

Ten income and estate tax planning strategies for 2023

Key tax facts for 2023

Highest marginal tax rates	37% on taxable income exceeding \$578,125 for single filers (\$693,750 for couples), 20% on capital gains and dividends applied on taxable income exceeding \$492,300 (\$553,850 for couples)
Medicare investment income surtax	3.8% surtax on net investment income (e.g., interest, capital gains, dividends, rental income, royalties, income from non-qualified annuities, “passive” business income) affecting taxpayers with more than \$200,000 in modified adjusted gross income (\$250,000 for couples)
Additional Medicare payroll tax	Extra tax of 0.9% on salary and wages as Medicare payroll tax increases from 1.45% to 2.35% on earnings above \$200,000 (\$250,000 for couples)
Child tax credit (CTC)	\$2,000 per “qualifying child” under 17 years old at the end of the year. An additional \$500 tax credit applies to other qualified dependents who are not qualifying children (e.g., dependent child age 17 or over). The tax credit is phased out as income exceeds \$200,000 (individuals) or \$400,000 (couples)
Standard deduction	\$13,850 for single filers, \$27,700 for married couples filing a joint return; an additional standard deduction amount for age 65+ or blind individuals applies (\$1,500 per spouse for married couples, \$1,850 for single filers)
Mortgage interest deduction	Deduction of interest on up to \$750,000 of aggregate mortgage debt used to build, acquire, or improve a property (including interest on a HELOC). Grandfather provision applies to debt acquired prior to 12/15/17; allows interest on up to \$1 million to be deducted
State and local taxes (SALT) deduction	Capped at \$10,000 in aggregate
Medical expense deduction	Available once total expenses exceed 7.5% of Adjusted Gross Income (AGI)
Estate/gift tax exemption	\$12,920,000
Annual gift tax exclusion amount	\$17,000

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Ten tax-smart strategies to consider in 2023

1. Consider Roth IRA conversions

A thoughtful strategy utilizing Roth conversions can be an effective way to hedge against the threat of facing higher taxes in the future. In fact, tax rates are scheduled to increase after 2025 when most of the current tax law provisions expire. Lower tax rates now translate to a lower cost for converting Traditional IRA assets to a Roth IRA. It is virtually impossible to predict tax rates in the future, given uncertainty in Congress, or to have a good idea of what your personal tax circumstances will look like years from now. Like all income from retirement accounts, Roth income is not subject to the 3.8% surtax and is also not included in the calculation for the \$200,000 income threshold (\$250,000 for couples) to determine if the surtax applies. IRA owners considering a conversion to a Roth IRA should carefully evaluate that transaction since the option to recharacterize, or undo, a Roth IRA conversion is no longer available.

2. Explore alternative ways to fund Roth accounts

Taxpayers at higher income levels are prohibited from contributing directly to Roth IRAs. For 2023, income phaseouts begin at \$138,000 (\$218,000 for married couples filing a joint return). Taxpayers may want to consider funding a non-deductible (i.e., after-tax) IRA and then subsequently converting to a Roth IRA. There are no income restrictions on Roth IRA conversions. However, adverse tax consequences, referred to as the “pro rata” rule, may apply if the individual owns other pretax IRAs (including SEP-IRA or SIMPLE IRA). Before considering this strategy, taxpayers should consult with their tax professional. Also, participants in 401(k) plans may be able to make voluntary after-tax contributions into their plan in excess of their salary deferral limit (\$22,500, or \$30,000 if age 50 or older). When allowed by the plan, after-tax contributions may be directly transferred to a Roth IRA without any income tax consequences upon a plan triggering event.* This may be a strategy for higher-income taxpayers to diversify their tax liability in retirement.

3. Maximize deductions in years when itemizing

With the large increase in the standard deduction under recent tax law changes, and the scaleback of many popular deductions, fewer taxpayers will choose to itemize on their tax return going forward. Some taxpayers may benefit by alternating between claiming the standard deduction some years and itemizing deductions other years. If possible, it would make sense to “lump” as many deductions into those years when itemizing. For example, taxpayers may want to consider making a substantial charitable contribution during a tax year when itemizing instead of making regular, annual gifts. In addition, with the repeal of the “Pease rule,” there are no phaseouts on itemized deductions at higher income levels.

4. Plan for the 10-year rule on inherited IRAs

Since most non-spouse beneficiaries will have to liquidate inherited IRAs within 10 years following the death of the account owner and likely pay taxes upon distribution, there may be strategies to transfer retirement savings in a tax-smart manner to the next generation. For example, consider naming heirs who are more likely to be in lower tax brackets as IRA beneficiaries.

5. Review estate planning documents and strategies

The increase in the lifetime exclusion amount for gifts and estates (\$12.92 million per individual in 2023) may have unintended consequences for some individuals and families with wealth under that threshold. They may think that they do not have to plan for their estate. However, taxes are just one facet of estate planning. It is still critical to plan for an orderly transfer of assets or for unforeseen circumstances such as incapacitation. Strategies to consider include proper beneficiary designations on retirement accounts and insurance contracts, wills, powers of attorney, health care directives, and revocable trusts. Additionally, existing trusts should be reviewed to determine if changes are needed as a result of the recent tax law changes.

*IRS Notice 2014-54

6. Plan for potential state estate taxes

While much attention is focused on the federal estate tax, certain residents need to know that many states have estate or inheritance taxes. There are a number of states that are “decoupled” from the federal estate tax system. This means the state applies different tax rates or exemption amounts. A taxpayer may have net worth comfortably below the \$12,920,000 exemption amount for federal estate taxes, but may be well above the exemption amount for their particular state. It is important to consult with an attorney on specific state law and potential options to mitigate state estate or inheritance taxes.

7. Develop a strategy for low cost-basis assets

Ensure stepped-up cost basis is maintained when property is transferred at death. For example, careful consideration should be made around lifetime gifts that may jeopardize a step-up in cost basis on property at death. When property is gifted, the party receiving the gift generally assumes the original cost basis. Additionally, certain trust provisions may be utilized to ensure that property receives a step-up in cost basis at death.

8. Expand use of 529 accounts for education savings

529 college savings plans retain existing tax advantages. Account earnings are free of federal income tax, and a special gift tax exclusion allows you to elect to treat up to \$85,000 of contributions as though those contributions had been made ratably over a five-year period. Qualified education expenses were expanded in recent years to include laptops, computers, and related technology. Recent changes allow families to use up to \$10,000 annually for K–12 tuition. Make sure to consult with a tax professional if considering a distribution for K–12 expenses since there may be adverse state income tax consequences.

9. Consider the charitable rollover option if you are a retiree

Retired IRA owners (age 70½ and older) may benefit from directing charitable gifts tax free from their IRA. Since even more retirees will claim the higher standard deduction, they will not benefit tax-wise from making those charitable gifts unless they itemize deductions. Account owners are limited to donating \$100,000 annually, which can include the required minimum distribution (RMD), and the proceeds must be sent directly to a qualified charity.

10. Maximize the 20% deduction for qualified business income (QBI)

The Tax Cuts and Jobs Act (TCJA) introduced a new provision (Section 199A) that allows certain taxpayers to generally deduct 20% of qualified business income on their tax return. Business income from pass-through entities such as sole proprietorships, partnerships, LLCs, and S corps may qualify for this new deduction. Certain types of businesses — defined as a specified service trade or business (SSTB) — may be limited from taking the deduction based on the taxpayer’s household taxable income. The deduction is subject to a phaseout for SSTBs once income exceeds \$182,100 (\$364,200 for married couples filing a joint return). SSTBs include businesses performing services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and certain brokerage services. Business owners impacted by the income phaseout may want to consider strategies to reduce taxable income, such as funding retirement accounts, deferring income, or accelerating business expenses.

Consult a qualified tax or legal professional and your financial advisor to discuss these types of strategies to prepare for the risk of higher taxes in the future. Personal circumstances vary widely, so it is critical to work with a professional who has knowledge of your specific goals and situation.

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