Certified Public Accountants

Proactive tax strategies for high-earning taxpayers

The IRS has issued clear warnings about its increased scrutiny of high-net-worth individuals, especially those using risky tactics to reduce tax obligations. However, this doesn't mean all high-earners are under the microscope. Instead, it's a timely reminder of the importance of proactive and careful tax management.

For those with higher incomes, there are several legitimate strategies to optimize your tax position without venturing into questionable practices. In this video, we will provide strategies for optimizing your financial situation while staying within the bounds of the law.

Leverage annual exclusion gifts

In 2024, an individual can gift assets or cash of up to $18,000 per recipient, and there is no cumulative limit on the number of recipients. So, if you have three children, you and your spouse could gift each child $36,000 without triggering any gift tax consequences, effectively removing $108,000 from your estate tax-free annually.

If you gift early in the year, you not only remove the principal amount from your estate but also any potential growth on that amount over the course of the year. This growth occurs outside of your estate, further reducing any future estate tax liability. This strategy also maximizes the value of the gift for recipients.

Portfolio flexibility: borrowing vs. selling

For those with stock portfolios, striking the right balance between liquidity, growth, and tax efficiency is key. When you need liquidity, there are two primary strategies to get cash from your portfolio: borrowing and selling.

Borrowing against the portfolio

Securities-based lending offers a way to access funds without selling investments. This approach makes the most sense in a rising market or when you expect the underlying securities to appreciate.

Borrowing avoids the tax liabilities you'd have if you sold appreciated investments, and in some scenarios, the interest on the loan may be tax deductible. If the borrowed funds are used for a business purpose, the loan interest is deductible.

While borrowing provides liquidity without disrupting your investment strategy, it can introduce other issues. Interest rates on loans should be carefully weighed against the expected return on the invested capital, especially if you're unable to deduct the interest. Also, there's the risk of a margin call if the value of the securities falls below a certain level, which could force you to sell assets at an unfavorable time.

Selling Holdings

Liquidating assets is a straightforward method of accessing cash. It provides immediate liquidity without incurring debt, but it also triggers tax liability and eliminates the potential for future growth.

This option might be preferable if you need to rebalance your portfolio, reduce exposure to a particular asset, or believe specific holdings are at a peak.

The primary consideration when selling investments is the potential capital gains tax. If you've held the asset for a year or less, any gain will be taxed at your ordinary income tax rate, while assets held longer than a year are taxed at more favorable long-term capital gains rates.

Some investors opt to sell other assets at a loss to reduce or offset taxes associated with gains, known as tax loss harvesting. However, careful planning is required to manage the tax impact effectively.

Making the decision

The decision between borrowing against your portfolio and selling boils down to a few different factors. What is the market outlook? If you think your investments will appreciate, borrowing might allow you to benefit from future growth. On the other hand, if a market correction seems imminent, selling the asset could reduce your exposure to losses.

Also, consider the potential tax impact. Borrowing tends to be more tax-efficient, especially if the loan interest is tax-deductible. If you're thinking about selling assets, be sure to consider the extent of your unrealized gains and look for strategic opportunities to reduce or offset those gains with losses.

Strategic philanthropy

Most are aware of the tax benefits associated with donating, but some strategies and charitable vehicles stand out - both in terms of impact and tax savings.

Donating appreciated stock

If you own stock that has appreciated considerably, donating it directly to a charitable organization offers two tax advantages. You can claim a tax deduction for the full market value of the stock and avoid the capital gains tax that would be incurred if the stock was sold first.

You can deduct up to 30% of your adjusted gross income if you donate the appreciated stock to qualifying institutions like hospitals, churches, or schools. However, you must itemize your deductions, and it's important to note that these rules are nuanced, with various factors influencing the deductibility limits. For instance, donations of cash, real estate, and privately traded stock are subject to different rules and limits.

Donor-advised funds

Donor-advised funds are a fairly well-known vehicle for supporting charitable causes without the complexities of creating your own nonprofit. These funds allow donors to make a charitable contribution and receive an immediate tax deduction for cash donations up to 60% of their adjusted gross income. The donors can then recommend grants from the fund to their chosen nonprofits over time. Donor-advised funds are typically managed by a third-party entity, making them fairly hands-off. But, this means they can also involve administrative fees and adherence to rules established by the managing entity.

Private foundations

For high-net-worth individuals who want to take strategic philanthropy to the next level, private foundations are an attractive option. However, they're not for everyone as they are costly to set up, subject to strict regulations, and more complex than donor-advised funds.

These foundations are primarily non-operating, meaning they focus on grant-making rather than direct program management. They offer immediate tax deductions for cash gifts up to 30% of adjusted gross income and appreciated stock donations up to 20% of adjusted gross income.

Private foundations must distribute at least 5% of their assets annually to charitable causes, but some founders use donor-advised funds to meet this requirement. This strategy ensures compliance with the law while maintaining the founder's ability to direct funds to recipients of their choosing over time.

While private foundations are more complex, some donors prefer this charitable vehicle for the amount of control they can retain in exchange. For instance, family members can be employed or serve as members of the board of a private foundation. You can accept many different types of assets, like closely held stock, and you have more options with respect to grant-making. Unlike donor-advised funds, private foundations can contribute to scholarship programs, individuals, and organizations other than 501(c)(3)s.

Ultimately, the decision whether to donate through a private foundation or donor-advised fund will depend on your financial situation, charitable goals, and willingness to engage in administrative oversight. Before embarking on either path, it's wise to consult with a tax professional who can offer tailored advice to ensure your philanthropic strategy is as impactful and efficient as possible.

Maximize SALT deductions

The state and local tax deduction, referred to as the SALT deduction, may offer advantages for pass-through entities. The Tax Cuts and Jobs Act of 2017 introduced a cap on the SALT deduction for individuals, setting a limit of $10,000. This change sparked considerable discussion, especially among individuals in high-tax states where the cap could dramatically increase federal tax liabilities.

In response, 33 states have introduced a pass-through entity tax. This gives pass-through business owners of partnerships, LLCs, and S corporations the option to pay state taxes on business income at the entity level rather than on their individual tax returns.

These state tax payments were traditionally considered a personal expense, making them subject to the SALT deduction cap. But, with the pass-through entity tax, these payments become deductible business expenses. Some states also offer business owners a state tax credit against their individual tax liability, reducing or completely offsetting their share of the tax paid by the business.

Opting into pass-through entity taxes can yield significant federal tax savings, extending beyond income taxes to potentially include self-employment taxes, the net investment income tax, and additional Medicare taxes. This strategy tends to be well-suited to high-income pass-through business owners in high-tax states, but, like most business deductions, it requires careful consideration.

Pass-through entity tax rules vary significantly across states, with differing rules and potential benefits. That said, the decision to leverage this potential deduction requires a deep understanding of both federal guidelines and the specific provisions of state tax laws. Business owners and their advisors must weigh several factors, including the business's income level, applicable tax rates, and the potential for future changes in state law.

Strategic tax planning for your financial journey

We've provided a brief overview of some tried-and-true tax-saving strategies, but the overarching theme is clear: informed, proactive tax planning is the key. These strategies underscore the importance of staying ahead in a changing tax landscape.

Tax planning isn't just about compliance; it's about seizing opportunities to maximize your wealth and financial well-being. However, the complexity of tax laws and the nuances of individual financial situations make it crucial to consult with tax professionals. A tailored approach that considers your circumstances, goals, and challenges can unlock the full potential of these strategies.

I

Final Thoughts

We encourage you to contact one of our expert advisors. They can guide you with strategies specific to your needs, ensuring that each step you take is proactive and informed.

About BT & Co. CPAs

From our founding in 1913 as a branch of Washington, Henry & Co., Federal Tax Consultants to officially becoming BT&Co. in 1989, a lot has changed – in our firm, our community, and in our profession. At the same time, many things at BT&Co. have stayed the same – our commitment to our community and our passion for helping our clients achieve success in their professional and personal lives.

We love numbers, but they don't fuel us. People are our greatest passion. What we do is serious work, but it doesn't have to be done void of personality and enjoyment- we don't ask our team to leave their uniqueness at the door. Our team redefines CPA daily.

BT and Company
4301 SW Huntoon St.
Topeka, KS 66604

(800) 530-5526

info@btandcocpa.com

www.btandcocpa.com