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Take Control of Your Finances: Essential Year-End Planning Opportunities

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With year-end rapidly approaching and the holiday season drawing near, the fast-paced routine of everyday life can easily consume our attention. However, amid the hustle and bustle, it is imperative not to lose sight of valuable planning opportunities which have the potential to yield significant financial benefits. With that in mind, we crafted a year-end financial checklist highlighting several timely planning considerations.

Tax and Charitable Planning

Harvest Losses in Taxable Investment Accounts

Loss harvesting presents a "silver lining" for taxable investors to take advantage of market declines. Realized losses can offset realized gains (and potentially up to $3,000 of current-year ordinary income), with any unused/excess realized losses resulting in a loss carryforward to be applied against future gains.

With global markets pulling back sharply since late July, many investments are near or in negative territory for the year, and investors may have the opportunity to harvest losses in taxable investment accounts.

As an example, consider Larry and Sandy Smith who hold three actively managed equity mutual funds in a taxable investment account; these three positions collectively have $200,000 in unrealized losses. The Smiths sell the positions and redeploy the sales proceeds to passive index funds. In doing so, the Smiths realize a $200,000 loss to offset current-year (and/or future) realized gains, while their portfolio remains positioned to benefit from a subsequent market recovery.

Beware of the "wash sale rule" which states that a loss cannot be realized for tax purposes if a substantially identical position was bought within 30 days before or after the sale.[1]

Manage Tax Bracket Variability

Individuals should consider how their current tax picture compares to prior years, as there may be "levers" which can be used to produce considerable tax savings.

[1] Source: Investor.gov – "Wash Sales"

In high-income years, individuals may wish to accelerate itemized deductions (most notably, charitable contributions) while deferring certain income items (such as the sale of a business, the sale of certain investments or stock option exercises). Charitably inclined taxpayers may wish to use a donor-advised fund to recognize a larger current-year deduction while making charitable grants at a future date and at a pace of their choosing.

In low-income years, individuals may wish to defer itemized deductions (such as charitable contributions) while potentially accelerating certain income items (such as investment sales, stock option exercises, Roth conversions, etc.).

Charitably inclined individuals who are nearing retirement and who expect a significant drop in taxable income post-retirement might consider accelerating charitable donations (either directly to charity or to a donor-advised fund) prior to retirement to maximize itemized deductions while in a higher income tax bracket.

Donate Appreciated Securities, Not Cash

It is estimated that December donations account for nearly a quarter to a third of annual nonprofit revenue.[2] With many nonprofits soliciting year-end donations, many individuals opt for the convenience of writing a check or charging a credit card although another giving option may be financially preferable.

Individuals with long-term appreciated securities held in a taxable account should consider potentially gifting such securities to charity. *Why?* The charitable organization receives the same economic benefit as a cash donation, while the taxpayer receives a tax deduction for the full market value of the gift and, importantly, avoids paying capital gains taxes on the gifted security.

Gifting appreciated securities can also be beneficial as it provides a tax-efficient means to rebalance a portfolio by reducing exposure to a given asset class or to a concentrated stock position, without incurring capital gains.

Keep in mind that gifts of long-term appreciated securities to qualified public charities (including donor-advised funds) are limited to 30% of adjusted gross income (AGI) while similar gifts to a private foundation are limited to 20% of AGI. Charitable gifts in excess of the AGI limits result in a charitable carryforward which can be used over the next five years.

Satisfy Required Minimum Distributions (RMDs) via a Qualified Charitable Distribution (QCD)

SECURE Act 2.0 raised the beginning age for required minimum distributions (RMDs) to 73; however, the age for taxpayer eligibility to make a Qualified Charitable Distribution (QCD) remains at 70½.[3,4]

[2] *Source: 2023 M+R Benchmarks Report*
[3] *Source: Fidelity – "SECURE Act 2.0: What the New Legislation Could Mean for You"*
[4] *Source: Fidelity – "Qualified Charitable Distributions (QCDs): Planning Your IRA"*

Under this provision, a taxpayer (age 70½ or older) may gift up to $100,000 each year from an IRA to qualified 501(c)(3) charitable organizations (donor-advised funds, private foundations and supporting organizations are excluded).[4]

A qualified charitable distribution neither counts as an itemized deduction nor as taxable income, though it does count towards satisfying the RMD for that year.

This strategy may be beneficial for charitably inclined individuals who receive a greater tax benefit from the increased standard deduction rather than itemized deductions.

[Note: Beginning in 2024, the eligible QCD amount will receive an annual adjustment; the QCD limit is increased to $105,000 for 2024.][5]

Consider a Roth Conversion

When global equities have fallen sharply in value, investors have an opportunity to convert Traditional IRA assets to a Roth IRA at a "discount."

Individuals who believe their future tax rate might be higher than their current tax rate might consider converting a portion – or all – of an existing Traditional IRA to a Roth IRA. Assuming the Traditional IRA has no basis, the amount of the conversion is treated as taxable income. In exchange, the Roth IRA grows tax-free with qualified distributions also treated as tax-free.

Individuals with notable IRA assets but with lower-than-usual income might consider this strategy, as it allows the taxpayer to essentially pay a reduced rate on the conversion while taxable income is low.

This strategy may also be beneficial for individuals with a taxable estate, as the tax cost of the conversion effectively reduces the size of the estate, while the named beneficiaries one day receive a very tax-favorable asset, compared to inheriting a Traditional IRA. In some cases, high-net-worth individuals might consider pairing a Roth conversion with accelerated charitable giving, as the charitable deduction will help offset the tax cost of the conversion.

Note that there are several factors (time horizon, overall net worth, tax bracket, etc.) to evaluate to determine whether a Roth conversion might ultimately be beneficial.

Analyze Mutual Fund Year-End Capital Gain Distributions

Mutual funds are required to pass along capital gains to fund shareholders.

Regardless of whether the fund shareholder actually benefited from the fund's sale of underlying securities, the shareholder will receive the capital gain distribution if the mutual fund is held as of the dividend record date.

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[5] *Source: Forbes – "IRS Announces Retirement Contribution Limits Will Increase In 2024" (November 2023)*

Mutual fund families typically provide estimates for year-end dividend distributions over the course of October and November, with such distributions most commonly paid in December.

Capital gain distributions can be either short-term or long-term. Short-term capital gain dividends are treated as ordinary income and thus cannot be offset by realized losses. In contrast, long-term capital gain dividends are treated as capital gains and can be offset by realized losses.

It is important to review unrealized gains and losses across mutual fund holdings in taxable accounts and to compare those figures against capital gain distribution estimates to determine if selling a mutual fund position *before* the year-end distribution would produce a tax savings.

In addition, investors should be careful with late-year purchases of actively managed funds in taxable accounts. Investing in a fund just prior to its capital gain dividend record date could result in additional capital gains taxes. An investor might instead choose to temporarily invest in a passive index fund and swap to the actively managed fund early in the next tax year.

Investment Planning

Revisit Portfolio Allocations and Longer-Term Investment Objectives

Periods of market stress can be instructive for investors to gauge whether their portfolio's allocation truly aligns with their risk tolerance and longer-term objectives. Ideally, an investor would already know his/her investment temperament before a market pullback to avoid making emotional, reactive investment decisions which can have dire consequences (for example, the unfortunate investor who "threw in the towel" in March 2020 at market lows rather than weathering the storm).

Investment goals can change over time and a portfolio's allocation should be flexible to adjust accordingly. The changing market landscape can also make certain investments which were less appealing previously to be more actionable at other times; for example, core U.S. bonds had very low yields (below 3%) for many years, but, as of this writing, many bond yields are now at or near their highest levels in 15 years.[6] Regularly reviewing a portfolio's allocation among cash, fixed income, global equities, real assets and, if applicable, alternative investments against longer-term goals is a critical exercise for investors.

Assess Portfolio Tax-Efficiency

Investors should think of their portfolios as an allocation among several different buckets: after-tax (taxable investment accounts), pre-tax (traditional retirement accounts) and no-tax (Roth retirement accounts).

[6] *Source: Bloomberg, "Meet the New Bonds, Same as the Old Bonds"; August 17, 2023.*

Rather than holding similar investments across all investment accounts, an investor should instead consider the "asset location" of investments to minimize "tax drag" to the greatest extent possible.

First, high-growth investments (such as global equities) should be allocated to Roth retirement accounts, given the favorable tax treatment afforded to Roth accounts. Actively managed equity mutual funds may be given additional consideration as capital gain dividends will not have tax consequences while produced inside the Roth account.

Next, taxable accounts such be structured to hold municipal bonds (if preferable over taxable bonds, given an individual's tax bracket) and more tax-efficient investments such as equities which generally produce favorably taxed income (qualified dividends).

Finally, traditional retirement accounts (such as an IRA, 401(k)/403(b), etc.) should hold less tax-efficient asset classes, such as taxable bond funds and REITs which produce non-qualified (ordinary income) dividends.

Monitor Excess Cash Reserves

According to Bankrate.com, the national average yield of savings accounts was a paltry 0.58% as of November 7, 2023. Given the current interest rate environment, many money market funds are currently yielding more than 5%. This may be a shorter-term opportunity until the Federal Reserve begins cutting the federal funds rate, but while short-term rates are at such favorable levels, individuals with excess cash reserves should look to maximize yield.[7]

Estate Planning

Review Estate Plans and Consider Using the Lifetime Gift Tax Exemption

The Tax Cuts and Jobs Act (TCJA) significantly increased gifting limits, with the lifetime gift tax exemption currently at $12.92 million per person, with a top federal estate tax rate of 40%.[8]

The increased exemption amounts, under TCJA, are scheduled to run through the end of 2025, after which the basic exclusion amount (BEA) is set to revert to the 2017 level of $5 million per person, plus inflation adjustments (estimated to be around $6-7 million per person, in current dollar terms).[8]

While the elevated exemption is scheduled to remain in place through 2025, high-net-worth individuals should not lose perspective of the unique planning opportunity to get additional assets out of a taxable estate.

[7] Source: CNBC – "Money market funds are paying above 5%. What to know before ditching your savings account" (August 2023)
[8] Source: Fidelity – "Prepare for Future Estate Tax Law Changes" (July 2023)

High-net-worth individuals should evaluate current assets and assess how much might be needed for their remaining lifetime, with consideration to gift "excess assets" to loved ones. Depending on the size of an outright gift, estate planning which incorporates making gifts to trusts may be advisable to provide parameters or safeguards for the intended beneficiaries.

As a reminder, the Treasury Department and IRS issued final regulations in November 2019 clarifying that taxpayers taking advantage of the increased exemption amounts would not be subject to a future clawback, should the exemption amount decrease from current levels.

Make Annual Exclusion Gifts

Individuals are allowed to make "annual exclusion gifts" which do not have gift tax implications. In 2023, the annual exclusion is $17,000 per donee.[9]

For high-net-worth individuals with – or likely to have – a taxable estate, utilizing annual exclusion gifts is an effective way to reduce one's taxable estate while also helping loved ones.

As an example, consider Mike and Mary Jones – a very wealthy couple with two married children (four spouses total) and five grandchildren. In 2023, the Joneses, as a couple, could gift $34,000 to each of the nine individuals for a combined total of $306,000, without such gifts counting against their lifetime gift tax exemption. By regularly making annual exclusion gifts, the Joneses are able to gradually reduce the size of their taxable estate.

For those saving for future college expenses, special rules allow a donor to use five years of annual exclusion gifts for contributions to 529 college savings plans (a limit of up to $85,000 for a single taxpayer or up to $170,000 for joint taxpayers).[10]

Finally, it is worth noting that medical payments made directly to a medical provider do not count as taxable gifts. Furthermore, tuition payments made directly to an educational institution do not constitute taxable gifts. Tuition is narrowly defined as the cost for enrollment; it does *not* include books, supplies or room and board.

Review Beneficiary Designations

Beneficiary designations should be reviewed periodically to ensure such plans and documentation align with desired intentions. Individuals who have recently experienced a significant life event (marriage, divorce, birth, adoption, etc.) may also need to make updates to existing estate plans and beneficiary designations.

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[9] Source: Kiplinger.com – "What's the Gift Tax Exclusion for 2023?" (December 2022)
[10] Source: Savingforcollege.com – "10 Rules for Superfunding a 529 Plan" (April 2023)

To unlock the full potential of your year-end planning, connect with our team of experts at Fiducient Advisors. Explore our website for a wealth of additional resources on Financial Planning. Our seasoned professionals and insights are ready to help guide you towards financial success.

About the Author

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Nick provides investment consulting services to high-net-worth investors, corporate executives, family trusts, and non-profit organizations. He services clients by providing advice and expertise on asset allocation, portfolio design, investment policy statements, manager search process and overall investment management. Nick heads the firm's Financial Planning Committee. Prior to joining the firm in 2007, Nick was a Senior Financial Planner with The Ayco Company where he provided comprehensive advice to affluent clientele. Nick earned a B.A. in Finance and Economics from the University of Illinois at Urbana-Champaign. He obtained the designation of Certified Financial Planner (CFP®) from the College of Financial Planning and is a CFA® charterholder and member of the CFA Society of Chicago. Nick enjoys spending time with his family, golfing, and long-distance running, having completed four marathons and multiple half-marathons.