused, at death without incurring a current tax) and the gift and generation-skipping transfer (GST) tax exemption (the amount that may be transferred to skip-persons outright or in trust without giving rise to a present or future GST tax) can be found in the current-year edition of Tax Facts & Figures, a separate, quick-reference tax facts guide.

The annual GST exclusion amounts are $18,000 to each donee. Gifts up to this amount will not be taxable or count against a donor's unified estate and gift tax exemption. Married filers can make joint gifts of up to $36,000 to each donee under gift-splitting rules.

The exclusion and GST exemption continues to be indexed for inflation. However, beginning January 1, 2026, the exclusion amount and the GST exemption will return to the pre-2017 Tax Act amounts ($5 million per taxpayer albeit increased for inflation adjustments from 2012 through 2025). The IRS has issued proposed regulations indicating there will not be a "claw-back" in determining the estate tax for deaths occurring after December 31, 2025 for taxpayers who take advantage of the higher applicable exclusion amount.

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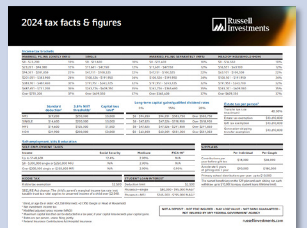
# Tax reform summary

| NEW LAWS FOR TAX YEARS 2018-2025 | |
|---|---|
| **Charitable contributions** | • Increased limitation for cash contributions from 50% of AGI to 60% of AGI<br>• All other limits based on AGI remain unchanged |
| **State, local, and foreign real property taxes** | • Deduction of up to $10k ($5k married filing separately, or single) for the aggregate of non-business:<br>- State and local property taxes, and<br>- State and local income taxes or sales taxes<br>• No deduction for foreign property taxes |
| **State/local income taxes** | |
| **Mortgage interest deduction** | • Existing mortgages grandfathered<br>• Generally deductible on new loans up to $750,000 MFJ<br>• Limited to two qualified residences<br>• No deduction for home equity loan interest |
| **2% itemized deductions, personal exemption phaseout (PEP) and limitation on itemized deductions (Pease)** | *Repealed*<br>Note: Trusts and estates can continue to deduct their administrative expenses. |
| **Child tax credit & Family tax credit** | • $2,000 credit per child under age 17 and $500 per non-child dependent<br>• Phase out increased to $200k/$400k<br>• SSN required for $1,700 refundable portion of credit |
| **Affordable Care Act** | Penalty lowered to $0 (this change continues to be in effect after 2025) |
| **Estate, gift, and generation-skipping transfer tax** | • No change to rates, annual exclusions, or basis step-up at death.<br>• Exemption amounts will be adjusted annually for inflation. |

### Tax Facts & Figures

Your quick reference guide to find the latest key tax rates, and more.

**russellinvestments.com/us-tax-resources**

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| NEW LAWS FOR TAX YEARS 2018-2025 | |
|---|---|
| **Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act)** | • Required minimum distribution age increased from 70½ to 72 years of age.<br>• Traditional IRA contributions can be made after age 70½.<br>• Any pre-tax amount contributed to a traditional IRA after age 70½ will reduce your allowable qualified charitable distributions.<br>• Beneficiaries of inherited retirement accounts must fully distribute those assets within 10 years, or be subject to a 50% penalty.<br>• New parents can withdraw up to $5,000 penalty-free from a retirement account to pay for birth and/or adoption expenses.<br>• The named beneficiary and any siblings can each use assets in a 529 plan to repay up to $10,000 in student loans.<br>• Unearned income by a child under age 19 or full-time student under age 24 that exceeds the Kiddie tax exemption will be taxed at the child's parent's marginal income tax rate.<br>• Changes from SECURE Act went into effect starting in 2020 and will continue after 2025. |
| **SECURE 2.0 Act of 2022** | • Required minimum distribution age increased to 73 years beginning in 2023 and to 75 years beginning in 2032.<br>• Catch-up contribution amounts for SIMPLE plans and for certain participants age groups in 401(k), 403(b), and governmental 457(b) plans will generally increase and will be indexed annually for inflation, effective December 31, 2024.<br>• Catch-up contribution limits for IRA holders aged 50 and older will be adjusted annually for inflation, effective December 31, 2023.<br>• Rollovers from 529 accounts to Roth IRAs will be permitted tax- and penalty-free, under certain conditions, and subject to a lifetime cap of $35,000, effective after December 31, 2023.<br>• New 401(k) and 403(b) plans will be required to automatically enroll participants once they become eligible. Employees will have the option to opt out. The initial automatic enrollment amount will be at least 3% and no more than 10% of salary, and will increase by 1% each year until it reaches 10%, but not more than 15%.<br>• Individuals facing federally declared disasters, domestic abuse, terminal illness, and other unforeseen emergencies will have penalty-free access to retirement funds, subject to certain conditions. Various effective dates apply.<br>• For full details on the SECURE Act, please visit russellinvestments.com/SECUREAct2. |





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SECTION 3

SECTION 3

# A DEEPER DIVE ON TAXES

If you're looking for a deeper dive on tax rates and key provisions, you are in the right section.

**In this section:**

- Tax rates
  - Ordinary income
  - Dividends
  - Capital gains
  - Net investment income tax
  - Passive activities
  - Self-employment tax
  - Alternative minimum tax
  - Kiddie tax
  - Section 199A deduction (pass-through activities)
- Excess business and net operating losses
- Transition (Section 965) tax
- Global Intangible Low-Taxed Income (GILTI)
- Pass-through Entity Tax (PET)
- Foreign Income and Foreign Tax Credits
- Virtual Currency

**This section contains content sourced from 2017 Tax Act: Private Wealth Summary of Select Provisions Impacting Individuals and the 2019, 2020, 2021 & 2023 Essential Tax and Wealth Planning Guide published by Deloitte. Deloitte provides industry-leading audit, consulting, tax, and advisory services to many of the world's most admired brands.**

# Tax rates: Ordinary income

Individuals whose primary source of income comes from employment will generate ordinary income in the form of wages, salaries, tips, commissions, bonuses, and other types of compensation. Other investments may also generate ordinary income in the form of interest, non-qualified dividends, net income from a sole proprietorship, partnership or limited liability company (LLC), rents, royalties, or gambling winnings. Ordinary tax rates range from 10% to 37% and will remain in place through 2025.

# Tax rates: Dividends

### Tax rates on qualified and non-qualified dividends

The tax rates for *qualified* dividends are 0%, 15%, and 20%. Qualified dividend rate income thresholds are typically adjusted each year for inflation.

Note that the 2017 Tax Act did not change the tax rates for qualified dividends and long-term capital gains (LTCG) from prior law and only marginally adjusted the brackets for inflation.

However, not all dividends meet the requirements to be taxed at the lower qualified dividend rates. These are called non-qualified dividends. Some examples of non-qualified dividends include those paid by:

- A foreign corporation in a country that does not have a tax treaty in place with the U.S.
- Real estate investment trusts (REITs)
- Master limited partnerships (MLPs)
- Employee stock options
- Tax-exempt organizations
- Savings or money market accounts



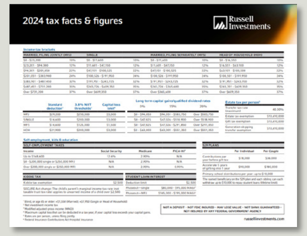


*Non-qualified* dividends are taxed at ordinary income rates, which can be as high as 37%. Dividends, whether qualified or non-qualified, may still be subject to the 3.8% net investment income tax (NIIT).

### Tax Facts & Figures

Your quick reference guide to find the latest key tax rates, and more.

**russellinvestments.com/us-tax-resources**




# Tax rates: Capital gains

### Long-term capital gains (LTCG) tax rates

LTCG tax rates are typically adjusted each year for inflation.

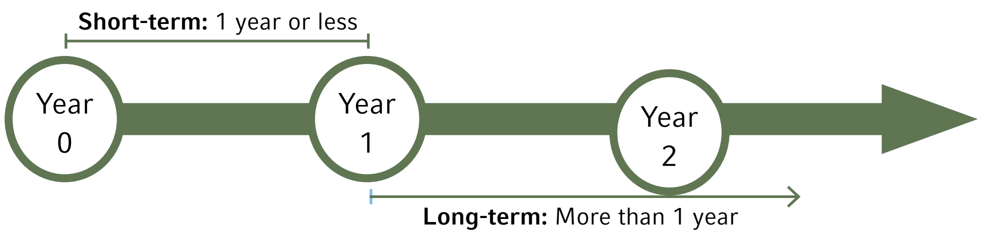
Certain sales of capital assets do not qualify for the lower capital gains rate. Qualified small business stock is generally subject to the 50% exclusion, and the remainder is taxed at 28%, subject to certain exceptions.

### Capital gains and capital losses

The decision to sell capital assets should be based on economic fundamentals, together with your client's investment goals; however, you should also consider the tax aspects. To illustrate, a taxpayer in the 37% tax bracket is subject to a 20% capital gains tax rate on assets held for more than one year; thus, a 17% rate differential exists between LTCG and short-term capital gains (STCG) (which are taxed at ordinary income rates). Both LTCG and STCG on almost all assets will be subject to the 3.8% NIIT.

Given the tax preferential nature of LTCG income, special attention should be given to the holding period of an asset to take full advantage of the LTCG rates. Certain sales of capital assets do not qualify for the lower capital gains rate. A STCG—or gain on the sale of an asset held for one year or less—is still a capital gain, but is taxed at ordinary income tax rates. Although STCG are taxed at the same rate as ordinary income, a benefit to STCG is that they can be offset with capital losses since an individual will net his or her capital gains and losses in arriving at their total capital gain income. Note that if capital losses exceed capital gains, a taxpayer can only deduct up to $3,000 of net capital losses against other income—the balance of their net capital loss is to be carried forward to future years.

**Holding period**




## Tax rates: Net investment income tax

### Net investment income tax (NIIT)

Individuals, trusts and estates with income above specific thresholds are subject to NIIT. An additional 3.8% NIIT is imposed on unearned income, including:

- Interest, dividends, capital gains (other than capital gains from the sale of property held in a trade or business in which the owner materially participates), annuities, royalties and rents
- Income from businesses in which the taxpayer does not actively participate (income not earned from a trade or business and income subject to the passive-activity rules)



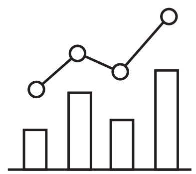


Because the tax applies to gross income from these sources, income that is excluded from gross income, such as tax-exempt interest, will not be taxed. The tax is applied against the lesser of the taxpayer’s net investment income (after investment-related and allowable deductions) or modified adjusted gross income (AGI) in excess of the threshold amounts. Some types of income are exempt from the tax, including:

- Income from businesses in which the taxpayer actively participates
- Gains from the disposition of certain active partnerships and S corporations
- Distributions from qualified plans and individual retirement accounts
- Wages and any item taken into account in determining self-employment income

For estates and trusts, the NIIT applies on the lesser of the undistributed net investment income, or the excess of AGI over the dollar amounts at which the 37% tax bracket for estates and trusts will begin. The threshold amount for the upcoming year is updated by the IRS each fall in a revenue procedure. Because this threshold is so low, consideration should be given to distributing income to beneficiaries who may be in lower effective tax brackets.

**NIIT**



A **3.8%** tax levied on certain unearned income of individuals

**Net investment income** means the excess of the sum of gross income from the following over properly allowable deductions:

- ☑ Interest
- ☑ Dividends
- ☑ Capital gains
- ☑ Annuities
- ☑ Rents and royalties
- ☑ Passive activities and trading partnerships

Does **NOT** apply to:

- ☒ Income that is derived in the ordinary course of a trade or business and not treated as a passive activity
- ☒ Distributions from qualified plans
- ☒ Wages
- ☒ Self-employment income

### Example 1:

John, a single taxpayer, earns $195,000 in compensation and $30,000 of dividend and interest income during the current tax year. These are his only items of income or loss.

John is subject to the 3.8% NIIT on the lesser of:

- Net investment income—$30,000 of dividends and interest income, or
- Modified AGI—$225,000 ($195,000 + $30,000) less the applicable threshold of $200,000, or $25,000.

Despite the fact that John has net investment income and modified AGI in excess of the threshold amount, he does not owe the 3.8% NIIT on his entire $30,000 of investment income. Rather, the amount of his net investment income that is subject to the 3.8% NIIT is limited to the excess of John's modified AGI ($225,000) over the threshold amount ($200,000), or $25,000. John's NIIT can be calculated as $25,000 x 3.8% = $950.





### Example 2:

Amanda and Michael, a married couple filing jointly, together earn $385,000 in compensation and $50,000 of dividend and interest income during the current tax year. These are their only items of income or loss. They are subject to the 3.8% NIIT on the lesser of:

- Net investment income—$50,000 of dividends and interest income, or
- Modified AGI—$435,000 ($385,000 + $50,000) less the applicable threshold of $250,000, or $185,000.

In this example, Amanda and Michael owe the 3.8% NIIT on their $50,000 of net investment income which would be $1,900 in NIIT ($50,000 x 3.8%).

## Tax rates: Passive activities

**Passive loss rules treat certain trade or business activities and rentals as passive activities**

Trade or business activities are classified as passive when the taxpayers' level of participation does not rise to the level of material participation. Rentals are treated as trade or business activities that are generally passive, regardless of the taxpayer's level of participation (subject to special rules for real estate professionals).

Individuals who own rental properties and qualify as a real estate professional are able to deduct up to $25,000 of losses per year against other income. This amount generally is phased out by 50% of the amount by which the investor's income exceeds $100,000. Therefore, the deduction is fully phased out if the investor has AGI of $150,000 or more. These amounts are not indexed for inflation.

It is important to be aware of the various types of income your clients have in order to understand how taxes will play a role in their individual situations.

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**Example:**

A client with significant capital gains or other portfolio income (i.e., interest, dividends, royalties) generally will not be allowed to offset this income with losses from a passive activity.

**Passive gains and losses**

Net losses from passive activities generally cannot be used to reduce other taxable income. Instead, these losses are suspended, to be deducted when the activity that generated the loss is disposed of in a taxable transaction, or when the taxpayer's passive activities begin generating taxable income. Credits arising from passive activities are subject to similar rules. Also, gifts (to family members or charity) do not permit the use of suspended passive losses or credits. Planning for passive activities has become increasingly important as passive income may be subject to the 3.8% NIIT.

## Tax rates: Self-employment tax

Taxpayers with income generated by operating a business as a sole proprietor, a partner in a partnership, or a member of a multi-member LLC, are usually subject to self-employment tax in addition to ordinary income tax. Self-employment tax is typically adjusted each year for inflation. Self-employment and Medicare taxes are in addition to the Federal Insurance Contributions Act-Hospital Insurance tax (FICA-HI). Once self-employment tax has been calculated, then half of that amount is deductible when calculating overall AGI for that year.

**FICA-HI tax**

An additional 0.9% FICA-HI tax applies to earnings of self-employed individuals or wages of an employee received in excess of $200,000 ($250,000 if MFJ). Self-employed individuals will not be permitted to deduct any portion of the additional tax. If a self-employed individual also has wage income, then the threshold above which the additional tax is imposed will be reduced by the amount of wages taken into account in determining the taxpayer's liability.

**FICA-HI tax**

Employee share is **0.9%** for an individual's wages, compensation, or self-employment income that exceeds threshold for filing status:

| Married filing jointly | Married filing separately | Single |
|---|---|---|
| $250,000 | $125,000 | $200,000 |

Self-employed individuals are not permitted to deduct any portion of the additional tax. This change does not affect the employer hospital insurance contribution.

## Tax rates: Alternative minimum tax

Alternative minimum tax (AMT) is imposed at a nearly flat rate on an adjusted amount of taxable income above a certain threshold, which is also known as an exemption. The exemption is substantially higher than the exemption from regular income tax. The AMT exemption is indexed for inflation and phased out as taxpayers reach higher levels of AMT income.

A prior year minimum tax credit is a credit for AMT paid in a prior year. If a taxpayer doesn't owe any AMT for the current year they may be eligible to use the credit for prior year minimum tax. If eligible, a taxpayer may decrease their regular tax liability in a later year, when they are not subject to AMT.

The ability to apply most non-refundable personal credits (including the Dependent Care Credit, the credit for the elderly and disabled, the credit for interest on certain home mortgages, and the Hope Education

Credit) against the AMT expired at the end of 2011 but was reinstated again on a permanent basis as part of American Taxpayer Relief Act of 2012.

Under the 2017 Tax Act, it is likely that most taxpayers will not be subject to AMT. Still, in order to navigate the AMT, taxpayers must be especially mindful of year-end cash payments, such as charitable contributions.

Falling victim to AMT has many possible causes, but you may be particularly prone to AMT if you have any of the following circumstances:

- Large LTCG or qualified dividends
- Large deductions for accelerated depreciation
- An exercise of incentive stock options
- Large amounts of tax-exempt income that is not exempt for state tax purposes
- Tax-exempt income from private activity bonds
- Mineral investments generating percentage depletion and intangible drilling costs
- Research and development expenses in activities in which you do not materially participate

## Tax rates: Kiddie tax

The Kiddie tax applies to a child under age 19 or a full-time student under age 24 with unearned income over a certain threshold. Note that the SECURE Act, passed on December 17, 2019, changed the treatment as previously defined by the 2017 Tax Act. The 2017 Tax Act applied tax rates from taxable trusts. The SECURE Act reverted the treatment of the unearned income back to the marginal income tax rate of the parents—not taxable trusts – for tax years 2020 and forward.





## Tax rates: Section 199A deduction (pass-through activities)

*The following provisions apply to taxable years beginning after 2017 and before 2026.*

### 20% deduction of domestic qualified business income

An individual, estate or trust taxpayer generally may deduct 20% of qualified business income (QBI) from a partnership, S corporation, or sole proprietorship as well as 20% of aggregate qualified REIT dividends, qualified cooperative dividends, and qualified publicly-traded partnership (PTP) income.

However, the deduction is limited to 20% of the amount by which taxable income exceeds net capital gain (the "overall limitation").

### Qualified business income (QBI)

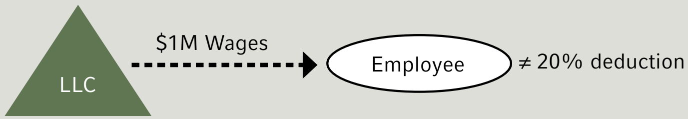
QBI is determined for each qualified trade or business (QTB) of the taxpayer. A qualified business is a business *other than*

- A specified service trade or business (SSTB) described in the pages that follow
- The business of performing services as an employee

QBI means the net amount of *qualified items* of income, gain, deduction, and loss with respect to the taxpayer's qualified businesses. Items are treated as qualified items only to the extent they are effectively connected with the conduct of a trade or business within the U.S.

## Example #1

Daniel earns $1 million in wages as an employee of an LLC. The definition of a qualified business does not include the business of performing services as an employee. Therefore, Daniel's wage income does not qualify for the 20% deduction.




Qualified items do not include specified investment-related income, gain, deduction, or loss such as capital gains and losses, dividend income, interest income, compensation, or guaranteed payments.

| TYPES OF DOMESTIC TRADE OR BUSINESS INCOME | YES | NO |
|---|---|---|
| Capital gains or losses | | ✖ |
| Dividends or dividend equivalents | | ✖ |
| Non-business interest income | | ✖ |
| Effectively connected income that is not attributable to a business | | ✖ |
| Ordinary income and losses under Section 751 | ✔ | |
| Section 1231 gains or losses that are treated as capital | | ✖ |
| Section 1231 gains or losses that are treated as ordinary | ✔ | |
| Income from guaranteed payments and payments for services under Section 707(a) | | ✖ |
| Deductions for guaranteed payments and payments for services under Section 707(a) | ✔ | |
| Current year losses that are disallowed, suspended, limited, or carried over | | ✖ |
| Losses previously disallowed, suspended, or limited, but currently allowed[1] | ✔ | |
| Section 481 adjustments (due to changes in accounting methods)[2] | ✔ | |

1 Only applies to losses that were disallowed, suspended, or limited in taxable years after 2017.
2 Only applies to Section 481 adjustments arising in taxable years after 2017.





### Specified service trade or business (SSTB)

SSTB means any trade or business

- Involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of that trade or business is the reputation or skill of one or more of its employees or owners, or
- Which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

Under the "de minimis rule," a trade or business is not an SSTB if

- Its gross receipts in a taxable year are $25M or less, and less than 10% of its gross receipts are attributable to the performance of services in an SSTB, or
- Its gross receipts in a taxable year are more than $25M and less than 5% of its gross receipts are attributable to the performance of services in an SSTB.

### Qualified trade or business (QTB)

- Architecture or engineering services
- Broadcasting or disseminating video or audio of professional sports or performing arts
- Retail banking, including taking deposits or making loans
- Insurance brokerage
- Payment processing and billing services
- Real property management
- Pharmaceuticals or medical devices
- Emergency care center, urgent care, or surgical center operators
- Lab services with no proximity to patients
- Health clubs and spas
- Consulting that is embedded or ancillary to the sale of goods

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### Specified service trade or business (SSTB)

- Stock brokerage
- Medical services, including those not directly provided to patients
- Pharmacist providing medical services
- Consulting services
- Investment banking
- Veterinary services
- Financial services, including arranging lending transactions
- Dealing in securities, commodities, or partnership interests
- Investment management
- Sports teams

### Wage and basis limitation

The amount of the deduction is limited to the greater of

- 50% of the W-2 wages paid with respect to the qualified trade or business, or
- The sum of 25% of the W-2 wages paid with respect to the qualified trade or business plus 2.5% of the unadjusted basis of all qualified property.

The wage and basis limitation does not apply to qualified REIT dividends, qualified cooperative dividends, and qualified publicly-traded partnership income.

### 2024 limitation thresholds

- Neither the SSTB limitation nor the wage and basis limitation apply in the case of a taxpayer with taxable income not exceeding $383,900 for married-filing-jointly or $191,950 for other taxpayers.
- The application of the SSTB limitation and the wage and basis limitation is phased in for individuals with taxable income exceeding this $383,900 for MFJ (or $191,950 for single) amount over the next $100,000 of taxable income for married-filing-jointly or $50,000 for other taxpayers.
- Thus, both limitations are fully applicable to taxpayers with taxable income of at least $483,900 (married filing jointly) or $241,950 (other taxpayers).

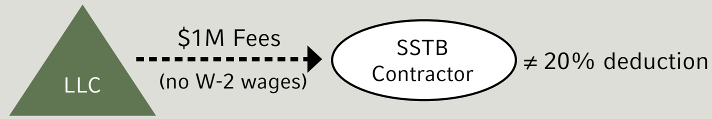




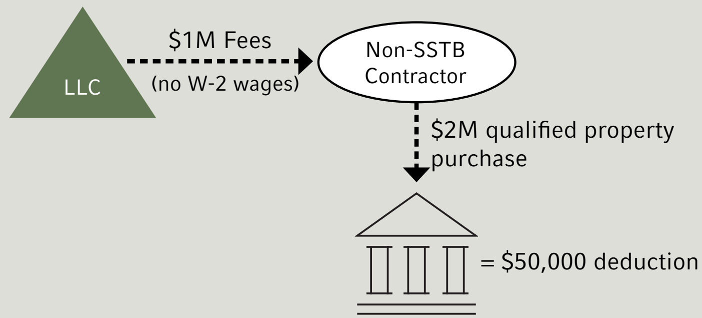
### Example #2

Daniel earns $1 million of income from a U.S. trade or business by performing services for an LLC as an independent contractor. Daniel's trade or business has no W-2 wages. In the current tax year, Daniel purchases qualified property with an unadjusted basis of $2 million.

If Daniel's sole proprietorship business is a SSTB (e.g., a trade or business where the principal asset of the trade or business is the reputation or skill of Daniel), the SSTB limitation would apply and Daniel's income earned as an independent contractor would not qualify for the 20% deduction.




If Daniel's trade or business is *not* a SSTB, then Daniel is entitled to claim a deduction of $50,000 (the greater of (i) 50% of the W-2 wages paid with respect to the qualified trade or business ($0); or (ii) the sum of 25% of the W-2 wages paid with respect to the qualified trade or business ($0), and 2.5% of the unadjusted basis of all qualified property
(2.5% x $2M = $50,000).

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## Aggregation

Because a taxpayer's deduction is subject to certain limitations, and these limitations are applied to each trade or business, the aggregation or disaggregation of trades or businesses could potentially impact a taxpayer's deduction.

In general, multiple trades or businesses may, but are not required to be, aggregated at the owner level. Aggregation is permitted if, among other requirements, the same person or group of persons directly or indirectly own a majority interest in each of the businesses to be aggregated for the majority of the taxable year (none of which can be a SSTB). If all of the requirements for aggregating multiple trades or businesses are satisfied, a taxpayer may aggregate trades or businesses operated directly with the taxpayer's share of qualified business income, W-2 wages, and unadjusted basis from trade or business operated through pass-through entities.

Among other requirements, to be aggregated at the owner level, the trades or businesses must exhibit at least two of the following three factors:

1. The businesses provide products and services that are the same (for example, a restaurant and a food truck) or they provide products and services that are customarily provided together (for example, a gas station and a car wash)
2. The businesses share facilities or share significant centralized business elements (for example, accounting, legal, purchasing)
3. The businesses are operated in coordination with, or reliance on, one or more of the businesses in the aggregated group (for example, supply chain interdependencies)





## How to determine which trades or businesses *may* be aggregated


### Ownership

Does the same person or group of persons, directly or indirectly, own 50% or more of each trade or business to be aggregated?

### Taxable year

Does such ownership exist for the majority of the applicable taxable year?

Are all items attributable to each trade or business to be aggregated reported on returns with the same taxable year?

### No SSTB

Are any of the trades or businesses to be aggregated an SSTB?

### Necessary factors

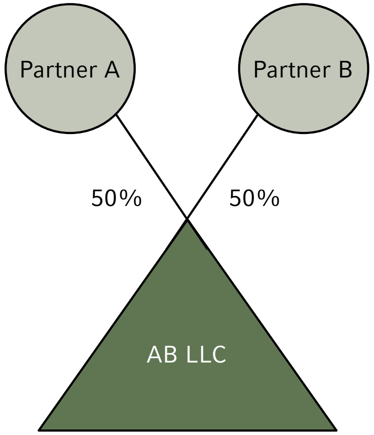
Do the trades or businesses exhibit at least two of the following three factors?

1. Products and services provided are **the same** or customarily provided together
2. **Shared facilities** or shared significant centralized business elements
3. **Operated in coordination with, or reliance on**, other businesses in the aggregated group

Only individuals, estates and trusts can aggregate trades or businesses

## Illustration of overall limitation

After determining the tentative deduction allowed under Section 199A, an overall limitation of 20% of the taxpayer's taxable income without regard to net capital gain, which for this purpose includes any qualified dividend income (QDI), is applied to determine the final deduction amount available for each taxpayer. The potential impact of the overall limitation is best illustrated with an example:




**Partners A and B each receive their current-tax-year Schedule K-1 from AB LLC.**

**Schedule K-1 footnotes include the following information (for each partner):**

- QBI allocated to owner: $1,000,000
- W-2 wages allocable to owner: $500,000
- Unadjusted basis immediately after acquisition (UBIA) of qualified property allocable to owner: $2,000,000
- Income from SSTB: None
- Aggregate qualified REIT dividends and qualified PTP income: None

| PERSONAL TAX RETURN ATTRIBUTES | PARTNER A | PARTNER B |
|---|---|---|
| Ordinary rate income | $1,000,000 | $0 |
| QDI and/or LTCG income (20% rate income) | $0 | $1,000,000 |
| **Total Taxable Income** | **$1,000,000** | **$1,000,000** |

While the new QBI deduction may provide taxpayers with an opportunity to reduce their overall effective tax rate, the computations are complex and require additional information gathering and analysis in order to accurately compute the deduction.

### Tentative Section 199A deduction before the overall limit

| THE LESSER OF: | A | B |
|---|---|---|
| 20% of QBI | $200,000 | $200,000 |
| Or | | |
| The greater of: | $250,000 | $250,000 |
| • 50% of W-2 wages paid by the qualified trade or business (QTB) | $250,000 | $250,000 |
| • Sum of 25% of W-2 wages paid by QTB and 2.5% of UBIA of qualified property | $175,000 | $175,000 |
| **Tentative deduction (the combined QBI under the statute)** | **$200,000** | **$200,000** |

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### Overall limit application

| THE LESSER OF: | A | B |
|---|---|---|
| Tentative deduction from previous | $200,000 | $200,000 |
| Or | | |
| Taxable income limitation | | |
| • Taxable income before Section 199A | $1,000,000 | $1,000,000 |
| • Less: Net QDI/LTCG taxed at preferential rate | $0 | $(1,000,000) |
| Taxable income | $1,000,000 | $0 |
| Multiplied by 20% | $200,000 | $0 |
| **Section 199A deduction allowed on Form 1040** | **$200,000** | **$0** |

### Rental real estate safe-harbor

It is often unclear whether a rental real estate enterprise is a trade or business for purposes of Section 199A. To help mitigate uncertainty, the IRS issued a proposed revenue procedure which contains a safe harbor, treating certain "rental real estate enterprises" as trades or businesses solely for purposes of Section 199A (the "safe harbor"). Until the proposed revenue procedure is published in its final form, taxpayers may use the safe harbor for determining whether a rental real estate enterprise may be treated as a trade or business for Section 199A.

If an enterprise fails to satisfy the requirements of the safe harbor, the rental real estate enterprise may still be treated as a trade or business for purposes of Section 199A if the enterprise otherwise meets the definition of trade or business.

### Rental real estate enterprise defined:

- An interest in real property held for the production of rents (may include multiple properties)
- A taxpayer must treat each property held for the production of rents as a separate enterprise or treat all similar properties held for the production of rents as a single enterprise

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- Commercial and residential real estate may not be part of the same enterprise
- The individual or relevant pass-through entity (RPE) relying on the safe harbor must hold the interest directly or through a disregarded entity

**Real estate excluded from safe-harbor**

- Real estate used as a personal residence by the taxpayer (including the owner or beneficiary of an RPE or trust relying on the safe harbor)
- Triple-net leased real estate

**Safe-harbor requirements**

- Maintain separate books and records for each rental real estate enterprise
- For taxable years beginning prior to January 1, 2023, perform 250 or more hours of “rental services” per year with respect to the rental enterprise
- For taxable years beginning after December 31, 2022; perform 250 or more hours of “rental services” with respect to the rental real estate enterprise during any three of the five consecutive taxable years that end with the taxable year
- Taxpayer must also maintain contemporaneous records showing safe harbor compliance

**Rental services defined:**

Rental services may be conducted by owners or by employees, agents, and/or independent contractors of the owners. They include the following:

- Advertising to rent or lease the real estate
- Negotiating and executing leases
- Verifying information contained in prospective tenant applications
- Collection of rent





- Daily operation, maintenance, and repair of the property
- Management of the real estate
- Purchase of materials
- Supervision of employees and independent agents

Rental services do not include financial and investment management activities.

**Summary**

- Available to individuals, estates and trusts
- Determined at the partner or S corporation shareholder level
- Maximum deduction of 20% of QBI, REIT dividends, and PTP income
- Effective for tax years beginning after December 31, 2017
- Terminates for tax years beginning after December 31, 2025
- The deduction is below the line; as a consequence, it:
  - Is not a component in computing AGI
  - Does not give rise to or increase a NOL, and
  - Is not suspended under the passive-loss rules
- QBI determined separately for each qualified trade or business, subject to W-2 wage and basis limitations (exception for lower-income taxpayers)
- SSTB income does not qualify, with an exception for lower-income taxpayers
- Aggregation may be permitted for taxpayer’s with multiple trades or businesses

## Excess business and net operating losses

Non-corporate taxpayers, such as individuals, trusts, and estates are subjected to new legislation under the 2017 Tax Act that limits the deductibility of trade or business (T/B) losses. Under the 2017 Tax Act, the deduction for certain trade or business losses of a taxpayer may be limited to $305,000 for single filers and $610,000 for married individuals filing jointly.

An excess business loss is the excess of:

- The aggregate deductions of the taxpayer for the taxable year which are attributable to T/B of such taxpayer, over
- The sum of:
    - The aggregate gross income or gain of such taxpayer for the taxable year which is attributable to such T/B, plus
    - $305,000 (or $610,000 for a married-filing-jointly return), also referred to as the “threshold amount." (The threshold amount is indexed for inflation.)

The Inflation Reduction Act of 2022 extends the EBL limitation by two years. Instead of expiring at the end of 2026, the losses will be disallowed for taxable years through 2028.

The 2017 Tax Act altered the net operating loss (NOL) ruleset such that:

- With limited exceptions, NOLs arising in tax years beginning after 2017 may only be carried forward (not back up to two years as under prior law),
- NOLs may be carried forward indefinitely (as opposed to up to 20 years under prior law), and
- In any given year, a NOL carryforward originating in or subsequent to 2018 cannot exceed 80% of regular taxable income. For AMT purposes, the limitation remains at 90% of AMT income.





The combined impact of these provisions can have a significant impact on owners of businesses that produce losses. In any year where a taxpayer has material losses from an active trade or business, an income-tax liability may now occur if income from other classes exceed the allowed loss (i.e., the lesser of the actual loss or the applicable $305,000/$610,000 threshold) despite the absence of net income or cash flow. In addition, the business owner can no longer immediately carry back a NOL if the owner had taxable income in one or more of the two prior tax years to generate an offsetting tax refund. Instead, the taxpayer must wait until a future year with net taxable income to take the loss. As a result, financing the tax liability in the face of the cash flow constraints inherent in a loss situation may be an issue.

Additional complexities may arise when considering how these rules will interplay with the rules of the QBI deduction. If an excess loss situation exists, then there can be no pass-through deduction. A Section 199A deduction can exist only when there is aggregate T/B income. However, altering the timing of controllable events may lessen the impact of these loss limitations in some situations.

## Example

Excess business loss and NOL limitations—timing matters

**Facts for an MFJ taxpayer**

| | 2024 | 2025 | 2026 |
|---|---|---|---|
| Trade or Business (T/B) A | $1,000,000 | $1,000,000 | $3,000,000 |
| Trade or Business (T/B) B | $(5,000,000) | $(1,000,000) | $(1,000,000) |
| LTCG | $1,000,000 | $4,000,000 | $1,000,000 |
| | **$(3,000,000)** | **$4,000,000** | **$3,000,000** |

| | 2024 TAX YEAR | 2025 TAX YEAR | 2026 TAX YEAR |
|---|---|---|---|
| Aggregate T/B deductions | $(5,000,000) | $(1,000,000) | $(1,000,000) |
| Aggregate T/B income | $1,000,000 | $1,000,000 | $3,000,000 |
| MFJ threshold | $610,000 | N/A | N/A |
| **Excess business loss** | **$(3,390,000)** | **N/A** | **N/A** |
| | | | |
| **Allowed T/B loss** | **$(1,610,000)** | **$(1,000,000)** | **$(1,000,000)** |
| | | | |
| LTCG | $1,000,000 | $4,000,000 | $1,000,000 |
| T/B income | $1,000,000 | $1,000,000 | $3,000,000 |
| Allowed T/B loss | $(1,610,000) | $(1,000,000) | $(1,000,000) |
| **Tentative taxable income** | **$390,000** | **$4,000,000** | **$3,000,000** |
| | | | |
| NOL allowed (up to 80% of taxable income) | N/A | $(3,200,000) | $(190,000) |
| **Taxable income** | **$390,000** | **$800,000** | **$2,810,000** |
| **NOL carryforward** | **$(3,390,000)** | **$(190,000)** | **$0** |

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## Example (continued)

### Observations

This example shows the impact of the new excess-business loss and NOL provisions. These new provisions impact the timing of the deductibility of the loss generated by trade or business B (T/B B). For simplicity, assume there are no itemized deductions and ignore the standard deduction.

In year one, the current-year loss is limited under the excess-business loss provision and creates a NOL.

In year two, the example shows the impact of the new NOL limitations limiting the deductibility of the NOL to 80% of the current year's taxable income.

In each year represented, these new provisions show the resulting taxable income, where under prior law there would be no such taxable income resulting.

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## Transition (Section 965) tax

Historically, taxpayers could defer U.S. taxation on offshore earnings. The transition tax as enacted by the 2017 Tax Act is a mandatory one-time tax on untaxed foreign earnings of certain specified foreign corporations as if those earnings had been repatriated to the U.S. It is imposed on U.S. shareholders that own 10% or more of a controlled foreign corporation (CFC) and U.S. corporate shareholders that own 10% or more of the shares of a foreign corporation where at least one domestic corporate shareholder is a direct, indirect, or constructive owner.

Under the final law, applicable shareholders will be taxed on their pro rata share of the net earnings and profits (E&P) of applicable entities. In the case of any S corporation which is a U.S. shareholder of an applicable entity, each shareholder of such S corporation may elect to defer payment of such shareholder's net-tax liability until the shareholder's taxable year which includes a triggering event.

The effective tax rate varies from 9.05%–17.54% for individuals and 8%–15.5% for corporations to the extent E&P consists of cash vs. non-cash assets. Taxpayers may elect to pay the resulting tax over eight years—8% in the first five years, 15% in year six, 20% in year seven, and 25% in year eight.





## Global Intangible Low-Taxed Income (GILTI)

The Global Intangible Low-taxed Income (GILTI) is a new provision enacted as a part of the 2017 Tax Act. This provision is an "anti-deferral" provision—it does not permit deferral of income to a U.S. shareholder of a controlled foreign corporation (CFC) as was true under the old law. U.S. shareholders of controlled foreign corporations are required to include in gross income their share of GILTI. GILTI is the income of a CFC, reduced for certain adjustments.

These provisions can be adverse to individuals and trusts, because:

- The income inclusion will frequently be "phantom income" (a tax attribute not represented by a cash distribution)
- Absent certain tax elections, individuals cannot claim underlying foreign tax credits to offset the U.S. tax liability, and
- It appears that the deemed inclusion cannot qualify for the lower 20% tax rate on qualified dividends that otherwise might be available.

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# Pass-through Entity (PTE) Tax

On November 9, 2020, the IRS issued Notice 2020-75, which permits a pass-through entity (partnerships and S corporations) to deduct certain state and local income taxes imposed on and paid by such-pass through entity (also known as "specified income tax payments") in computing their non-separately stated income or loss and are not taken into account in applying the SALT deduction limitation to any individual who is a partner in the partnership or shareholder in the S corporation.

Based on these considerations, electing into a PTE Tax regime may seem like the obvious choice to enable passthrough entity owners to increase their federal tax benefit from state tax payments. However, this analysis can be surprisingly complex. Whether to elect into a state's PTE Tax regime is the passthrough entity's decision. As such, it is critical that passthrough entities and their owners work together to evaluate the potential implications of passthrough entities' state PTE Tax election(s) on their owners.

## What to Consider Before Making an Election

Several issues should be addressed in deciding whether to make the election to be taxed at the entity level, such as:

- Does the operating agreement accommodate special allocations, if any, of PTE Tax expense? If not, should amending the agreement be considered? Note: S corporations are not permitted to have disproportionate distributions.
- The tax consequences to PTE owners in their resident state where that state does not allow a resident taxpayer to claim a credit for their share of taxes paid to another state by the entity.
- What are the internal administration considerations (for example, reducing cash distributions to owners benefiting from the PTE Tax to reflect the entity-level expense while leaving nonbenefited owners unaffected)?

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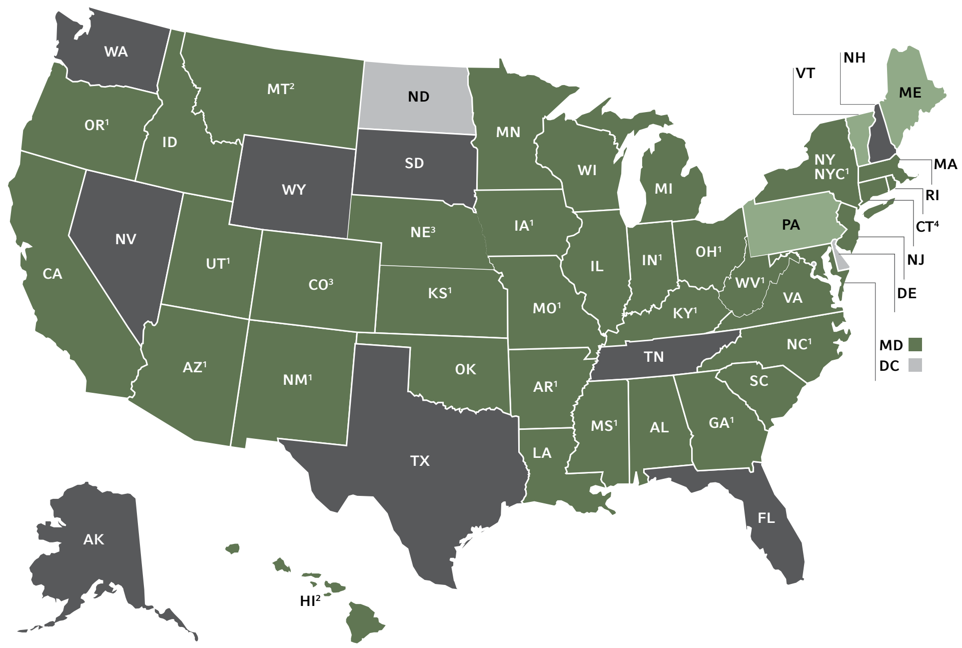
## States with Enacted or Proposed Pass-Through Entity (PTE) Level Tax




- States that enacted a PTE Tax since TCJA SALT deduction limitation, effective for 2021 (or earlier), unless noted
- States with no owner-level personal income tax on PTE income
- States with proposed PTE tax bills
- States with an owner-level personal income tax on PTE income that have not yet proposed or enacted PTE taxes

Enacted PTE tax: [1]Effective in 2022. [2]Effective in 2023 or later. [3]Retroactive to 2018. [4]Mandatory 2018-2023, elective starting 2024. Source: AICPA as of December 19, 2023.

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## Foreign Income and Foreign Tax Credits

Generally, US citizens and residents are subject to tax in the United States on their worldwide income, including income they receive as shareholders from foreign corporations, but the tax rate on the foreign income may be reduced if it meets certain requirements.

Foreign dividends are “qualified” dividends under US tax law if the following requirements are met:

1. The foreign corporation is also incorporated in a US possession
2. The foreign corporation is eligible for the benefits of a comprehensive income tax treaty with the US
3. The stock for which the dividend is paid is readily tradable on an established securities market in the US

There are two ways that US taxpayers are generally allowed to reduce their US tax liability by all or a portion of the amount of income tax paid to foreign governments as a result of receiving foreign-source income. Foreign-source dividends paid to a US taxpayer are generally subject to foreign tax withholding, which is withdrawn from the dividend amount before it is paid to the shareholder. In order avoid being double taxed on foreign-source income, US taxpayers may generally claim one (but not both) of the following to reduce their US income tax liability:

**Foreign Tax Credit:**

- Provides a dollar-for-dollar decrease to one’s tax liability

**Foreign Tax Deduction:**

- Decreases taxable income
- The reduction to one’s tax liability is based on their marginal tax bracket

The US has tax treaties with several foreign countries. Under these treaties, residents or citizens of the US are taxed at a reduced rate, or exempt from foreign taxes, on certain items of income they receive

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from sources within foreign countries. Most income tax treaties contain what is known as a ‘savings clause’, which prevents a citizen or resident of the US from using the provisions of a tax treaty to avoid taxation of US-source income. The amount of foreign tax that qualifies as a credit is not necessarily the amount of tax withheld by a foreign country. If one is entitled to a reduced rate of foreign tax based on an income tax treaty between two countries, only the lower rate qualifies for the credit.

## Virtual Currency (Cryptocurrency)

The IRS explains that certain digital assets, notably “virtual currencies,’ are to be treated as “property” since they do not have “legal tender status.” The implication then is clear: transactions in crypto/virtual currencies are barter transactions (property for property exchanges). Additionally, such property is not “foreign currency” under the tax code.

The US government has still much to write in terms of tax rules specific to digital assets. For now, one pays taxes on transactions with these assets as one does on transactions with other types of property: reporting gains or losses each time the assets are used in transactions. And that gain or loss is the difference between the fair market value of the digital asset at the time of the transaction and its tax basis (generally, the amount paid at the time one originally acquired the digital asset). The character of the gain or loss generally depends on whether the digital asset is a capital asset in the hands of the taxpayer. The period during which the digital asset is held begins on the day after it is acquired and ends on the day it is sold or exchanged.

Given the complex and unresolved issues related to taxation of virtual currency, a more comprehensive analysis of one’s specific circumstances is merited, including whether the scope of the activity rises to the level of “trading” or mere “investing”. More questions about the tax treatment of the virtual currency can be answered by referring to IRS Notice 2014-21.

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SECTION 4

SECTION 4

# SMARTER ASSET MANAGEMENT

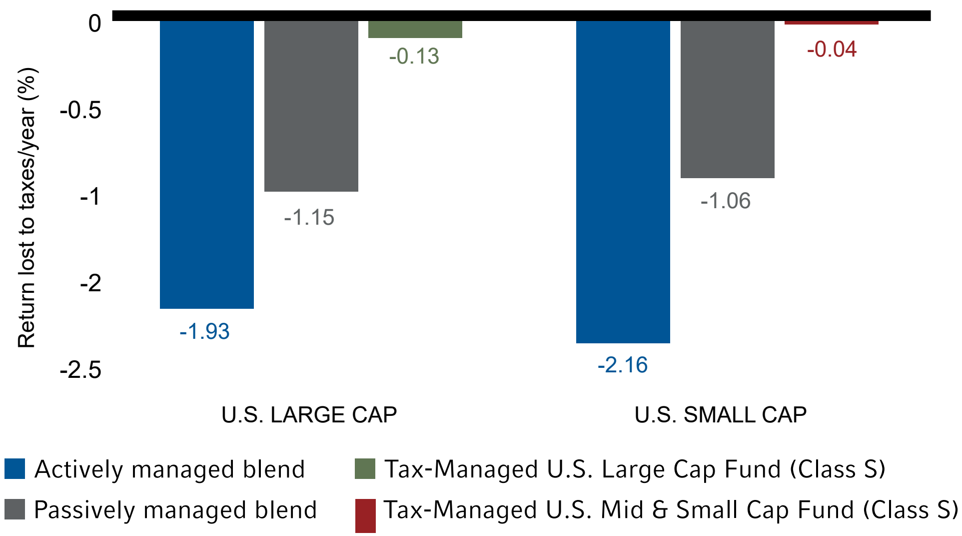
If you have tax-sensitive clients—and who doesn't—just taking a few steps to help manage those taxes is smarter asset management. But where do you start? Knowledge is power.

**In this section:**

- Tax drag: Actively, passively and tax-managed mutual funds
- Is that mutual fund tax-efficient?
- Tax aspects of various asset classes
- Principles of after-tax equity portfolio management
- Tax-implications of yield vs. total return income approaches
- Tips to help transition to tax-managed investing
- Sample scenario

# Tax drag: Actively, passively and tax-managed mutual funds

**Average annual tax drag for 3 years ending December 31, 2023**




***Performance quoted represents past performance and should not be viewed as a guarantee of future results. The investment return and principal value of an investment will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted.***

Universe averages: Created table of all U.S. equity mutual funds, ETF's, and U.S. Municipal Fixed Income funds as reported by Morningstar. Calculated arithmetic average of Morningstar's Tax Cost Ratio for all share classes as listed by Morningstar. Passive is defined as being an index fund as reported by Morningstar.

Morningstar Categories included: US Large Blend, US Small Blend. Average of Morningstar's Tax Cost Ratio for universes as defined. Passive is defined as being an index fund as reported by Morningstar or part of an ETF Category. All returns are net of fees. Tax-Managed Funds averages reflect funds as identified by Morningstar.





# Is that mutual fund tax-efficient?

To help assess whether a mutual fund is appropriate for a tax-sensitive investor, the first place to look is the prospectus. Does the fund have tax-management as a stated objective? Beyond that, you can look at the fund's after-tax performance numbers. Here are a few additional key items to review.

- **Estimated capital gains distributions**
  For insights into potential capital gains exposure, you can often go to a fund company's website. Most fund companies publish estimates at least once in the fall each year. Some companies, including Russell Investments, publish estimates more frequently. Understand how these potential distributions add up and compare.

- **Potential Capital Gains Exposure (PCGE score)**
  This is a measure of the percentage of a fund's assets that represent unrealized gains (or gains that have not yet been realized and distributed). It can be an indicator of potential future capital gains distributions and, therefore, a lower number is better for tax-sensitive investors. A fund realizes gains when securities within the fund are sold (as a result of turnover and/or fund redemptions). For example, a fund that has a cost basis of $50 million, with capital appreciation of $50 million results in a PCGE score of 50%. So, if an investor buys into a fund with a high PCGE (which means there are a lot of gains embedded in the fund) and turnover occurs in the fund, the investor may receive distributions for gains that occurred before they purchased the fund. This would be called "buying into the gain." However, PCGE can be negative, in which case an investor could be "buying into the loss" and benefitting from unrealized losses and/or capital loss carryforwards within the fund.

- **Portfolio turnover**
  This figure is calculated as the lesser of purchases or sales divided by the net assets of the fund. It essentially represents the amount of assets that are "turned over" each year, which could have tax implications. For example, if a manager sold all of its holdings in one year and purchased completely different positions, turnover would be 100%. Turnover can cause distributions so it has the potential to increase tax bills. That said, not all turnover is created equal.

  Some turnover creates a tax liability, and some turnover has the potential to deliver a 'tax benefit'. It's important to understand what is driving the Portfolio Turnover statistic.

### Example

Tax-loss harvesting is the act of selling an asset that is lower in price than its original purchase price (adjusted cost basis). This difference can be a loss that is "harvested" and potentially used today or in the future to offset against gains. Creating this loss is considered a potential tax benefit and can help in deferring the recognition of gains (if there are any!) until later periods. Done correctly, this deferral of gain recognition is intended to increase after-tax returns and help maximize after-tax wealth.

- **Tax drag**
  Tax drag represents how much a fund's return is reduced by taxes, paid by the investor on distributions. Tax drag can be calculated as the pre-tax return minus the pre-liquidation after-tax return. If you have two funds with similar after-tax returns, comparing the two funds' tax drag figures can be a good indicator of which fund will do a better job at keeping taxes low, based on history.

- **Pre- and post-liquidation mutual fund returns**
  These terms are frequently used on mutual fund fact sheets and other performance reporting vehicles—understanding their meaning is important.

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**Pre-liquidation after-tax return**
A tax-adjusted total return that is based on a few assumptions:

1. The investor does not sell the holding at the end of the time period.
2. Distributions are taxed at the highest federal tax-rate prevailing, including the 3.8% net investment income tax (NIIT), and then reinvested.
3. State and local taxes are excluded.
4. Only the capital gains are considered for tax-exempt funds, because the income from these funds is non-taxable. Note that while municipal bond interest is generally tax-free at the federal level, the buying and selling of underlying municipal bonds can trigger taxable capital gains.

This data point follows the guidelines established by the SEC in the spring of 2001 for reporting after-tax performance. Besides the tax-adjustment, this total return is also adjusted for the effects of sales loads per the SEC's recommendation.

A specific investor's after-tax returns depend on an investor's tax situation and may differ from those shown on standardized performance reports. These after-tax returns are not relevant to investors who hold their fund shares through tax-deferred arrangements, such as 401(k) plans or individual retirement accounts. This return assumes the investor still owns their fund shares.

**Post-liquidation after-tax return**
Post-liquidation after-tax return assumes that the fund shares have been sold by the investor and has the exact same holding period for time period shown. It also includes the taxes on distributions similar to the preliquidation calculation but includes the change in NAV. If the fund has realized capital losses, the return after taxes on distributions and sale of fund shares may be higher than the return before taxes and the return after taxes on distributions. The calculation of return after taxes on distributions and sale of fund

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shares assumes that a shareholder has sufficient capital gains of the same character to offset any capital losses on a sale of fund shares and that the shareholder may, therefore, deduct the entire capital loss.

*When evaluating different investment options, we recommend using the pre-liquidation after-tax return. This more closely matches the after-tax return of a buy-and-hold investor. The post-liquidation after-tax return has the most meaning if the investor had that exact purchase date and liquidation (sale) date.*

**Summary**

Take the time to understand the investment process that generated the after-tax return and taxable distributions. For instance, is the investment process explicitly designed to manage taxes? Does the process include a focus on tax-loss harvesting, minimizing wash sales, managing holding period, and managing the fund's yield? All of these may potentially help reduce taxes over time. Typically, these strategies are available only in investment vehicles that are explicitly stated as being "tax-managed" or "tax-aware." If a fund caters to both taxable and non-taxable (e.g., 401(k) or IRA) shareholders, the portfolio manager will likely be indifferent to taxes. By being explicitly tax-aware, the portfolio manager has a broader tool kit to help manage the pinch of taxes.





## Tax aspects of various asset classes

In considering exposure to an asset class, the primary feature that has the potential to enhance returns from an after-tax perspective is the ability to defer paying taxes. When wealth that would have been paid in taxes remains invested, the investor potentially improves his/her return, even though he/she will likely eventually pay taxes later. Though, deferring taxes is easier in some asset classes than others.

Asset classes with high income (e.g., dividends) are not very tax efficient because dividends force taxes to be paid immediately. If an 8% return is achieved, where half of the return is from dividends, the return will be reduced to 7.05%, if the dividend tax rate is 23.8%. Asset classes that pay high dividends or generate income that is not qualified such as real estate investment trusts (REITs) and fixed income investments can be inefficient investments for a non-qualified account. Obviously, the higher the tax rate due to the type of income or dividend, the higher the tax drag.

When it comes to implementing an investment strategy within an asset class, all else equal, strategies that generate less taxable gains should be preferred because tax liabilities are deferred. High turnover strategies that consistently sell positions that have outperformed can be particularly unattractive in taxable accounts. Consider a hypothetical example where the market returns 8% and a fund manager generates 10% return, but with a turnover of 80%.

If the investor has a tax rate of 40.8%, assuming no dividends, we can approximate the tax drag as:

$$\boxed{\begin{gathered}\text{total return x turnover x tax rate = tax drag}\\ 10\% \times 80\% \times 40.8\% = 3.26\%\end{gathered}}$$

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Due to taxes, the return of 10% is reduced to 6.74% (10% - 3.26% = 6.74%), which is less than the market return of 8%. Indeed, strategies that generate costly turnover are bad. However, not all turnover is bad. A tax-efficient fund manager can systematically sell positions that are at a loss, creating losses that can potentially be used to offset gains.

Considering the goal of deferring taxes paid, some asset classes have better tax-management qualities than others. We discuss these potential opportunities for major asset classes next.

**U.S. Equity**

U.S. equity is relatively tax-efficient. Dividends of U.S. equity are qualified income so long as the stock has been held for 60 days. The dividend yield of U.S. equities tends to be lower than international equities. Moreover, the dividend yield can be lowered actively while controlling other risk exposures.

Taxes that might be generated by costly turnover can be easily managed by either investing in a passive vehicle; or even better, one that is specifically tax-managed with a long-term mindset and where systematic loss harvesting is done.

Large cap equity tends to be more tax-efficient than small cap equity. Large cap funds, generally, have lower turnover than small cap funds. This occurs because small cap stocks have higher volatility, and because a larger percentage of small cap companies migrate from the index due to being acquired or due to increasing in size, which would move them potentially to another index.





**International Equity**

International equities tend to be less tax-efficient than U.S. equities. There are federal withholding taxes, and dividends can be taxed as ordinary income depending on the country. In the developed international equity asset class, approximately 74% of dividends are qualified, leaving 26% that are non-qualified. In emerging markets approximately 55% of the dividends are non-qualified*. Therefore, the tax rates applied to dividends are higher on average than for U.S. equities.

There is ample potential opportunity to manage capital gains tax in this asset class through a systematic loss-harvesting strategy. Moreover, American depositary receipts (ADRs) can be used where possible to help avoid unfavorable tax treatments. Certain aspects of dividend yields can also be actively managed while maintaining desired exposures.

Something to consider, capital loss carry forwards (CLCF) acquired by many mutual funds during the Global Financial Crisis in 2008 and 2009 likely expired in 2017. This is due to a change to U.S. tax law in 2010, which mandates capital losses recognized prior to 2010 to expire eight years after recognition. Because returns in international equities have generally been lower than U.S. equities since 2010, many mutual funds likely had their CLCF's expire in 2017—further increasing the importance of an active systematic loss-harvesting strategy.

* Based on the average 2021 Qualified Dividend Income reported by the five largest Foreign Large Blend and Diversified Emerging Markets ETFs by AUM.

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**Global Listed Real Estate**

Global listed real estate investments typically obtain a higher percentage of their total return from income than equity investments. Some real estate investments, such as development companies, may also produce qualified income; however, the majority of income produced in this asset class will be treated as ordinary income. Higher tax rates on income and a higher percentage of the return coming from income generally inhibits deferring taxes paid. Moreover, when investing globally investors need to consider the country of their investment and the categorization of the investment by the IRS. For example, passive foreign investment companies will pay ordinary income tax on income. Note that the 2017 Tax Act allowed for a 20% reduction of certain REITs income. This new treatment helps reduce tax burden for U.S. REITs income.

**Global Infrastructure**

Global infrastructure investments tend to have yields that are a larger share of the total return than typical equity investments, which translates to less taxes deferred. However, unlike REITs, infrastructure investments primarily generate qualified income if the companies are U.S. based or have tax treaties with the U.S. As most investors gain access to global infrastructure investments by investing in listed companies, previously stated concerns for foreign investments apply.





**Commodities**

Investing in commodities is typically done using either futures or swaps. Returns generated from these types of contracts are tax-inefficient. Capital gains from futures can qualify for 60% long-term gain status and 40% short-term gain status under Section 1256. However, these gains are realized each year—regardless if you sell the fund or not. 100% of returns from commodity swaps are taxed as short-term gains. This means that all gains are realized each year and taxed at one's marginal tax rate—i.e. commodity swaps neither defer tax nor capture lower tax rates. Commodities are tax-inefficient unless an investor holds physical commodities, which is impractical for most commodity investments. Moreover, some physical commodities, such as precious metals, are treated as collectables, which are taxed at the lesser of one's ordinary income tax rate or 28%.

**Non-Municipal Fixed Income**

The majority of the total return of fixed income will come from the coupons paid on the bonds. The coupons are taxed as ordinary income. This means that almost all of the gains will be realized each year, and taxed at the investor's marginal income tax rate. Additionally, if the bonds are foreign, additional foreign taxes may apply. Non-municipal income is not very tax efficient.

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## Municipal Bonds

Coupons paid from municipal bonds are exempt from federal taxes but may be subject to state taxes depending on one's state of residence. Returns from capital appreciation are taxable. As bond returns are mostly due to coupons paid, municipal bonds are generally very tax-efficient.

For investors in higher tax brackets, municipals will typically have higher after-tax yields than comparable non-municipal bonds. As you can see in the following chart, an investor paying the highest marginal federal tax rate (37% + 3.80% NIIT = 40.8%) that holds a municipal bond yielding 2.50% is receiving the taxable equivalent yield of 4.22%.

**Tax-Exempt vs. Taxable Yield**

| FEDERAL TAX RATE (MARRIED FILING JOINTLY) | | | | | | |
|---|---|---|---|---|---|---|
| Federal Rate | 12.00% | 22.00% | 24.00% | 32.00% | 35.00% | 37.00% |
| NIIT | 0.00% | 0.00% | 3.80% | 3.80% | 3.80% | 3.80% |
| **Total** | **12.00%** | **22.00%** | **27.80%** | **35.80%** | **38.80%** | **40.80%** |
| **Tax-Exempt Yield** | **EQUIVALENT TAXABLE YIELD** | | | | | |
| 1.00% | 1.14% | 1.28% | 1.39% | 1.56% | 1.63% | 1.69% |
| 1.50 | 1.70 | 1.92 | 2.08 | 2.34 | 2.45 | 2.53 |
| 2.00 | 2.27 | 2.56 | 2.77 | 3.12 | 3.27 | 3.38 |
| 2.50 | 2.84 | 3.21 | 3.46 | 3.89 | 4.08 | 4.22 |
| 3.00 | 3.41 | 3.85 | 4.16 | 4.67 | 4.90 | 5.07 |
| 3.50 | 3.98 | 4.49 | 4.85 | 5.45 | 5.72 | 5.91 |
| 4.00 | 4.55 | 5.13 | 5.54 | 6.23 | 6.54 | 6.76 |
| 4.50 | 5.11 | 5.77 | 6.23 | 7.01 | 7.35 | 7.60 |
| 5.00 | 5.68 | 6.41 | 6.93 | 7.79 | 8.17 | 8.45 |
| 5.50 | 6.25 | 7.05 | 7.62 | 8.57 | 8.99 | 9.29 |
| 6.00 | 6.82 | 7.69 | 8.31 | 9.35 | 9.80 | 10.14 |
| 6.50 | 7.39 | 8.33 | 9.00 | 10.12 | 10.62 | 10.98 |
| 7.00 | 7.95 | 8.97 | 9.70 | 10.90 | 11.44 | 11.82 |





## Municipal Bonds

*(continued)*

The elimination of certain federal tax deductions, including deductions for state and local property taxes, may prove positive for municipal bonds. This change in the tax code may have a significant impact on high-income residents of states with higher taxes and high property values, such as New York, California and New Jersey. For these investors, municipal bond investments can be among the most efficient ways to manage tax liabilities when losing deductions. Hence, this part of tax reform may lead to fewer deductions which could increase the value of tax-exempt interest income from municipal bonds.

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# Principles of after-tax equity portfolio management

**Here are eight basic principles for reducing the impact of federal taxes on equity investments.**

### 1 Harvest losses

Security values fluctuate somewhat randomly over short periods of time, while ideally trending upwards over the long run. During these random fluctuations, selling a position that drops below its cost basis creates a loss that can be carried forward. This loss can be used to offset a gain elsewhere or at another time. As long as the overall composition of the portfolio is materially unchanged, harvesting losses can improve after-tax performance.

### 2 Pay attention to the holding period

Under current IRS rules, selling investments prior to holding them for over one year may generate STCG which can significantly affect the tax bill. STCG are taxed as ordinary income, which can be as high as 40.8% of the gain, after accounting for the recent 3.8% NIIT. LTCG are taxed at a maximum tax rate of 23.8% including NIIT. Tax-managed strategies should avoid STCG, and even limit realizing LTCG.

### 3 Reduce turnover

Depending on an investor's individual situation, capital gains taxes are typically only paid when an investment is sold at a gain. High turnover strategies that cause the selling of positions at a gain erode after-tax return. For example, if a position is sold for a 10% gain after one year, and 20% tax is assessed on the gain, the return is reduced to 8%.





### 4 Eliminate wash sales

If a security is sold for a loss, a potential tax benefit is obtained that can be used to offset a gain elsewhere. This benefit is negated if the same—or a substantially identical—position is repurchased within 30 days of the sale date. Systematically avoiding wash sales is an important step in constructing an efficient after-tax strategy. In a multi-manager portfolio, managers acting autonomously can easily generate wash sales.

### 5 Defer realized gains

Deferring the realization of capital gains allows any future returns to compound on a potentially higher base. Keep in mind that taxes will likely be due at some point and tax rates could be higher once they are due. Future capital gains taxes could potentially be avoided if assets are passed through death or given to charity.

### 6 Select tax lots

When a partial sale of a position is made, the tax impact of selling shares purchased at different prices and dates needs to be evaluated. If there is an ability to sell lots with a higher cost basis, then gains can be deferred relative to a naïve approach. By reducing immediate taxes, gains are deferred, which, as discussed previously, can improve after-tax return. This statement assumes that future tax rates won't be higher, however, and no one can predict what future rates could be.

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## 7 Manage portfolio yield

Dividends generate a potential tax liability in the year they are paid and can be taxed as ordinary income. These taxes reduce the principal to which investment returns accrue. Reducing dividends helps defer taxes paid, which promotes a larger principal amount with greater compounding potential. In managing dividend yield, desired portfolio exposures need to be considered.

## 8 Centralize the portfolio management of multiple managers

When multiple money managers are combined in a single portfolio, there are opportunities to reduce turnover, defer gains and avoid wash sales by using an overlay portfolio manager who coordinates the trading activity across all managers. With total portfolio management (TPM), active manager positions are held in a single custody account, where the active manager security positions are implemented by the overlay manager. Considerable tax benefits can be derived using TPM:

- When any manager signals a sale, the sale can be transacted from the most beneficial tax lot considering all managers and all tax lots.
- When one manager is buying a position and another is selling the same position, the total transaction can be lessened because all or part of the buyer's purchase can be fulfilled by the seller, with potentially no actual transaction required in the portfolio.
- Wash sales that occur across managers can be managed. For example, if one manager sells a security at a loss and another manager requests purchase of the same security, the overlay manager can delay the purchase until the end of the wash sale period. Keep in mind that this approach does not guarantee that wash sales will not occur from time to time.





- If a manager signals a sale of a short-term gain position that is nearing conversion to long-term status, the overlay manager can delay the sale.
- If a portfolio position drops significantly below its cost basis, some of the position can be sold to book a loss. If desired, the position can be added to after the wash sale period. It is still possible, of course, that transitions between money managers may require the sale of portfolio securities resulting in the realization of net capital gains, even after the application of these tax-management strategies.

# Tax-implications of yield vs. total return income approaches

Yield isn't the only way to generate income from a portfolio—and in many cases, it may not be the most efficient, especially when taxable accounts are involved.

### Looking beyond yield for income

Depending on the investor's circumstances and preferences, consider generating income by taking systematic withdrawals from a total return portfolio. For example, investors who:

- Prefer greater control over their cashflow pattern,
- Don't mind spending portfolio principal and
- Are attempting to generate a cashflow stream from a taxable account

may find a total return portfolio helps them reach their goals in a more tax-efficient manner while also reflecting their circumstances and preferences.

**Let's look at an example**

Assume a $1 million nest egg from which an investor wants to withdraw $45,000 per year—a 4.5% withdrawal rate.

Let's consider two portfolio options for achieving this goal:

**Portfolio option #1**

**A yield-oriented portfolio targeting a 4.5% yield**

To achieve the yield target, this hypothetical portfolio would be allocated 50% to U.S. stocks and 50% to bonds. The portfolio would derive a 2% yield from dividends and 7% from U.S. and global high yield bonds.

**Portfolio option #2**

**Total return-oriented portfolio from which the investor will take systematic withdrawals equivalent to the $45,000 income requirement**

Let's assume that this portfolio is allocated 60% to stocks and 40% to bonds to help it continue to grow over the long term despite the withdrawals. The stock portion of the portfolio would generate approximately 1% in dividend yield (assume a diversified portfolio of U.S. and non-U.S. stocks, large cap and small cap exposure); the bond portion approximately 4.5% (assume an aggregate bond-type portfolio). The total yield of the portfolio would be approximately 2.4%. The investor would make up the remainder of the desired income by systematically selling shares from the portfolio.

| | YIELD PORTFOLIO | TOTAL RETURN PORTFOLIO with systematic withdrawals |
|---|---|---|
| **Allocation** | 50% stocks / 50% bonds | 60% stocks / 40% bonds |
| **Dividend yield** | 2% | 1% |
| **Bond yield** | 7% | 4.5% |
| **Total yield** | 4.5% | 2.4% |

For illustrative purposes only.

What does the cashflow stream look like for these two portfolio options—especially once taxes are considered?





In both approaches, the **pre-tax cashflow** is the desired $45,000. However, the **after-tax cashflow** looks very different for both portfolios:

- The yield portfolio leaves the investor with $28,340 after taxes;
- The total return portfolio leaves the investor with $35,990 after taxes.

| | YIELD PORTFOLIO | TOTAL RETURN PORTFOLIO |
|---|---|---|
| Pre-tax income from yield | $45,000 | $24,000 |
| *Taxes due* | $16,660 | $8,772 |
| **Post-tax income from yield** | **$28,340** | **$15,228** |
| | | |
| Pre-tax income from withdrawal | - | $21,000 |
| *Taxes due* | - | $238 |
| **Post-tax income from withdrawal** | - | $20,762 |
| | | |
| Total pre-tax portfolio income | $45,000 | $45,000 |
| *Taxes due* | $16,660 | $9,010 |
| **Total after-tax portfolio income** | **$28,340** | **$35,990** |

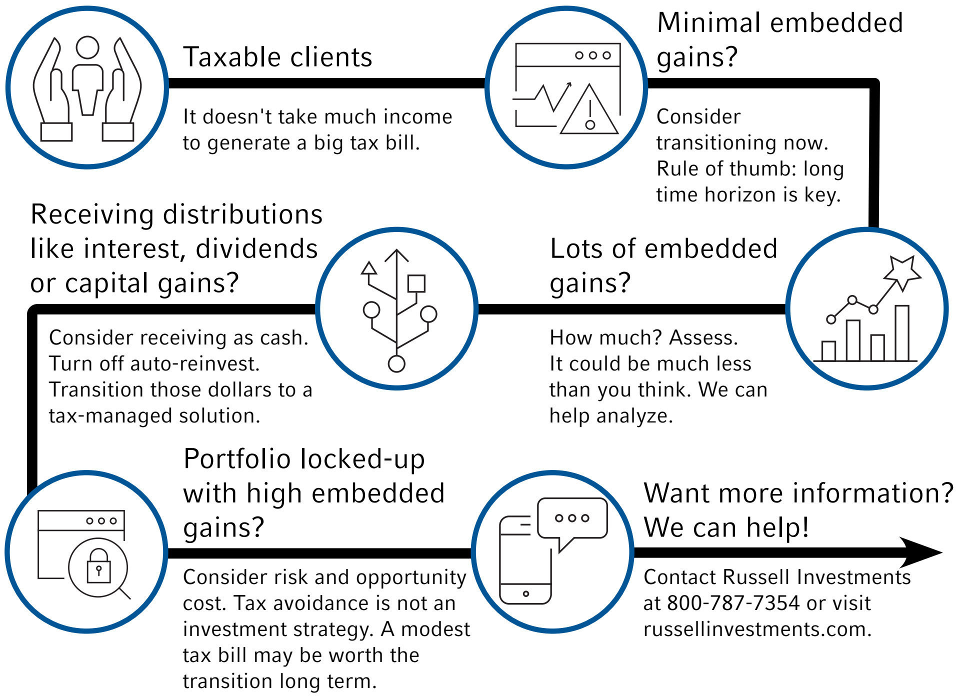
This is a hypothetical illustration and not meant to represent an actual investment strategy.

That difference of more than 25% in the amount of after-tax spending is due to the higher tax rate applied to the yield portfolio's cashflow than to total return portfolio —particularly LTCG. The total return portfolio generated $24,000 of the desired $45,000 cashflow from dividends and interest and the remaining $21,000 through systematic selling of shares, thereby reducing the tax liability of the portfolio.

Of course, this doesn't mean that a total return approach is best for all investors. In fact, a yield-oriented approach is typically a better fit for investors who have a preference to not invade principal, do not mind some variability in their cashflow, and are drawing income only from non-taxable assets. In contrast, for clients who are considering drawing income from taxable assets, want to control their cashflow pattern and don't mind spending principal, the potential tax advantages of a total return approach may be better suited.

# Tips to help transition to tax-managed investing

If your client is considering transitioning assets to a more tax-aware portfolio, the following general guide, based on today's federal tax rates, is designed to help you and your client minimize unexpected taxable impacts. Of course, these ideas may not be appropriate for every investor, but this can give you a sense of the type of considerations that might be beneficial. Depending on the client's cost basis, tax bracket and unique considerations, these ideas may need to be modified to fit their specific situation. Of course, this shouldn't be considered tax advice and you and your clients need to carefully assess each individual situation before proceeding, including consulting with a tax advisor.








| SITUATION | IF SUITABLE FOR THE INVESTOR, CONSIDER THE FOLLOWING |
|---|---|
| Client without significant embedded capital gains. | Transition now.<br><br>*Note:* If you have clients that have inherited investment assets, the cost basis of those assets may have benefited from a 'step-up in basis'. This means that the value of the asset(s) is determined to be the higher market value of the asset at the time of inheritance, not the value at which the original party purchased the asset. |
| Client recently took tax hit with capital gains distribution and reinvested that distribution. | If there is little or no gain in that reinvested distribution, liquidate it and transition that money to tax-managed investments. |
| Client expects to receive a capital gains distribution. | Set up the client's account(s) to pay gains out in cash. When the gains are paid out, invest those dollars in tax-managed investments. Each year, transition more assets over. It's important to note that if gains aren't reinvested, either in the original investment or in the new tax-managed investment, the investor will not benefit from the compounding that the reinvestment of these gains may offer. |
| Client with embedded gains. | Your client may incur capital gains tax if they sell their holdings, however, depending on the client's individual situation it may make sense to pay a little today to set your client up for the long term. Personal situations and tax brackets may change, of course. No one knows what their tax bracket will be in the future, but if an investor's tax bracket ends up being higher in the future, it may make sense to pay now. If the investor's tax bracket in the future might be lower, however, then it might not make sense to transition assets to tax-managed investing today.<br><br>Use tax lots to your advantage. With accurate cost-basis information on all of your client's purchases, you can aim to sell the highest cost positions first.<br><br>Typically, it's best to sell any long-term positions first to benefit from preferential LTCG rates at the federal level but, depending upon the tax lots, it sometimes makes sense to sell the newer position(s) for a lower capital gain.<br><br>Transition proceeds to tax-managed investments. |

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# Sample scenario

A couple (married filing jointly) in the top tax bracket purchased a hypothetical multi-asset balanced mutual fund three years ago. Assume the equity portfolio had a 32% cumulative pre-tax return (9.7% annualized return). Under which of the following three scenarios would it make sense to sell this investment in favor of a more tax-sensitive one?

## 1 Tax cost to switch

Consider the following:

- Has the asset's value appreciated since it was purchased? Is the current market value greater than the original cost or adjusted basis?
- For how long has the client held the asset? Holding periods of 12 months or less may be subject to a higher tax rate than longer holding periods.
- Does the investor have any capital losses or loss carry forwards that could be used to offset the gain?

Applied to the sample scenario: If the couple chose to sell the mutual fund, taxes would take an 8% bite out of their investment return. (Based on a 23.8% tax on the LTCG of 32%, causing the after-tax cumulative return to drop from 32% to 24%—an 8% difference.)

## 2 Potential improvement in after-tax returns

Consider the following:

- What kind of improvement can you plan for by being smart around taxes? It depends. Are you looking at only U.S. equity, international equity, U.S. bonds, or a fully diversified multi-asset portfolio? Every asset class is different.

Applied to the sample scenario: Based on returns of the couple's multi-asset balanced portfolio for the past 10 years, the advisor assumes a 2% improvement in after-tax returns



is possible from a diversified portfolio that is explicitly tax-managed. The advisor recognizes that historical returns are no prediction of future results and that diversification does not protect against all loss or guarantee a profit.

## 3 Investor's time horizon

Consider the following:

- The investor's expected time horizon for holding the new investment will influence whether the new investment has the potential to make up the cost of making the portfolio switch in the first place. The longer the investor's time horizon, the more options they likely have.

Applied to the sample scenario: The couple plans to hold the investment for at least five years.

### Putting it together

Based on the factors above, the estimated payback periods are:

| CUMULATIVE CAPITAL GAIN (%) | PAYBACK PERIOD* |
|---|---|
| 0% | Now |
| 30% | 3.5 Years |
| 50% | 5.7 Years |
| 100% | 11.9 Years |

*Hypothetical example for illustrative purposes only. Tax rate assumed = long-term rate at highest marginal rate (23.8% = (Max 20% LTCG + 3.8% NIIT). Payback period assumes 2% per annum compound excess returns after tax of a tax-managed solution relative to non-tax-managed.

For the couple in the sample scenario, a switch to a tax-managed solution could potentially add value. The tax hit they would sustain for selling their hypothetical mutual fund that enjoyed a 32% long-term investment gain would potentially have a payback period of just over 3.5 years. Given they are expecting to hold the new investment for at least five years, this move could be beneficial.

Some may feel that the 11.9 years' payback period for portfolios with a 100% cumulative capital gain is a long time, but many investors have time horizons that are longer than this. For instance, a couple in their early 60's could easily have at least 20 years ahead of them in which to wait out a payback period.

As you consider your clients' situations, you may find that in many cases it's in the client's best interest to pay the investment tax now, with the understanding that improved after-tax returns will benefit their long-term wealth and improve their odds of reaching a successful outcome. One change to consider immediately is to reinvest distributions or income generated from non-tax-managed assets in a tax-smart manner.

Also keep in mind that periods of higher volatility can potentially reduce existing capital gains and create additional opportunities to transition assets over to tax-managed investing.

Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. It is not representative of a projection of the stock market, or of any specific investment. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

Russell 1000® Index: Measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership.

The S&P 500® Index is a free-float capitalization-weighted index published since 1957 of the prices of 500 large-cap common stocks actively traded in the U.S. The stocks included in the S&P 500® are those of large publicly-held companies that trade on either of the two largest American stock market exchanges: the New York Stock Exchange and the NASDAQ.





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SECTION 5

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# TAX PLANNING APPROACHES

Tax planning approaches can be an important topic in your conversations with tax-sensitive clients. Of course, the tax planning tactics contained in this guide are general in nature. You should work with your clients' tax advisors to determine applicability and implementation considerations for your clients' specific facts and circumstances.

**In this section:**

- Income tax planning
  - Capital gains
  - Net investment income
  - 529 savings plan
  - Deductions
  - Section 199A deduction
  - Alternative minimum tax
- Retirement planning
- State tax planning
- Wealth transfer planning
- Entity conversion considerations

**This section contains content sourced from the *2016, 2019, 2020, 2021 & 2023 Essential Tax and Wealth Planning Guide* published by Deloitte. Deloitte provides industry-leading audit, consulting, tax, and advisory services to many of the world's most admired brands.**

# Income tax planning: Capital gains

**Planning tactic #1**

**Consider tax brackets when realizing capital gains.**
If you anticipate your client being in a lower tax bracket in future tax years or expect significant amounts of capital losses in the next tax year, you may want to consider having your client realize capital gains in the current tax year, but deferring tax recognition until the next tax year. Your client can accomplish this by using such approaches as entering into an installment sales agreement (but not when selling marketable securities, as such gain is not deferrable) or implementing other investment techniques. Consult a tax advisor for planning techniques specific to your client's situation.

**Planning tactic #2**

**Consider harvesting losses to offset short-term capital gains.**
If your client has short-term capital gains (STCG) (which are taxed at ordinary income tax rates), you may consider selling capital assets that will generate a capital loss in order to offset the STCG. Taxpayers are allowed to deduct up to $3,000 of net capital losses against ordinary income each year. Any net capital losses in excess of $3,000 are carried over to future years. While harvesting losses can make sense from a tax perspective, make sure your clients are not overlooking investment implications and transaction costs that could more than offset the tax gains. In some cases, the primary benefit of harvesting a tax loss is simply to offset the payment of capital gains tax.

Taxpayers may find that they are unable to sell or otherwise dispose of stocks in their investment portfolio, perhaps due to the stocks having very little to no value. A taxpayer may deduct the cost basis of stock in the year it becomes completely worthless. Losses that are generated from worthless securities are treated as capital transactions and thus generate a capital loss. In some instances, such as when a taxpayer owns an investment in a partnership that becomes worthless, a taxpayer may be able to generate an ordinary loss.

**Planning tactic #3**

**Consider the wash sale rules.**
Under the "wash sale" rules, if securities are sold at a loss and the same—or substantially the same—securities are purchased within 30 days before or after sale of the original securities, the loss cannot be recognized until the replacement securities are sold. These rules apply even if the purchased securities are in the seller's IRA. There often is a satisfactory alternative, however. To realize the loss and maintain the ability to benefit from any market up-side, consider selling a stock or mutual fund to realize a loss and then replacing it in your client's portfolio with one having similar characteristics in the same industry or style group.

**Planning tactic #4**

**Gift appreciated assets.**
Taxpayers interested in family wealth planning might consider gifting appreciated assets (or those that are expected to appreciate) to their children who are not subject to the Kiddie tax, but that have taxable income that qualifies for the 0% long-term capital gains (LTCG) tax rate. Because taxpayers with taxable income qualifying for 15% or 20% LTCG rates versus a 0% rate for taxpayers in the lowest tax brackets, your client may realize an immediate tax savings. Combining utilization of the gift tax annual exclusion with a gift of appreciating assets can be a powerful wealth-transfer planning tool. Keep in mind that the applicable age for applying the Kiddie tax is children under age 19 or dependent full-time students under age 24.

**Planning tactic #5** **Sell a business through a stock sale.**
If your client is considering selling a business, they may attempt to structure the transaction as a sale of the company's stock rather than a sale of the company's assets. In most circumstances, a sale of the company's stock will constitute a sale of a capital asset eligible for the lower capital gains tax rate, as opposed to a sale of the assets, a portion of which may be subject to tax as ordinary income. Additional tax savings accrue if the business constitutes a qualified small business, the stock of which has been held for at least five years. Generally, 50% of the gain on such a stock sale (limited to the greater of 10 times the taxpayer's basis in the stock or $10 million) is excludable from income with any remaining gain being taxed at 28%. The qualified small business stock exclusion is 75% for stock acquired after February 17, 2009 and on or before September 27, 2010, and 100% for stock acquired after September 27, 2010 (the Protecting Americans from Tax Hikes Act of 2015 permanently extends the exclusion of 100% of the gain). The buyer will typically want to structure the transaction as a sale of assets in order to take advantage of certain depreciation rules; therefore, some negotiation is to be expected. Note that for stock acquired on or after September 27, 2010, the associated alternative minimum tax (AMT) addback is also eliminated.

**Planning tactic #6** **When selling S-corp or C-corp stock, consider electing to use disposition of assets treatment.**
If planning on selling C-corp or S-corp stock, consider electing to have certain dispositions treated as a disposition of assets rather than disposition of stock. The election allows a step-up in the basis of the entity's assets upon the disposition, thus equalizing the inside and outside basis of the assets and eliminating the built-in gain on a future after-sale disposition of the underlying assets.

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Purchasers other than corporations (e.g., individuals, trusts, estates, and partnerships) may be able to benefit from this type of election that requires the consent of sellers and purchasers. Because the availability and advisability of making this election depends upon each taxpayer's factual circumstances, your client should consult with a tax advisor to explore the possibility of making an election.

## Income tax planning: Net investment income

**Planning tactic #1** **Defer capital gains or harvest losses.**
As discussed earlier in the capital gains section, consider deferring capital gains or harvesting losses when possible. As part of the analysis as to whether to harvest losses, it is also important to analyze transaction costs, as well as the underlying economic considerations.

**Planning tactic #2** **Consider installment sale treatment.**
For current-tax-year sales, your client may consider electing into installment sale treatment (where available) and deferring the gain over the payment period (instead of recognizing the entire amount of gain in the year of sale). This would allow your client to defer the income and the associated capital gains tax over the installment payment period. Sales of marketable securities are not eligible for installment sale treatment.

**Planning tactic #3** **Rebalance your client's portfolio.**
Consider rebalancing your client's investment portfolio by increasing investments in growth assets and decreasing emphasis on dividend-paying assets. This will remove income from your client's earnings and manage their exposure to the net investment income tax (NIIT). Keep in mind that sales of taxable income-producing assets will be subject to capital gains rates and potentially to the 3.8% NIIT. You should work with your client to review their investment strategy in light of the impact of higher tax rates.

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If you anticipate your client's tax rate to increase in the future, tax-exempt investments may produce a greater yield than taxable investments.

## Income tax planning: 529 savings plan

*View current year contribution limits in the latest edition of Tax Facts & Figures, a separate quick-reference tax facts guide.*

**Planning tactic #1**

**Decide how your client will withdraw funds.**
529 savings plans aren't exclusive to college—taxpayers can distribute from a 529 plan on tuition expenses for elementary or secondary public, private, or religious school tuition and eligible expenses. In addition, the named beneficiary of the 529 plan and each sibling can each withdraw up to $10,000 to repay student loans.

**Planning tactic #2**

**Fund the 529 plan.**
Contributions are considered gifts for tax purposes; taxpayer gifts totaling up to the maximum annual contribution amount per child will qualify for the annual exclusion. This means that a taxpayer and their spouse can each gift up to the maximum annual contribution amount per child, without gift-tax consequences. If each taxpayer contributes more than the maximum annual contribution amount for the current tax year, the excess amount will count against their lifetime estate and gift tax exemption. Using a special election, a donor can fund up to five years of annual exclusions into these plans in year one. For example, in 2024, one can contribute $90,000, or $180,000 per married couple, to each child's (or grandchild's) Section 529 plan without incurring gift or generation-skipping transfer (GST) tax. If other gifts are made by the donor to that child or grandchild from 2024–2028, however, those gifts would use some of the donor's applicable exclusion amount, as well as some of the donor's GST tax exemption, with respect to any gift made for a grandchild. By funding these plans in advance, the growth in the fund occurs in an income tax-exempt environment.

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**Planning tactic #3**

**Plan for tax-free withdrawals.**
Qualified withdrawals are federal income tax-free so long as they are equal to, or less than your Qualified Higher Education Expenses (QHEE). Ensure that withdrawals are used for qualified education expenses, such as tuition, room & board, books & supplies, special services, computers & related equipment, or to repay student loans.

**Planning tactic #4**

**Overfunded 529 plan?**
If funds remain in the 529 plan, there are multiple options. The taxpayer can leave the money in the account, in anticipation of their child continuing onto the next level of their education. They can also change beneficiaries without incurring tax penalties, by switching the plan to another family member, or by rolling over funds from the 529 account to the 529 plan of another child of theirs. Lastly, the named beneficiary on the 529 plan and each sibling can each withdraw up to $10,000 to repay student loans. It's important to try and minimize the likelihood of overfunding a 529 plan, as there is a penalty of 10% for non-qualified withdrawals.

**Planning tactic #5**

**529-to-Roth IRA Rollovers**
The SECURE 2.0 ACT allows taxpayers to roll unused 529 funds into the beneficiary's Roth IRA without a tax penalty. Starting in 2024, taxpayers can roll unused 529 assets—up to a lifetime limit of $35,000—into the account beneficiary's Roth IRA, without incurring the usual 10% penalty for nonqualified withdrawals or generating any taxable income.

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The following rules apply to 529 plan rollovers to Roth IRAs:

- The 529 plan must be under the beneficiary's name for a minimum of 15 years.
- Yearly conversions cannot exceed annual Roth IRA contribution limits.
- The lifetime 529 to Roth IRA rollover limit is $35,000.
- 529 plan contributions (including earnings accrued on those contributions) made in the last five years cannot be transferred to a Roth IRA.
- If the beneficiary makes any IRA contributions in a given year, the eligible 529 to Roth IRA rollover amount is reduced by the size of that contribution.
- The rollover must be direct (e.g., plan-to-plan or trustee-to-trustee). Taxpayers cannot take a distribution — a check — from a 529 and send it to a Roth IRA.





# Income tax planning: Deductions

With respect to deductions, the key planning issue is determining in which year the deduction will generate the greatest tax benefit. Understanding this allows you to determine the most appropriate timing for deductions. As your client's tax rate rises, deductions are likely to be more beneficial; conversely, if your client's tax rate declines, they likely will become less beneficial.

### Planning tactic #1

**Donate appreciated securities.**
If your client is planning to make a contribution to a public charity, they might consider a gift of appreciated securities. By making such a contribution, your client may be able to deduct the full market value of the gift for both regular and AMT purposes (if the securities were held for more than one year), whereas, if the securities are sold and the after-tax proceeds donated, both your client and the charity will receive a lesser benefit.

### Example

If your client contributes an appreciated security that has a basis of $20,000 and a fair market value of $100,000, they may take a deduction equal to $100,000 (subject to certain limitations) and the charity receives a gift worth $100,000. If they sold the securities and donated the after-tax proceeds, the charity may receive only $84,000 [$100,000 – (($100,000 – $20,000) x 20%)]. The tax will be even larger if the sale is subject to the 3.8% NIIT discussed previously as well as state income taxes. In addition, your client would receive a smaller income-tax charitable deduction.

**Planning tactic #2** **Investment interest expense planning.**
Investment interest expense is only deductible to the extent of current-year net investment income. Dividends that are taxed at the lower qualified dividends' reduced rates are not treated as investment income for purposes of this calculation; therefore, your client may consider electing to tax a portion of qualified dividends (or LTCG) at ordinary income rates to increase use of the investment interest deduction. Your client may elect to recognize just enough of the qualified dividends to be taxed at ordinary income tax rates to offset investment interest expense and allow the remainder of qualified dividends to be taxed at the lower 15% or 20% rate (or 0% rate for lower-income taxpayers). Alternatively, if your client anticipates being in a higher tax bracket in the current tax year, they should consider whether carrying over an investment interest expense into a future year is more advantageous than electing to recognize qualified dividend income (and/or capital gains) as ordinary income for a current-year offset.

## Income tax planning: Section 199A deduction

**Consider the limitation thresholds.**
Neither the specified service trade or business limitation nor the wage and basis limitation apply in the case of taxpayers with taxable income below $191,950 ($383,900 MFJ) for 2024.

If you anticipate your client being close to these thresholds in 2024 or future years, you may want to consider having your client defer gains/income or accelerate losses/deductions to maximize your client's Section 199A deduction.

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## Income tax planning: Alternative minimum tax

The ability to apply most non-refundable personal credits (including the Dependent Care Credit, the credit for the elderly and disabled, the credit for interest on certain home mortgages, and the Hope Education Credit) against the AMT expired at the end of 2011, but was reinstated again on a permanent basis as part of the American Tax Relief Act of 2012.

**Planning tactic #1** **Perform an AMT diagnosis.**
Falling victim to AMT has many possible causes, but your client may be particularly prone to AMT if they have any of the following circumstances:

- Large LTCG or qualified dividends
- Large deductions for accelerated depreciation
- Mineral investments generating percentage depletion and intangible drilling costs
- Research and development expenses in activities in which your client does not materially participate
- An exercise of incentive stock options (ISOs)
- Large amounts of tax-exempt income that is not exempt for state tax purposes
- Tax-exempt income from private activity bonds

If they are affected by one or more of these circumstances, you should discuss your client's AMT situation with their tax advisor.

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**Planning tactic #2** **Do a multi-year analysis of potential planning options.** Some of the differences between the AMT and regular tax systems are merely matters of timing. For instance, AMT generally requires slower depreciation than is permitted for regular tax purposes. Paying AMT in one year may generate a credit against a future year's regular tax when adjustments are due to timing differences. Overall, your client may be better off paying AMT currently in order to gain a credit in a later year—but only a multi-year analysis modeling the potential effect of planning options conducted by their tax advisor will tell.

**Planning tactic #3** **Consider disqualifying ISO dispositions.** Consider whether any of your client's stock obtained by exercising ISOs should be disqualified before the end of the year to reduce AMT liability if the stock has dropped in value. A disqualifying disposition will limit compensation income to the difference between the exercise price and the lower value of the stock at sale. If there is a wash sale (i.e., the same stock is repurchased within 30 days of the disqualifying disposition), compensation will be computed on the spread at exercise (at the old, higher value).

**Planning tactic #4** **Watch out for other AMT traps.** Income from private activity (municipal) bonds is taxable for AMT purposes, except certain private activity bonds issued in 2009 and 2010. Certain mortgage interest, such as from a home equity loan, is not deductible for AMT purposes as home mortgage interest if the funds from the loan are not used to buy, build, or substantially improve a primary or second home. If your client used the borrowed funds in their business or to make investments, be sure to consult with their tax advisor as the home equity loan interest may still be deductible.





# Retirement planning

Sound retirement planning involves a range of economic and tax considerations. Most importantly, though, it involves consistent discipline to save. Individuals sometimes wonder whether they should skip making retirement plan contributions in light of uncertain market conditions. Keep in mind that there is no ability to make up missed retirement plan contributions in later years, and the potential for tax-favored earnings on those contributions is lost. Regardless of your client's current and future tax situation and the market outlook, they should always consider contributing the maximum amount to their retirement plans annually. *View current year contribution limits in the latest edition of Tax Facts & Figures, a separate quick-reference tax facts guide.*

**Planning tactic #1** **Establish a Keogh plan.** Sole proprietors or partnerships may establish a Keogh plan for themselves and their employees. Although they do not have to make contributions until the due date of the tax return (including extensions), they must establish the plan by the end of the year. Self-employed individuals may contribute the lesser of the annual defined contributions limit or 100% of self-employment income to a defined contribution Keogh plan; however, any non-deductible amount (generally, any amount above the lesser of the annual defined contributions limit or, in the case of plans for self-employed individuals with no employees, 20% of net self-employment income) is subject to a 10% excise tax. Self-employed individuals, therefore, generally contribute only the lesser of the annual defined contributions limit or 20% of their net self-employment income. For purposes of the 20% limitation, net self-employment income includes a deduction for contributions to the plan. Older individuals should consider establishing a defined-benefit Keogh plan, which will likely allow a higher contribution amount.

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**Planning tactic #2** **Establish a defined-benefit plan.**

If your client is an owner/employee of an S corporation without other employees, they may consider establishing a defined-benefit plan. Generally, an owner/employee may be able to contribute more to a defined-benefit plan than a defined-contribution plan. In addition, your client may make contributions to the defined-benefit plan in a year in which they do not receive any compensation (or earned income if they are considered self-employed). In contrast, contributions to a defined-contribution plan are limited to the lesser of the annual defined contributions limit or 100% of compensation (or earned income for persons considered self-employed); therefore, if they earn no compensation in a particular year, they may not make a contribution to a defined-contribution plan for that year. On the other hand, to avoid excise taxes, they may be required to make contributions that they would prefer not to make in a given year.

**Planning tactic #3** **Establish solo 401(k) plans and SEP IRAs.**

In addition to contributing to Keogh plans, self-employed individuals are eligible to establish solo 401(k) plans and SEP IRAs. Solo 401(k) plans must be established prior to year-end of the year in which the deduction will be taken, whereas a SEP IRA may be established and funded at the time of filing the individual income tax return (including extensions). Each plan has its advantages and disadvantages; therefore, if your client is self-employed, you should discuss retirement plan options with them to determine which plan works best.

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**Planning tactic #4** **Board members can establish a Keogh or other self-employed retirement plan.**

Earning compensation for serving on a company's board of directors may qualify as self-employment income and, therefore, be subject to self-employment tax. If your client earns self-employment income, they may qualify to sponsor a Keogh or other self-employed retirement plan. Qualification as self-employment income may be possible even if they are an employee of the company, as long as the self-employment earnings are sufficiently segregated from wage income. The rules in this area are complex; if they earn director fees, discuss this topic with your client and their tax advisor.

**Planning tactic #5** **Analyze contributions to employer-sponsored 401(k) plans.**

Many investors have considered stopping contributions to their 401(k) plans in favor of investing in currently taxable accounts due to the lower capital gain and dividend rates. Recall though that amounts contributed to a 401(k) plan are pre-tax, which means they may lower your client's current tax bill and affect AMT planning. Also, if their employer offers matching contributions, your client could be giving up "free" money. Talk to your client to determine how best to invest funds in a currently taxable account or a tax-deferred account.

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**Planning tactic #6**

**Make contributions to a Roth IRA or Roth 401(k).**
Consider talking with your clients about making contributions to a Roth IRA or Roth 401(k) if there is reason to believe their tax rate may be higher in retirement. Although contributions to a Roth IRA or Roth 401(k) are never deductible, any income earned within the Roth IRA or Roth 401(k) may be free from federal income tax when they withdraw money from the account. Unlike traditional IRAs, Roth IRAs do not require minimum distributions starting at age 72 (73 if you reach age 72 after December 31, 2022).

**Planning tactic #7**

**Make catch-up retirement plan contributions.**
If your client is age 50 or older by year-end, they may make additional catch-up contributions to their retirement plans. Check with your client's plan administrator for the proper procedure to make catch-up contributions to their 401(k) plan.

**Planning tactic #8**

**Establish a spousal IRA.**
A spouse who has little or no earned income and who is not an active participant in an employer-sponsored retirement plan can still have an individual retirement account. The maximum annual contribution to a spousal IRA is the lesser of the maximum annual contribution amount or the combined taxable compensation of both spouses. The deduction for such contribution begins to be phased out for qualifying AGI.

Although the contribution may not be deductible, the amounts contributed will still grow tax-deferred; therefore, this may still be a good retirement planning option.





**Planning tactic #9**

**Make IRA contributions prior to the end of the year.**
Your client can do this even though the contributions are not due until the IRS filing deadline for that tax year. Making contributions earlier increases the effect of compounding on retirement account earnings. As with the spousal IRA, even if the contribution is not deductible, it will grow tax-deferred. If your client's contribution is deductible, their AGI will be lower, possibly allowing them to take advantage of certain credits and deductions that are limited by AGI levels. Take this into consideration when making year-end decisions. Individuals are allowed to contribute to both a 401(k) plan and an IRA in the same year; however, if they contribute to a 401(k) plan (or any other employer-sponsored retirement plan), their ability to deduct contributions to an IRA in the same year will be limited if their AGI exceeds the qualifying income limits.

**Planning tactic #10**

**Re-allocate tax-inefficient assets.**
Consider allocating tax-inefficient assets such as taxable bonds and Treasury Inflation-Protected Securities (TIPS) to tax-deferred accounts such as IRAs and 401(k)s. If your client has a Roth IRA, consider using this account for their higher-expected-return, tax-inefficient assets such as real estate investment trusts (REITs) and commodity-futures funds. If your client does not have a Roth IRA, consider allocating these assets to their traditional IRA account. Consider allocating low-turnover LTCG assets and municipal bonds to their personal accounts.

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## Planning tactic #11

**Withdraw excess contributions before year-end to minimize excise tax.**

An excise tax is imposed on excess contributions to various savings vehicles. Generally, excess contributions to an IRA, medical savings account, health savings account, or Coverdell account (also known as an Education IRA) are subject to a 6% excise tax. Excess contributions to other qualified plans—such as 401(k) plans, Keogh, and pension plans—in excess of the deductible amount are subject to a 10% excise tax. To avoid potential excise taxes, consider suggesting your client withdraw excess contributions before year-end.

## Planning tactic #12

**Skip retirement distributions before age 72.**

If an individual is under age 72 and does not need the funds, consider talking with your client about skipping distributions from qualified plans until required minimum distributions (RMDs) are mandatory. The client can also choose beneficiaries with long life expectancies to delay distributions; make sure these beneficiary designations are always up to date.

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## Planning tactic #13

**Roth IRA conversions**

All taxpayers have the opportunity to convert traditional IRAs into Roth IRAs without limitations based on their income level. If your client currently has retirement accounts, you and their tax advisor should discuss the possibility of converting to a Roth IRA. While income taxes would be due currently, your client and their heirs may have more after-tax wealth as a result of the conversion because qualified distributions from a Roth IRA are tax free, including the income and appreciation components of such distributions. In order for a distribution to be a qualified distribution, a five-year holding period must be satisfied, and one of the following four requirements must be met:

1. The distribution is made on or after the date on which the individual attains age 59½
2. The distribution is made to a beneficiary or the individual estate after the individual's death
3. The distribution is attributable to the individual being disabled
4. The distribution is to pay for certain qualified first-time homebuyer expenses (up to $10,000)
5. The distribution is to pay for birth and/or adoption expenses incurred by new parents (up to $5,000)

A non-qualified distribution may be subject to a 10% early withdrawal penalty.

There are several other advantages to Roth IRAs. The mandatory distribution rules applicable to traditional IRAs during the lifetime of the owner do not apply. There are also income tax benefits to heirs who inherit a Roth IRA.

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Unlike distributions from a traditional deductible IRA, the distributions are not subject to income tax when withdrawn by a designated beneficiary. (Distributions from a non-deductible IRA will be partially taxable, as the heirs recoup the decedent's basis in the IRA.) Additionally, taxpayers may also convert any portion of their balance in an employer-sponsored 401(k) account into a Roth 401(k) under that plan. The conversion option for retirement plans would only be available if the employer plan sponsors this feature.

**Planning tactic #14**

**Contribute to a non-deductible IRA that can be converted to Roth IRA later.**

If your client is not eligible to contribute to a Roth IRA due to the income threshold, they should consider contributing to a regular non-deductible IRA so those amounts can be converted to a Roth IRA. Contributions to a non-deductible IRA build basis in the plan, which will be non-taxable when converted. The conversion can take place on the same day as the non-deductible contributions or later. Consult with a tax advisor if your client has other IRAs. The 2017 Tax Act eliminates the ability to recharacterize traditional-to-Roth IRA conversions. As a result, once an individual has converted an amount in a traditional IRA to a Roth IRA, that conversion is irrevocable. Regular, annual IRA contributions, to either type of IRA, can still be recharacterized.





- **Roth 401(k) contribution program**
  Employees who elect to contribute to a 401(k) plan may designate some or all of these contributions as Roth IRA contributions (designated Roth contributions) if their particular 401(k) plan permits such treatment. Designated Roth contributions are included in taxable income in the contribution year; however, distributions from the designated Roth portion of the 401(k) plan after the employee reaches age 59½ will be tax-free. Designated Roth contributions must be accounted for separately within the 401(k) plan.
- **Non-spousal inherited retirement assets**
  An individual receiving an inherited qualified retirement plan from a decedent other than a spouse may roll over the inherited account into an IRA. The rollover must be executed by a trustee-to-trustee transfer. The inherited amounts transferred to the IRA will be treated as an inherited IRA subject to the IRA minimum distribution rules; thus, beneficiaries must fully distribute the inherited amounts within 10 years. Any remaining funds after the 10-year period will be subject to a 50% penalty.
- **Distributions from tax-preferred retirement savings**
  In general, a 10% early withdrawal penalty applies to distributions from qualified plans and IRAs for participants who have not yet reached age 59½. There are numerous exceptions to this general rule; therefore, if your client needs to withdraw funds prior to age 59½ they should consult a tax advisor.

Generally, taxpayers who have reached age 72 by December 31st must start receiving required minimum distributions (RMDs) from qualified plans or be subject to severe penalties. Generally, minimum distributions from qualified plans must begin for the calendar year in which the taxpayer reaches age 72 and must be paid no later than April 1st of the following year. For every year thereafter, distributions must be made by the end of the year. The rules differ between self-employed individuals and non-self-employed individuals, so check with a tax advisor to determine whether your client is subject to special rules.

An excess accumulation is any amount of a RMD that is not distributed in a timely manner. A hefty 25% excise tax is imposed for each year the excess is not distributed. Although penalties may be waived under certain circumstances, individuals should make every effort to comply with the RMD rules.

**Planning tactic #15**

**Withdrawing funds before age 59½.**

In general, a penalty is imposed on withdrawals from a qualified plan or IRA prior to age 59½. Ideally, your client will not need plan funds prior to age 59½; however, where funds are withdrawn from a qualified plan or IRA prior to age 59½, the withdrawal may take place without penalty if the participant died or suffered a qualified disability. In addition, depending on the type of plan, it may be possible to withdraw funds without penalty under one or more of the following circumstances:

1. The payments are made following separation from service after attaining age 55 (not applicable to IRAs)
2. The payments are made in a series of substantially equal payments over the life of the participant (or joint lives of the participant and beneficiary)

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3. Distributions are used to pay qualified medical expenses that exceed 10% of AGI
4. Distributions are made to a non-participant under a qualified domestic relations order
5. Distributions are used to pay QHEE
6. Up to $10,000 is used for first-time homebuyer expenses
7. Certain distributions of dividends on employer securities are made by employee stock option plans (ESOPs)
8. Up to $5,000 is used by new parents to pay for birth and/or adoption expenses

Exceptions vary depending on the type of plan; therefore, you should discuss your client's options in depth and consult with their tax advisor.

**Planning tactic #16**

**Consider timing of initial required minimum distribution (RMD).**

Although the first RMD does not need to be paid until April 1st of the year following the year the taxpayer reaches age 72, postponement of the initial payment will result in doubling up on payments in the following year. For example, if an individual reaches age 72 in the current tax year, the first RMD does not need to be paid out until April 1 of the following year; however, the RMD for the current tax year also must be received by December 31 of the next year, resulting in two payments in the next year. This will increase the individual's AGI and may push them into a higher tax bracket in the next tax year and potentially bring into play other limitations discussed previously.

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**Planning tactic #17**

**Qualified charitable distributions (QCD)**
A Qualified Charitable Distribution (QCD) is a tax-free transfer from an IRA to a qualified charity. A QCD allows individuals who are 70 ½ years old or older to donate a maximum of $100,000 to one or more qualifying charities directly from a taxable IRA and can be counted toward satisfying one's required minimum distribution, up to $100,000. It is important to note that the QCD does not qualify for an income tax charitable deduction but rather escapes income tax liability on the transfer. Transfers to a donor-advised fund, supporting organization or private foundation to not qualify as QCD gift.

Beginning in 2024, the Consolidated Appropriations Act of 2023 provides for an annual increase (indexing for inflation) of the annual limit for QCDs.

**Planning tactic #18**

**Roth IRAs do not require distributions at age 72.**
The RMD rules do not apply to Roth IRAs during the lifetime of the owner. Distributions from Roth IRAs are required after the death of the participant if the spouse is not the sole beneficiary. When the spouse is the sole beneficiary of a Roth IRA, the Roth IRA may be treated as owned by the surviving spouse after the death of the first spouse.

**Planning tactic #19**

**Investing inside and outside of retirement accounts.**
If you expect a client to be in a higher tax bracket in future years or expect tax rates to increase significantly in a client's retirement years, it may be more advantageous to invest in equities outside of that client's retirement accounts as they approach retirement. By doing so, they can obtain the favorable capital gains tax rate when they sell the investment. Your client also may consider investing in taxable bonds in their retirement accounts, where the ordinary income generated can be deferred. Retirement plan distributions are generally taxed at ordinary income tax rates, which can be as high as 37%. Your client should work with their tax advisor to complete a multi-year tax projection to determine the best method of investing for retirement while keeping taxes to a minimum.





## State tax planning

Most tax planning focuses on saving federal taxes; however, state tax planning—especially for individuals living, working, or holding property in states with high tax rates—is equally important. Some individuals work and earn income in more than one state, requiring an analysis of the tax laws of several states as well as the possibility of having to file several different state income tax returns.

States such as Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not have individual income taxes, but most states do—with California having the highest rate of more than 13%. State laws vary widely, and the interaction between laws can be complicated. This guide cannot possibly cover all aspects of state tax planning; therefore, we encourage you to consult a local tax advisor for more detailed state tax planning techniques.

In addition to a separate income tax, many states have their own gift, estate, and inheritance taxes. In other words, your client may be liable for not only federal taxes in these areas, but also state taxes. Consideration of state taxes must be part of any taxpayer's overall financial planning, especially individuals who are considering moving to another state upon retirement. Although the taxpayer may save income taxes by the move, total taxes in the new locale may create an unexpected tax burden.

**Planning tactic #1**

**Use incentives.**
Many states offer special business incentives to those who work in or operate a business in that state. For example, multiple states offer an enterprise zone credit that may offset sales tax or provide significant hiring credits.

**Planning tactic #2** **Consider early tax payment discounts.**
Certain states may allow a discount for early payment of taxes. For example, some Florida counties provide a discount of up to 4% for early payment of property taxes.

**Planning tactic #3** **Consider nexus and filing requirements.**
Taxpayers (including trusts) who have a sufficient nexus with more than one state may owe taxes and have reporting requirements in multiple states. Nexus may be created through a variety of contacts; however, the most common are working in another state, owning property in another state, or engaging in a business activity in another state. Trusts may have nexus due to the residency of the beneficiary, the trustee, or the person who funded the trust (even if he or she died many years earlier). To complicate matters, each state may have its own definition of nexus, residence, and domicile. Credits may be available in your client's resident state to offset taxes paid to other states; therefore, you should check with a local tax advisor to determine where taxes may be due, what credits may be available, and whether your client must file a tax return in more than one state.

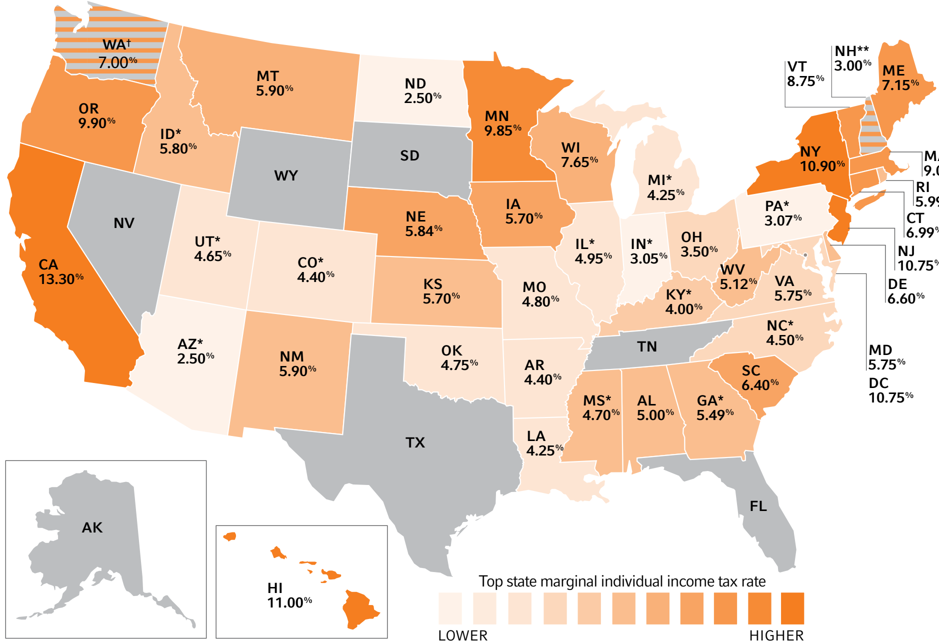
**Planning tactic #4** **Consider impacts of the 2017 Tax Act.**
Conformance with certain provisions of the 2017 Tax Act varies by state. For example, the treatment of the pass-through deduction, Section 199A, varies by state and may also vary based upon the type of taxpayer seeking to claim the Section 199A deduction. For individual income tax, the majority of states do not conform to Section 199A.





**How high are income tax rates in your state?**

Top marginal state individual income tax rates, (as of January 1, 2024)




Note: Map shows top marginal rates: the maximum statutory rate in each state. This map does not show effective marginal rates, which would include the effects of phase-outs of various tax preferences. Local income taxes are not included.
(*) State has a flat income tax. (**) State only taxes interest and dividend income.
(†) State only taxes capital gains income.
Source: Tax Foundation; state tax statutes, forms and instructions; Bloomberg Tax.

## Wealth transfer planning

Wealth transfer planning determines how an individual will "slice up the pie" and encompasses the many activities necessary to confirm that one's affairs are in order and the parties succeeding to your wealth do so as you intend. Keeping a current wealth-transfer plan is essential to its success. Once an estate plan is in place, periodic reassessment will help determine that it reflects recent life events, market and regulatory changes, and evolving legacy objectives. An effective plan may lessen

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the likelihood of family conflict, reduce estate costs, reduce taxes, and preserve wealth. Gathering an effective team of advisors will help facilitate the success of this ongoing process.

Increasing tax efficiency can provide for greater wealth transfer to heirs and/or charity, and is therefore an integral part of the wealth transfer planning process. The transfer tax system includes three separate taxes: the gift tax, the estate tax, and the generation-skipping transfer (GST) tax.

### Gift tax

- **Gift tax rate:** Most uncompensated (or insufficiently compensated) transfers of property during life are subject to the federal gift tax. The gift tax is computed based on the fair market value of the property transferred.
- **The lifetime gift exclusion:** The amount of property that each person can transfer tax-free is referred to as the applicable exclusion amount. The applicable exclusion amount is used to calculate the credit available to offset the gift tax calculated for current-year transfers.
- **Gift tax annual exclusion:** In addition to the lifetime gift tax exclusion amount, each individual taxpayer is allowed an annual exclusion from gift tax for certain gifts. To qualify for the gift tax annual exclusion, gifts must be of a present interest. A present interest implies that the donee has a substantial present economic benefit arising from the gift property. Many outright transfers qualify for the annual exclusion, including gifts of cash, marketable securities, and income-producing real estate.





### Example #1

Assume a couple has three married children and three grandchildren. In 2024, each spouse can transfer up to $18,000 per person free of gift tax. The couple could give $108,000 to their children, $108,000 to their children's spouses, and $108,000 to their grandchildren—a total of up to $324,000—without using any of the couple's combined lifetime gift tax exclusions and not incur any gift tax. Transferring assets today via annual exclusion gifting can also save future estate taxes. Under this scenario, assuming an applicable estate tax rate of 40%, and assuming combined wealth in excess of the then-applicable exclusion amount, $129,600 of future estate tax is saved.

**Exceptions:**

- **Education and medical gift exceptions:** Tuition payments made directly to educational institutions and certain payments made directly to health care providers are not taxable gifts and do not absorb a gift tax annual exclusion. For example, a grandmother who wishes to help pay for a granddaughter's education can write tuition checks directly to the school and give her the maximum annual gift contribution amount in cash without making a taxable gift. However, if she reimburses her granddaughter for tuition the granddaughter paid, she will have made a taxable gift to the extent the amount gifted exceeds the maximum annual gift contribution amount. Tuition is not limited to college tuition; any qualified school's tuition can be excluded. In addition, medical expense does not just mean those for doctors and hospitals; any qualified medical expense, including health insurance premiums, can be paid under this exclusion.
- **Gifts to your spouse:** Outright gifts to your spouse, assuming the spouse is a U.S. citizen, qualify for an unlimited marital deduction and are not subject to gift tax. Gifts to non-citizen spouses are instead subject to an annual exclusion limitation ($185,000 for 2024).

## Example #2

Continuing from Example #1, let's assume the couple also pays the annual college tuition costs of their three grandchildren this year. Assuming the annual tuition cost is $30,000 per grandchild, an additional $90,000 can be transferred gift-tax-free, and an additional $36,000 of future estate tax is saved.

### Estate tax

The estate tax is imposed on the fair market value of all assets includible in a client's estate at the time of death and the value of taxable gifts made during one's lifetime. The only permitted reductions to the taxable estate are debts and expenses of administration, the value of assets passing in a qualified manner to one's spouse, the value of qualified assets passing to qualified charities, and the applicable exclusion amount at the date of death. Generally, if the total of one's gross estate and prior gifts exceeds the applicable exclusion amount at the date of death, the excess is taxed at the then top marginal transfer tax rate.

Qualified transfers to a spouse who is a U.S. citizen are covered by the unlimited marital deduction, so such transfers may be made totally free from the estate tax. Thus, with proper planning, the estate tax for married individuals can be deferred until the death of the surviving spouse. Most transfers to qualified charities are covered by an unlimited charitable deduction.





## A note on portability

A surviving spouse can use his or her own basic exclusion amount plus the unused exclusion amount of his or her most recent deceased spouse to offset the tax on the survivor's subsequent gifts or to offset his or her taxable estate. Note that the GST tax exemption (discussed next) is not portable.

### Generation-skipping transfer tax

The generation-skipping transfer (GST) is imposed in addition to the gift and estate tax on direct or indirect transfers or bequests made to a "skip person"—a recipient who is at least two generations younger than the donor or decedent, such as a grandchild. An indirect transfer arises when a skip person is either distributed assets from or becomes indefeasibly vested in the assets of a trust.

If there were no GST tax, a transfer to a grandchild would be subject to the gift or estate tax once, while a gift to a child who then further gifts or bequeaths those assets to their child would be subject to transfer tax twice. The GST tax is intended to tax the transfer to the grandchild twice at the time it is made (through both the gift/estate tax and the GST tax), to compensate for the otherwise skipped level of tax. Furthermore, with respect to a taxable gift to a skip person, the cash used to pay the GST tax is also subject to the gift tax.

The GST tax exemption for the current tax year is the same as the gift and estate tax applicable exclusion amount. The GST tax rate is equal to the maximum federal estate tax rate for the year that the skip person receives or becomes permanently vested in assets.

There is also an annual exclusion amount available for transfers subject to the GST tax. The GST tax annual exclusion amount is the same as the gift tax annual exclusion amount.

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## Making gifts to absorb part or all of the applicable exclusion amount

Under the TCJA, the applicable exclusion amount (AEA)—the amount that can be left to others by gift or bequest without incurring a gift or estate tax—was increased from $5 million to $10 million, indexed for inflation. In 2024, the AEA is $13.61 million. The TCJA states that the increased $10 million exclusion will only be in place until the end of 2025, when it will revert to the previous $5 million limit indexed for inflation. Under current law, the increased AEA is a "use it or lose it" proposition. Once it sunsets, it will be as if it had never existed.

Thus, those in a position to make gifts should consider making gifts that absorb part or all of the AEA. For those concerned that future changes in the law might somehow simply defer any gift tax but leave the donor exposed to a higher estate tax later, on November 26, 2019, the IRS released final regulations, clarifying that when the AEA amount reverts back to $5 million at the end of 2025, the AEA amount governing the computation of the estate tax will be the greater of the AEA at the date of death or the AEA actually used before 2025.

## Gifting "hard-to-value assets

Gifting "hard-to-value" assets where a valuation discount can be taken is another planning consideration to enhance the performance of gifted assets relative to a simple gift of cash. Examples of hard-to-value assets include minority interests in closely held business and investment entities and fractional interests in real estate. The depth of any discount is often challenged by the IRS and has been the object of regulatory control as recently as 2017. It is reasonably foreseeable that future focus on the ability to discount appropriate assets will occur.

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## Making transfers to grantor trusts

Grantor trust status arises where the grantor retains either an economic interest or power over trust property, which are significant enough to require the income of the trust to be taxed to the grantor as if the trust's assets were owned by the grantor. Thus, the trust is disregarded for income tax purposes, with two significant outcomes. First, the trust grows income tax–free, since the grantor is legally obligated to report and pay tax on the trust's tax attributes; and second, transactions between the trust and the grantor are disregarded. If the grantor trust is structured in a manner that precludes estate inclusion, these two outcomes allow a gift in trust to convey more wealth for the same AEA than is possible for an outright gift. Grantor trust status ends when the grantor dies or revokes the grantor trust powers. The income tax paid by the grantor is not considered an additional gift to the trust since the payment of the tax is in satisfaction of the grantor's legal obligation.

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### State transfer taxes

One benefit of wealth transfer planning by gift rather than by bequest may be the avoidance of state transfer taxes. Connecticut is the only state that currently has a gift tax. Thus, for many wealthy taxpayers, lifetime transfers may only result in a federal tax, but transfers at death may result in both a federal and state transfer tax.

Many state transfer taxes are patterned after the federal transfer tax system. However, there are differences, and state taxes may be incurred even in situations in which there is no federal tax. As of March 2022, 11 states and the District of Columbia impose only an estate tax, while five states have only an inheritance tax. Maryland has both. The estate tax has been repealed in Delaware and New Jersey (though New Jersey's inheritance tax remains). Remember that estate taxes are generally borne by the estate whereas inheritance taxes are borne by the beneficiary receiving assets from an estate.

In the states that have an exclusion amount smaller than the federal amount, unless planned for, an estate/inheritance tax may arise upon the death of the first spouse where the testamentary plan is built upon the federal exclusion amount.

The variety in state tax rules requires transfer tax planning focused not by the federal rules but by the rules of one's state of legal domicile. In states that have estate and/or inheritance tax exclusions smaller than the federal exclusion, transfer tax planning with respect to the first death is paramount. In states without transfer taxes but with high income taxes, tax planning is balanced between federal estate tax planning and income tax basis planning for inherited assets.

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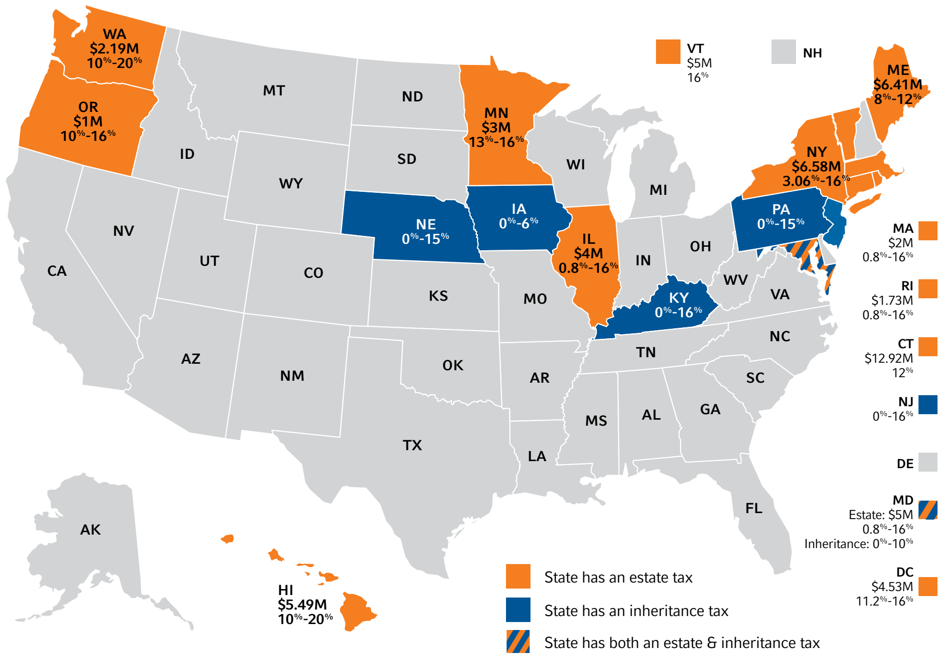
### Does your state have an estate or inheritance tax?

State estate & inheritance tax rates and exemptions in 2023




Note: Exemption amounts are shown for state estate taxes only.

Inheritance taxes are levied on the posthumous transfer of assets based on the relationship to the decedent; different rates and exemptions apply depending on the relationship. CT's exclusion is scheduled to rise further, matching the federal threshold by 2023.

Source: Tax Foundation; Bloomberg Tax; state statutes.

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# Entity conversion considerations

## Key provisions to consider

The new tax law created substantial changes in corporate, pass-through, and individual tax provisions. In light of these changes, many companies and their owners are now asking whether it makes sense to reconsider the structure of the business. However, it is important to think through a wide variety of consequences, including the tax consequences, before making a conversion.

Consider, for example:

- The entity's likely future distributions policy,
- The likelihood and potential timing of a sales transaction as the exit strategy, and
- Whether such a sale is likely to be an asset sale or a sale of an equity interest.

## Sample considerations for analyzing a conversion from pass-through to C-corporation

- Annual distributions—now and into the future
- Qualification for Section 199A deduction
  - U.S.-sourced vs. non-U.S.-sourced income
  - Qualified business income
- Character of income recognized
  - LTCG and qualified dividends
  - Section 212 portfolio deductions
- Owners of the company
- Growth of the business assets vs. growth of cash distributed
- Section 351 considerations





- International considerations
  - Structure
  - Foreign tax-credit planning
  - Certain gain recognition provisions such as overall foreign loss recapture and Section 367
  - Impact on dual consolidated loss rules
- Potential future changes in tax law
- Carryforward attributes of partners
- Accumulated adjustments account distribution planning for terminated S-corporations
- Estate planning
- Implications of Section 7519 payments for fiscal-year filers
- Exit strategy considerations
  - Sale of partnership interest
  - Stock vs. asset deal of corporation
  - Holding period upon exit
  - Purchase price considerations
- State tax implications
  - State sourcing and income tax rates
  - Investment partnership rules
  - Compliance costs
  - State tax footprint of the entity
  - State tax footprint of the owners

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SECTION 6

SECTION 6

## TAX MANAGEMENT CAN BE GOOD BUSINESS

You have seen the difference that tax-managed investing can make for investors, but have you considered what that difference might mean to your business?

**In this section:**

- Opportunity
  - Asset location
  - 7 sources of assets that could benefit from a tax-managed approach
  - Taxable trusts
- Trust types, taxation, and considerations
- DIY or outsource?
- Know your client's CPA
- CPA discovery questions

# Opportunity: Asset location

For many clients, offering a standardized approach to tax management—such as investing in municipal bonds/funds instead of corporate bonds and using tax-managed funds for equities in non-qualified accounts—can be sufficient to help meet the client's desired after-tax wealth creation outcome. In fact, depending on the client's situation, it could be the most optimal approach, once the related costs and benefits of such programs are taken into account.

But for certain clients, a more tailored approach to tax management may be warranted. Think, for instance, of those clients who are especially tax-sensitive or those with sizeable qualified and non-qualified accounts. The approach you may want to consider in these sorts of cases is called "asset location."

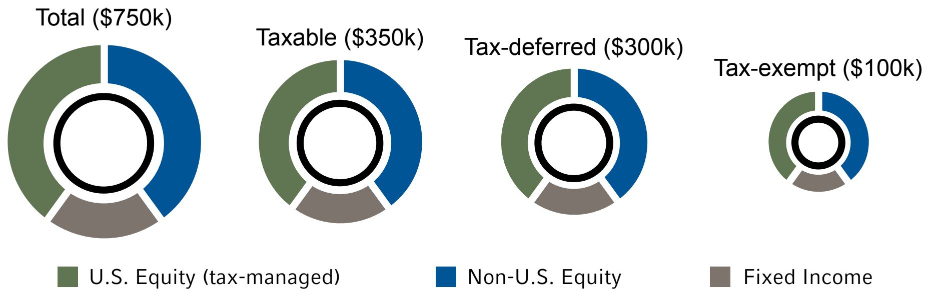
### What exactly is asset location?

At the most basic level, it is allocating assets across a household in the most tax-efficient way possible. For example, let's say you have identified that a balanced allocation will best help your client meet their goals. Now, that client, like most investors, has money spread across taxable, tax-deferred and possibly tax-exempt accounts. A naïve implementation of that balanced allocation across the whole household would allocate each different account—taxable, tax-deferred and tax-exempt—in the same way, each with the same asset allocation.





## Naïve implementation: each account is allocated in the same way cross qualified and non-qualified account types

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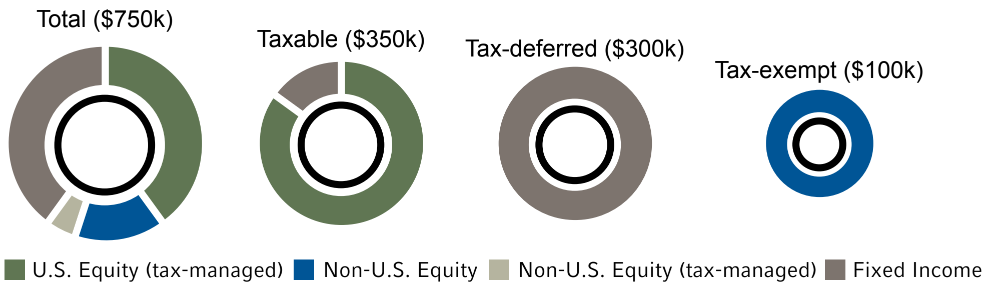
### But some asset classes are more tax-efficient than others.

Income-generating asset classes (like fixed income and real estate) may or will generally generate higher tax bills than asset classes with a focus on capital growth, or asset classes managed for taxes (like tax-managed funds). So, wouldn't it make more sense to optimally locate the asset allocation across the various account types, so that when viewed in aggregate, the total portfolio (household) rolls up to the balanced allocation AND is optimized for tax-efficiency? That, in a nutshell, is asset location. In our view, asset location is becoming one of the most under-appreciated traits of top wealth managers and a competitive advantage.

## Optimal implementation: asset location across account types optimized for tax-efficiency

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### The "asset location" approach to tax management

At a high-level, this approach guides financial advisors to more specifically evaluate the relative tax implications of placing certain assets/asset classes in qualified versus non-qualified accounts.

- Non-qualified: Assets that tend to be more tax-efficient and/or can be managed to help minimize tax costs (think municipal bonds or mutual funds specifically managed for taxes) should be used in non-qualified accounts.
- Qualified: Assets that aren't typically tax-efficient or that could lose a meaningful amount of value to taxes (think commodities, real estate investment trusts, taxable bonds, non-U.S. equities) should be used primarily in qualified accounts.

#### Example

When looking at a fixed-income portfolio, both tax-exempt bond portfolios (muni bonds) and corporate and high-yield debt can be valuable in a client's portfolio. But if they are in the "wrong" type of accounts, their effectiveness may be reduced.

To implement asset location correctly, you need to see and understand all of the client's assets—whether they are currently located in qualified or non-qualified accounts—and even assets beyond traditional investment accounts. For instance, consider a client who owns real estate. Depending on the type of real estate they own, a real estate investment trust portfolio may be redundant and could increase the client's overall investment risk rather than reducing it through appropriate diversification. Further, if the client's real estate investments generate income, it could also have implications for the fixed-income portion of the client's portfolio.





### A potential growth tool for you

The potential benefit to clients of such hands-on oversight and tailored solutions that take into account their total investment portfolio are clear. These clients are likely to recognize and appreciate the care you put into developing a deep understanding of their entire financial picture and formulating a financial plan and solution set designed to meet their unique goals.

And for advisors, the approach can help uncover hidden assets—those assets your client may have declined to disclose to you—and potentially increase your key clients' loyalty to you, helping you grow your business in the areas where you can add the most value. So, don't shy away from these client situations. Instead, relish them for the challenge and growth opportunity they can represent.

## Opportunity: 7 sources of assets that could benefit from a tax-managed approach

So, how do you become the go-to expert for taxable accounts? How can you uncover these non-qualified assets? And where can you go to get the resources to help with taxable investing know-how?

To begin, it's best to focus efforts where help can be applied specifically—to specific clients. This is a list of the seven top sources of taxable assets we see through our work. Using this list, we believe advisors can focus their efforts on the clients and situations that need tax management the most.

### The top 7 sources of taxable assets

1. The sale of real estate
2. The sale of a business
3. Deferred compensation
4. Inheritance
5. Insurance proceeds
6. Trusts
7. Current taxable assets

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### 1. The sale of real estate or other assets due to downsizing

For many investors who are downsizing—either due to becoming empty nesters or moving into permanent remote work—the sale of a house likely results in a sizable capital gain from the price paid many years ago. Even after the *primary home deduction*, more often than not the sale of a long-time residence results in a sizable cash event. Moving to a new smaller residence and getting the benefit of time and leisure is exciting, but at the same time carefully thinking through how to invest the sale proceeds (taxable assets) is critical for many investors to have a comfortable and relaxing retirement.

Even if the sale relates to a vacation property, a farm or pastureland, or other real estate holdings, the proceeds in the vast majority of cases become taxable investment dollars.

We believe tax-managed investment solutions should be given strong consideration for these events.

### 2. Sale of a business

Business owners often make large sacrifices in order to dedicate themselves to their business venture. And they make a large commitment to growing and managing the business. Many expect and plan for the business to be their source of retirement security. But do they realize that the sale of their ownership in it (i.e., monetization of their business stake) is a taxable event? And that this is likely to be the largest tax bill they may see in their lifetime? The result may be less retirement savings than they expected. Advice from a tax-smart advisor could be extremely important in these situations. Consider how helping business owners better plan for retirement and reduce their tax bill can add significant value to your relationship with them.

### 3. Proceeds from stock grants and deferred compensation plans

For many senior-level professionals, stock grants and other forms of equity participation are a major part of their compensation and their retirement savings. And senior sales/product professionals with a high





but variable income often use the available deferred compensation plan to protect some income from taxes as a way to save for retirement.

The reality of these events plays out nearly daily somewhere in the country. The common thread with both is *the taxman cometh*. The shock of having to pay the tax all at once (which happens quite often with these events) can be overwhelming for even the most educated investors. This is an opportunity to help the client understand that the outcome of this scenario may be a sizeable tax bill.

More importantly, it's an opportunity to lay out the next steps of what to do with the proceeds going forward. You can help the client place these assets into a tax-smart solution that actively works to reduce capital gains taxes and minimize excessive tax exposure. In this way, the investor enjoys a solution that is both tax-managed *and* liquid.

### 4. Inheritance

While a death is a sad time for families, an inheritance likely provides an opportunity to plan for the future. In most cases, an inheritance is all in non-qualified assets. A tax-managed portfolio, diversified across stocks, bonds and real assets, can provide the beneficiary with instant liquidity, the potential for growth and the ability to withdraw assets on a systematic basis.

### 5. Insurance payouts

Similar to an inheritance, it is typically a sad event that generates an insurance or death-benefit payout. However, in many cases this payment comes tax-free. Through the use of a tax-smart approach and active tax management, a disciplined investment plan for this payout can result in a beneficial retirement nest egg.

### 6. Trust accounts

Trust accounts are created for a variety of reasons. In many cases they are created to support the ongoing needs of a specific individual or organization. Trusts that aren't pass-through entities—meaning trusts

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that have their own tax identification number and file their own tax return—have a unique tax situation. Once taxable income exceeds $15,201, these trusts are most often taxed at the highest tax level possible. Today that rate is 37%, in addition to the 3.8% net investment income tax (NIIT), for a total top marginal tax rate of 40.8%.

The use of a tax-smart approach to the management of these underlying assets can make a significant difference to long-term returns.

### 7. Current taxable assets with an unwanted tax bill

Most investment products are not managed to maximize after-tax returns. More often than not, the objective is to maximize the pre-tax return, while the after-tax return is secondary, if considered at all.

In many instances, these return-seeking products are fine to use within tax-advantaged accounts, where taxes are exempt or deferred, but these same products can cause great tax costs within taxable accounts. We have seen numerous examples where investors have bought *income funds*, not understanding the tax cost of that income, how much less of it they would keep after-tax and whether they actually needed that income in the first place.

Placing tax-inefficient products within a taxable account can have a potentially significant impact. Take the time to analyze the accounts of your current clients to make sure the investments in them make sense for the tax status of the account (qualified vs. non-qualified). We believe you can use this as a major point of differentiation, as many advisors don't do this for their clients. Lastly, give thoughtful consideration to how to transition a client from tax-inefficient investments to ones that are tax-managed and help put the investor's best after-tax foot forward!





**The bottom line:** *Taxes matter. Investment portfolios can and do generate taxable events for clients. And the cost of those taxes can be significant for investors. Taxes on investments offer nothing to portfolios but wasted potential. So it's important that the management of these assets take the cost of taxes into consideration. By focusing on after-tax outcomes, you can help your clients find the solution before it becomes a problem.*

## Opportunity: Taxable trusts

When considering opportunities for tax-managed investing, don't overlook taxable trusts. Why? Because the current progressive IRS tax rates can make the value of tax-managed investing an excellent fit for these types of accounts. In turn, taxable trusts can be an attractive area for advisors to look for new business.

However, before launching headlong into pursuing these potential opportunities, it helps to brush up on a few of the basics.

### The purpose of taxable trusts

Trusts create a separation between the beneficiary and the assets and impose professional asset governance. Irrevocable trust transfer is considered a completed gift and assets are out of the grantors estate, assuming the grantor has retained no interest in the trust assets or the ability to dictate changes to the beneficial enjoyment of trust assets. An outcome of gifts in trust is that the trust's net asset value, including all subsequent appreciation and all accumulated income (subject to the GST rules discussed below) is outside the reach of the estate and gift tax rules while such assets remain in trust. Trusts may be subject to tax

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on investment income that is not distributed to the beneficiaries. These tax rates are much more progressive than those paid by individuals and are an attempt by the IRS to keep people from sheltering assets. This is why tax-managed investing can be such a great solution to help fulfill the fiduciary duty on these accounts.

Advisors may not only benefit from being on the look-out for taxable trusts and related opportunities, but these opportunities may be easier to find than many advisors assume.

In 2022, over 3.7 million trust tax returns were filed with the IRS.* Odds are good that many advisors already have a client or a prospect who is thinking about setting up a trust (as grantor), who is the fiduciary or a beneficiary of a trust, or who is the tax preparer of taxable trusts (Form 1041).

### How taxable trusts are taxed

| If taxable income is: | The tax is: |
|---|---|
| Not over $3,100 | 10% of the taxable income |
| Over $3,100 but not over $11,150 | $310 plus 24% of the excess over $3,100 |
| Over $11,150 but not over $15,200 | $2,242 plus 35% of the excess over $11,150 |
| Over $15,200 | $3,659 plus 37% of the excess over $15,200+ unearned income will qualify for an additional 3.8% NIIT |

Consider the following regarding the progressive nature of these rates:

- **The trust hits the 24% marginal rate at income above $3,100.** A married couple filing jointly would not touch this rate until taxable income above $201,051.
- **The trust hits the top marginal rate (37%) at income above $15,200.** A married couple filing jointly would not touch this rate until taxable income above $731,200.

* Source: 2022 IRS Data Book.

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- Note, the tax rates above do not include the additional 3.8% NIIT. For a married couple, this 3.8% applies to modified adjusted gross income (AGI) above $250,000. **Trusts get the pleasure of paying the 3.8% at modified AGI above $15,200.**

### The impact to investment accounts

At these low taxable income levels for the top rates, the trust investment size does not need to be that large to hit the top rate. Consider the following example:

| WHAT ACCOUNT SIZE COULD PAY THE TOP TAX RATE? | |
|---|---|
| Assumed mutual fund account balance | $175,000 |
| Fund declares 10% capital gain distribution | 10% |
| **Taxable gain** | **$17,500** |

If capital gain was short term in nature, rate of 40.8% applies.
If long term in nature, rate of 23.8% applies.

**The bottom line:** *Tax-managed investing should be a key consideration for the creation and ongoing management of taxable trusts. It's likely that you know someone who is already part of a trust or considering the creation of a trust. You probably also know a fiduciary, beneficiary or tax-preparer of trusts. A little bit of knowledge in this area may help you identify taxable-trust opportunities in conversations with your clients and prospects.*

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# Trust types, taxation, and considerations

This list below is not all-inclusive, but rather is a brief summary of some of the different types of trusts that are commonly used.

***Types of Trusts:***

**Grantor**

- The trust's settlor (i.e., creator) or another person holds a certain right or rights under IRC Sections 671-679 that cause the trust to have "grantor status".
- For income tax purposes, the person holding the rights, rather than the trust itself, is responsible for payment of tax on the trust's income.

**Revocable**

- Can be amended, altered, or revoked by a settlor at any time, provided the settlor is not mentally incapacitated.
- Any income generated by a revocable trust is taxable to the trust's creator, similar to grantor trusts.

**Irrevocable**

- Cannot be amended or revised until the terms or purposes of the trust have been completed.
- Cannot spend trust funds for the benefit of anyone other than the beneficiary unless specifically authorized in the terms of the trust document.
- When a trust sells an asset and realizes a gain, and the gain is not distributed to beneficiaries, the trust pays capital gains taxes on those gains.





**Simple**

- Trust document requires all income to be distributed currently to the beneficiaries.
- Trust document does not allow for charitable deductions.
- Trustee generally does not make distributions to beneficiaries other than required income distributions.
- Trust income is considered taxable to the beneficiaries.
- Trust must file tax returns annually and pay tax on their income; however, the trust is permitted a $300 exemption and a deduction for the amount of income distributed to beneficiaries each year, which results in the trust generally only paying tax on its capital gains.

**Complex**

- Trustee can accumulate or distribute income, pursuant to the terms of the trust document.
- Trustee can retain or distribute trust corpus, pursuant to the terms of the trust document.
- Trust may pay amounts to and/or hold amounts for charity. The contribution must be made pursuant to the governing instrument in order to be deductible. The contribution must be from gross income and paid for charitable purposes.
- Trust must file tax returns annually and pay tax on their income, permitted a $100 exemption and a deduction for the amount of income distributed to beneficiaries each year.
- Trust beneficiaries must report and pay taxes on trust income received from the trust via distributions.

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**Special Needs**

- Trust provides access to funding to someone who is physically or mentally disabled or chronically ill.
- Trust preserves the beneficiary's eligibility for needs-based government benefits such as Medicaid and Supplemental Security Income (SSI).
- A qualified disability trust is allowed a $5,000 income exemption when filing its tax return

***Considerations:***

- Verify the proper classification of the trust (i.e., estate, grantor, complex, simple).
- Does the trust have multiple grantors?
- Consider community property issues if the grantor(s) live(d) in a community property jurisdiction.
- Has the grantor, trustee, or any beneficiary moved? If so, state tax filings could be affected.
- Does the trust hold foreign financial accounts or specified foreign financial assets? If so, additional tax return reporting and disclosures may be required.

Trusts follow state law, which often limits both the trust's duration and a trustee's conduct. State laws should be carefully considered when forming a trust.





# DIY or outsource?

If only all of your work could be completed with the single click of a button. Life would be so easy!

Financial advisors know all too well that "easy buttons" are few and far between. There is so much that goes into running a successful financial advisory practice. Here's just a few activities that take up a lot of time and energy for advisors:

- Client transactions
- Stock trades
- Market volatility
- Dividend and interest reinvestment
- Suitable investment selection
- Contract expirations
- Compliance requirements
- Rebalancing
- Client meetings
- Tax management

And this is just the tip of the iceberg.

Take "tax management" as an example. Of course, it's a critical part of helping tax-sensitive clients maximize their after-tax wealth. But it's complex. How much time and effort does it require—and, at the end of the day (or tax year, or client's working life), is the toiling worth it for your client and for you?

For instance, tax-loss harvesting is a key strategy to help sustain long-term capital gain deferrals. How are you currently going about accomplishing that strategy? Are you finding the time to evaluate opportunities on a regular (monthly or more frequently) basis in your clients' accounts? Are you able to capitalize on market declines to create value for your clients? Where are you reinvesting the proceeds of the harvesting activity? How are you managing the "wash sale" rule?

Another example is tax-lot management. Whenever a client transaction occurs, chances are that new tax lots are created as well. Every tax lot has a different tax liability (or asset) attached to it. How—and by whom—is that liability (asset) being monitored at your practice? Are you managing the tax lots at the time of trade, or are the tax lots being managed at a later date? If the lots are managed after the time of trade, is a CPA dealing with it at tax time? How are the tax liability and tax costs of the trade being assessed?

For taxable (non-qualified) accounts, tax management is arguably as important as asset selection and asset allocation. Without it, a tax-sensitive investor could lose a meaningful amount of portfolio value to taxes post-trade.

Armed with the knowledge of the time and effort required to successfully implement various tax-management strategies, now may be a good time to consider how tax management is being implemented in your practice. Do you have a sustainable plan in place? How might you be able to create even more value for clients, while at the same time managing your own workload? This then becomes the question—DIY or outsource?





## Know your client's CPA

Probably the one person who cares more about taxes than your clients are your clients' CPAs. Tax-managed investing helps you get on the same side of the table as the CPA, helping you to potentially build a closer partnership with both your client and your client's CPA.

**Where do you find CPAs?**

First things first. Ask your top clients for introductions. Ultimately, working together in a coordinated effort is in the best interest of the clients' long-term goals.

If you incorporate tax-managed investing into your investment approach, your common ground with CPAs will provide an opportunity for you to reach out to build relationships with additional CPAs, potentially increasing referral business.

Here are two more ways to locate CPAs in your area.

1. Search for them using the American Institute of CPAs State CPA Contact Information: https://www.aicpa.org/forthepublic/findacpa.html
2. Use LinkedIn as a potential marketing opportunity, a way to identify common connections, and to stay current on key accounting topics and CPA pain points.
   - If your firm's email policy allows, consider Sponsored InMail to mass deploy a "personalized" prospecting message
   - Search for CPAs in your current list of LinkedIn contacts—you may be surprised to see how many CPAs you already know or are connected to
   - Search for LinkedIn CPA Groups (a good way to identify relevant discussion topics)

Of course, please remember to follow your compliance procedures and policies pertaining to the use of social media communications with the general public.

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# CPA discovery questions

There is such a thing as a bad referral. As you seek out professional partnerships, it is critical to identify the right relationships that may be a good fit for your business. Just asking the right questions may help you sort out which relationships will be the most mutually rewarding.

**CPA discovery questions**

- Does your practice currently incorporate investments?
- What portion of your business includes investment advice?
- How is your business structured to include investments?
- What do you use for investment options?
- Do you work in a team environment or partner with other professionals?
- How do you work with other advisors in your area?
- Are you trying to grow your practice?
- What do you look for in an ideal client? What are good/bad referrals?
- Do your clients seek investment advice from you?
- Do your clients ask for more complete financial planning advice than your firm currently provides?
- Have you incorporated strategic investment planning as an option with client tax planning?
- Do you currently work with an investment advisory firm, or provide investment advisory services in-house?
    - If an outside firm, do they provide everything you need, efficiently and effectively—essentially, with their work and planning flowing seamlessly with your tax and business services?
    - If investment advisory services are provided in-house, are you confident and comfortable with the level of service and investment options you currently provide? If not, would you be interested in partnering with someone who could provide this link?

SECTION 7

SECTION 7

# RUSSELL INVESTMENTS' TAX-MANAGED INVESTING PROGRAM

**In this section:**

- Russell Investments' tax managed investing program
- A suite of tax-managed solutions
- Tax-managed tools & resources

# Russell Investments' tax-managed investing program

We're not only leaders in active tax management, we're also pioneers, having spent the past 35 years sharpening our approach to remove complexity, solve problems and save time. We have been helping investors grow after-tax wealth since 1985.

### A history of our continuous innovation in the tax-managed investing space

**1980** Our first multi-manager fund launches

**1985** Our first municipal bond mutual fund goes live

**1996** We introduce our first tax-managed equity mutual fund

**2001** We begin offering separately managed accounts and unified managed accounts

**2003** We unveil our tax-managed total portfolio solutions

**2014** We enhance trading strategies for improved tax efficiency

**2019** Tax-managed real assets mutual fund unveiled

**2020** We begin offering tax overlay and portfolio transition services within a new SMA program

1980 | 1990 | 2000 | 2010 | 2020

We believe tax-managed investing can help improve after-tax wealth for tax-sensitive investors. We are here to serve advisors looking to unlock true return by helping their tax-sensitive clients keep more of what they earn.

**To help advisors succeed, we offer:**

- a robust suite of tax-managed investment solutions
- easy-to-use tools that demonstrate the value of tax management
- guidance on working with and hosting events for CPAs
- client review materials, regular reports showing estimated capital gains, research papers, webinars and more

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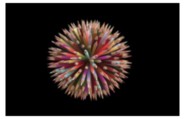
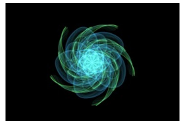
# A suite of tax-managed solutions

We offer a comprehensive suite of tax-managed investment solutions, from mutual funds and model portfolios to separately managed accounts (SMAs) and unified managed accounts (UMAs).

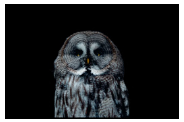
**TAX-MANAGED MUTUAL FUNDS**
Since 1985



**SEPARATELY MANAGED ACCOUNTS (SMA)**
Since 2001
*Tax overlay optional*



**UNIFIED MANAGED ACCOUNTS (UMA)**
Since 2001



**TAX-MANAGED MODEL PORTFOLIOS**
Since 2003

**PERSONALIZED MANAGED ACCOUNTS (PMA)**
Since 2020
*SMAs with tax overlay and personalization included*

**STATE-SPECIFIC TAX-MANAGED MODEL PORTFOLIOS (CA & NY)**
Since 2021

To learn more, contact the Russell Investments sales and service team at 800-787-7354, email us at service@russellinvestments.com, or visit russellinvestments.com.

Please note that the products listed here may or may not be available for investment on your firm's platform(s).

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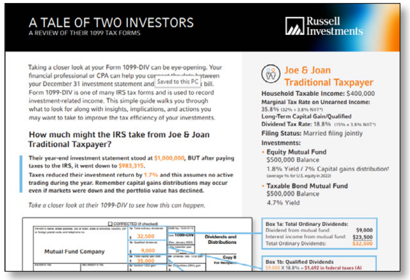
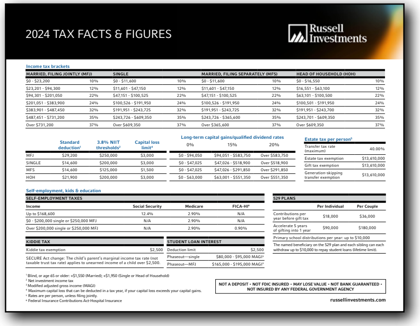
# Tax-managed tools & resources

Designed to power up your client conversations.

**1099 Guide: A Tale of Two Investors**




**2024 Tax Facts and Figures**




**Tips to expand your CPA relationships**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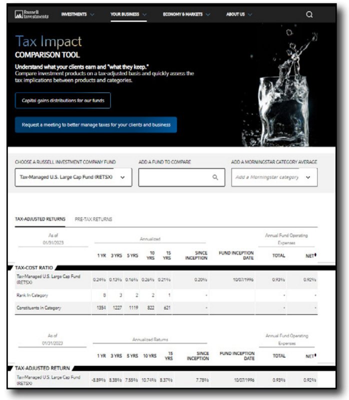
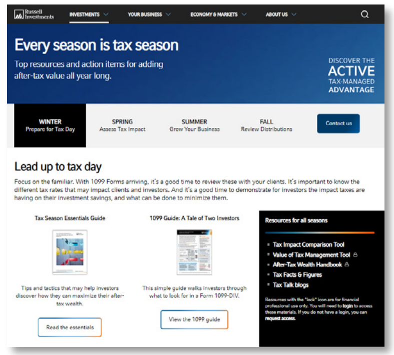



**Tax Impact Comparison Tool**

*Compare investment products on a tax-adjusted basis*




**Tax Resources**

For access to the above resources and more, visit **russellinvestments.com/us-tax-resources**

Important note: The materials and tools listed above may or may not been approved for use by your firm. Please check with your home office before sharing them with your clients.

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## IMPORTANT RISK DISCLOSURES

Fund objectives, risks, charges, and expenses should be carefully considered before investing. A summary prospectus, if available, or a prospectus containing this and other important information can be obtained by calling 800-787-7354 or by visiting russellinvestments.com. Please read a prospectus carefully before investing.

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### METHODOLOGY FOR TAX DRAG:

Includes all open ended investment products – mutual funds/ETFs that are both active and passive. Tax Drag reflects the arithmetic average of Morningstar Tax Cost Ratio. Data includes all share classes and reflects Morningstar category of US Equity and Taxable Bond for equities and fixed income respectively.

### MORNINGSTAR CATEGORY DEFINITIONS:

Large Blend: Large-blend portfolios are fairly representative of the overall U.S. stock market in size, growth rates, and price. Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large cap. The blend style is assigned to portfolios where neither growth nor value characteristics predominate. These portfolios tend to invest across the spectrum of U.S. industries, and owing to their broad exposure, the portfolios' returns are often similar to those of the S&P 500 Index.

Small Blend: Small-blend portfolios favor U.S. firms at the smaller end of the market-capitalization range. Some aim to own an array of value and growth stocks while others employ a discipline that leads to holdings with valuations and growth rates close to the small-cap averages. Stocks in the bottom 10% of the capitalization of the U.S. equity market are defined as small cap. The blend style is assigned to portfolios where neither growth nor value characteristics predominate.

Taxable Bond: A group of similar funds that invest primarily in fixed-income securities. Funds in the following categories are assigned to this broad asset class: Long-Term Government, Intermediate-Term Government, Short-Term Government, Long-Term Bond, Intermediate-Term Bond, Short-Term Bond, Ultrashort Bond, International Bond, High Yield Bond, Emerging Markets Bond and Multisector Bond.

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This material is not an offer, solicitation or recommendation to purchase any security.

Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.



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russellinvestments.com

# 2024 TAX FACTS & FIGURES

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## Income tax brackets

| MARRIED, FILING JOINTLY (MFJ) | | SINGLE | | MARRIED, FILING SEPARATELY (MFS) | | HEAD OF HOUSEHOLD (HOH) | |
|---|---|---|---|---|---|---|---|
| $0 - $23,200 | 10% | $0 - $11,600 | 10% | $0 - $11,600 | 10% | $0 - $16,550 | 10% |
| $23,201 - $94,300 | 12% | $11,601 - $47,150 | 12% | $11,601 - $47,150 | 12% | $16,551 - $63,100 | 12% |
| $94,301 - $201,050 | 22% | $47,151 - $100,525 | 22% | $47,151 - $100,525 | 22% | $63,101 - $100,500 | 22% |
| $201,051 - $383,900 | 24% | $100,526 - $191,950 | 24% | $100,526 - $191,950 | 24% | $100,501 - $191,950 | 24% |
| $383,901 - $487,450 | 32% | $191,951 - $243,725 | 32% | $191,951 - $243,725 | 32% | $191,951 - $243,700 | 32% |
| $487,451 - $731,200 | 35% | $243,726 - $609,350 | 35% | $243,726 - $365,600 | 35% | $243,701 - $609,350 | 35% |
| Over $731,200 | 37% | Over $609,350 | 37% | Over $365,600 | 37% | Over $609,350 | 37% |

| | Standard deduction[1] | 3.8% NIIT thresholds[2] | Capital loss limit[4] | Long-term capital gains/qualified dividend rates 0% | 15% | 20% |
|---|---|---|---|---|---|---|
| MFJ | $29,200 | $250,000 | $3,000 | $0 - $94,050 | $94,051 - $583,750 | Over $583,750 |
| SINGLE | $14,600 | $200,000 | $3,000 | $0 - $47,025 | $47,026 - $518,900 | Over $518,900 |
| MFS | $14,600 | $125,000 | $1,500 | $0 - $47,025 | $47,026 - $291,850 | Over $291,850 |
| HOH | $21,900 | $200,000 | $3,000 | $0 - $63,000 | $63,001 - $551,350 | Over $551,350 |

### Estate tax per person[5]

| | |
|---|---|
| Transfer tax rate (maximum) | 40.00% |
| Estate tax exemption | $13,610,000 |
| Gift tax exemption | $13,610,000 |
| Generation-skipping transfer exemption | $13,610,000 |

## Self-employment, kids & education

| SELF-EMPLOYMENT TAXES | | | |
|---|---|---|---|
| **Income** | **Social Security** | **Medicare** | **FICA-HI[6]** |
| Up to $168,600 | 12.4% | 2.90% | N/A |
| $0 - $200,000 single or $250,000 MFJ | N/A | 2.90% | N/A |
| Over $200,000 single or $250,000 MFJ | N/A | 2.90% | 0.90% |

| 529 PLANS | | |
|---|---|---|
| | **Per Individual** | **Per Couple** |
| Contributions per year before gift tax | $18,000 | $36,000 |
| Accelerate 5 years of gifting into 1 year | $90,000 | $180,000 |
| Primary school distributions per year: up to $10,000 | | |
| The named beneficiary on the 529 plan and each sibling can each withdraw up to $10,000 to repay student loans (lifetime limit). | | |

| KIDDIE TAX | |
|---|---|
| Kiddie tax exemption | $2,500 |
| SECURE Act change: The child's parent's marginal income tax rate (not taxable trust tax rate) applies to unearned income of a child over $2,500. | |

| STUDENT LOAN INTEREST | |
|---|---|
| Deduction limit | $2,500 |
| Phaseout—single | $80,000 - $95,000 MAGI[3] |
| Phaseout—MFJ | $165,000 - $195,000 MAGI[3] |

[1] Blind, or age 65 or older: +$1,550 (Married); +$1,950 (Single or Head of Household)
[2] Net investment income tax
[3] Modified adjusted gross income (MAGI)
[4] Maximum capital loss that can be deducted in a tax year, if your capital loss exceeds your capital gains.
[5] Rates are per person, unless filing jointly.
[6] Federal Insurance Contributions Act-Hospital Insurance

Russell Investments

## Retirement

| IRA AND ROTH IRA CONTRIBUTIONS | | PHASEOUT FOR DEDUCTING IRA CONTRIBUTION FOR QUALIFIED PLAN PARTICIPANTS | | PHASEOUT OF ROTH CONTRIBUTION ELIGIBILITY | | SEP CONTRIBUTION | |
|---|---|---|---|---|---|---|---|
| Under age 50 | $7,000 | MFJ | $123,000 - $143,000 MAGI[3] | MFJ | $230,000 - $240,000 MAGI[3] | Up to 25% of compensation | Limit $69,000 |
| Age 50 and over | $8,000 | Single or HOH | $77,000 - $87,000 MAGI[3] | Single or HOH | $146,000 - $161,000 MAGI[3] | To participate in SEP | $750 |
| **SIMPLE elective deferral** | | **Qualified plan contributions** | | | | | |
| Under age 50 | $16,000 | 401(k), 403(b), 457, and SARSEP - Under age 50 | $23,000 | Highly-compensated employee income level | $155,000 | Limit on additions to defined contribution plan | $69,000 |
| Age 50 and over | $19,500 | 401(k), 403(b), 457, and SARSEP - Age 50 and over | $30,500 | Annual compensation taken into account for qualified plans | $345,000 | Annual benefit limit on defined benefit plan | $275,000 |

## Taxable trust tax rates

| IF TAXABLE INCOME IS: | THE TAX IS: |
|---|---|
| Not over $3,100 | 10% of the taxable income |
| Over $3,100 but not over $11,150 | $310 plus 24% of the excess over $3,100 |
| Over $11,150 but not over $15,200 | $2,242 plus 35% of the excess over $11,150 |
| Over $15,200 | $3,659 plus 37% of the excess over $15,200+ unearned income will qualify for an additional 3.8% NIIT |

### Pass-through entity taxes

An eligible individual taxpayer generally may deduct 20% of domestic qualified business income from a partnership, S corporation, or sole proprietorship. There are many qualifications and exemptions. Be sure to consult with a tax advisor.

### Alternative minimum tax (AMT)

Exemptions - $133,300 for married, $85,700 for single and $66,650 for married filing separately.
Phase-out of exemption begins at $1,218,700 for married taxpayers and $609,350 for others.

## For more information:

Call Russell Investments at **800-787-7354** or visit **russellinvestments.com**.

Many trusts have to pay tax on the income generated from stocks, bonds, mutual funds, etc. that is not distributed to the beneficiaries. Their tax rates are much more progressive than those paid by individuals.



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