Strategic Tax Planning

Last year brought the worst returns for all major asset classes since 2008, and the 4th worst year for the S&P 500 since World War II. Like most severe market downturns, 2022 also marked the end of a market cycle, and the beginning of something new. Since the Financial Crisis in 2008, markets have been driven by Fed Policy: low interest rates and quantitative easing. These forces created unique winners and losers within financial markets, and eventually resulted in the inflation spike that ended the party. While we do not know what will define the next market cycle, we know it is likely to be different than what we experienced over the last 10-15 years.

As fiduciaries to our clients, our primary job is to maximize wealth relative to a client's risk & time horizon. Investment management is the primary tool we use to this end, but smart tax planning can also have an enormous impact on growing and maximizing long-term wealth.

While much of the tax planning we do with clients is complex and specific to their particular tax situation, there are some universal tax strategies that are relevant to virtually all US taxpayers. What's more, congress has made monumental changes to the tax code over the past two decades in ways that drastically changed the math on many tax-related strategies. Despite the very different tax landscape, many people still hold onto old tax "truisms" that are outdated relics of prior tax codes and need to be re-evaluated.

Summary of Tax Code Changes

Year	Law	Change	New Marginal Rate ($300,000 W2 Income)
1999			39.6%
2001	EGTRRA	Lowered most tax rates	33%
2012	PPACA (ObamaCare)	Both raised and lowered tax rates, depending on income	33%
2017	TCJA	Lowered tax rates, added new deductions	24% (19.2% Self Employed)
2022	SECURE 2.0	Changed rules on various types of retirement accounts	24% (19.2% Self Employed)

Source: Bradford Tax Institute

One of the most important tax planning tool available to all Americans are tax-qualified retirement accounts such as IRAs, 401Ks, etc. These accounts typically allow either pre-tax or Roth contributions, and last month's passage of the landmark "SECURE 2.0" Act provides even greater flexibility for these accounts.

Historically the "rule of thumb" has been to save primarily pre-tax, based on the belief that people will have a higher income and therefore a higher marginal tax rate while working than while retired. Additionally, many CPAs are trained and paid to focus on minimizing current year tax liability, which does not always align with maximizing long-term wealth.

We have our own "rule of thumb", which is to always do math and not trust in "rules of thumb". If the primary goal is "spendable wealth", then any comparison must factor in the tax cost of both contributions & withdrawals.

- Changing a $1,000 pre-tax *contribution* to Roth generates additional taxable income. In the 24% tax bracket it would cost $240 in taxes to make the switch leaving only the remaining $760 for the Roth.
- A $1,000 *withdrawal* from a pre-tax account also generates taxable income. In the 24% tax bracket it would cost $240 in taxes, creating the same spendable wealth as withdrawing $760 from a Roth.

The math comes down to comparing a client's tax brackets the year of a contribution vs. the year of a withdrawal:

Scenario	Result
Higher tax rate when contributing	**Pre-tax results in more spendable wealth**
Higher tax rate when withdrawing	**Roth results in more spendable wealth**
Identical tax rate in both years	**No difference in spendable wealth**

Thinking of it as a math equation, we are left with four variables needed to determine the correct tax strategy:

1) Current Year Income
2) Current Tax Code Brackets
3) Future Retirement Income
4) Future Tax Code Brackets

The obvious dilemma is that we only really know the first two variables and therefore we can only determine a client's current tax rate. Because the tax code is always changing, we are forced to compare a known tax savings now (pre-tax) with an unknown tax savings in the future (Roth).

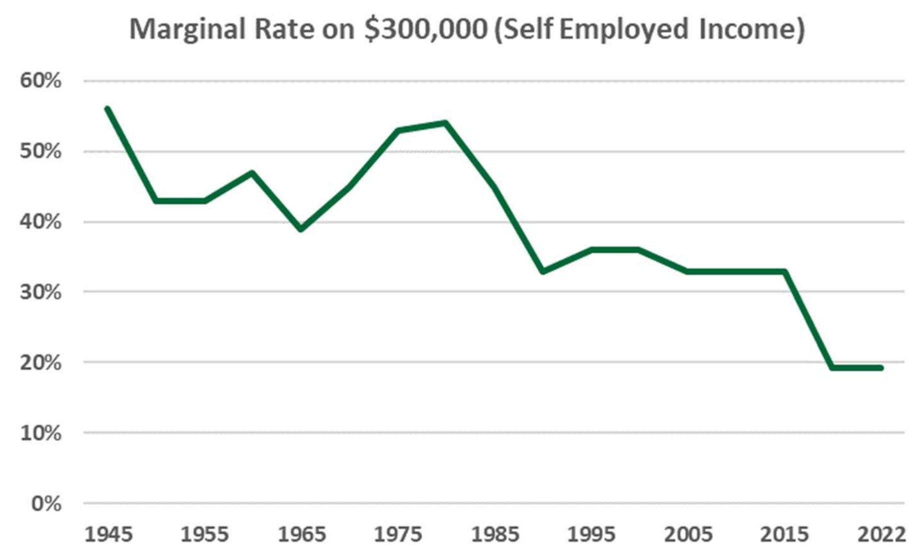
While we cannot be *certain* about future tax rates there is very little in the realm of investment management that we can be certain of. This does not stop us from using the tools at our disposal to make strategic decisions. Of the unknown variables above we can do a fair approximation for #3 using statistical projections. The cash flow modeling we do with our clients is designed to project future retirement income with a reasonable degree of accuracy. Since tax brackets are fairly wide, we do not need pinpoint accuracy. Here is an example of current federal income tax brackets:

Single (Taxable Income)	Married Filing Jointly (Taxable Income)	Marginal Tax Rate
$11,000	$22,000	10%
$44,725	$89,450	12%
$95,375	$190,750	22%
$182,100	$364,200	24%
$231,250	$462,500	32%
$578,125	$693,750	35%
All Higher Income	All Higher Income	37%

Source: Internal Revenue Service

Because tax brackets are structured with these wide ranges, good cash flow modeling is typically accurate enough to project what tax bracket a client is likely to be in – if we could know what those future tax brackets will be.

The final variable, what future tax brackets will look like, is the most difficult to predict. From a historical perspective we are currently living under the lowest tax rates in the post-WWII era, but our national debt & deficit make it unlikely rates will remain this low in the future; particularly for high incomes.



Source: The Tax Foundation & US Inflation Calculator

While we have no way to know what exactly future tax rates will look like, it is reasonable to think that they will eventually revert to more historically "normal" levels. If that happens, then for many people a pre-tax contribution today may end up shifting taxable income from today's record-low rates into significantly higher rates in the future. If this scenario happens, the vast majority of people would be better off having made Roth contributions.

Because future tax rates are unknown the best anyone can do is to make an educated guess. However, in terms of probabilities it seems fairly likely that rates will eventually go up, or at least fairly unlikely that rates will go down even further. That means that for someone will have a high income both now and in retirement, Roth contributions today have the potential to increase their long-term spendable wealth.