Tax Planning 101

Overview

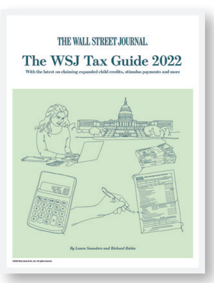
Tax planning can be complicated, not to mention unpleasant. As a result, many people avoid the matter completely and take no proactive steps. This is a dangerous financial planning error that often reveals itself when options have become limited or nonexistent.

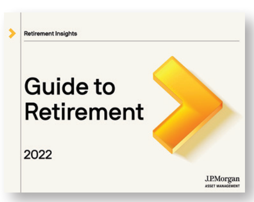
But even thinking about consulting a tax professional raises difficult questions. Where should one even start? We are happy to make referrals to qualified experts and coordinate the overall process.

It is far beyond the scope of this brief guide to cover the wide variety of individual situations, so we focus instead on two core pillars of the tax code that apply to all investors: income taxes and investment taxes. Our "Tax Planning Checklist" is an accompaniment to this briefing.

Resources

For additional detail about tax planning, we highly recommend *The Wall Street Journal Tax Guide 2022* and J.P. Morgan's *Guide to Retirement – 2022*. The text and tables in this briefing's sections on income and investment tax rates and brackets, including the 3.8% surtax, come directly from the *Wall Street Journal* guide, and illustrations from J.P. Morgan are clearly noted. Finally, we recommend the *Schwab Charitable Giving Guide* for those interested in developing a plan to manage their giving at any point in a philanthropic journey.

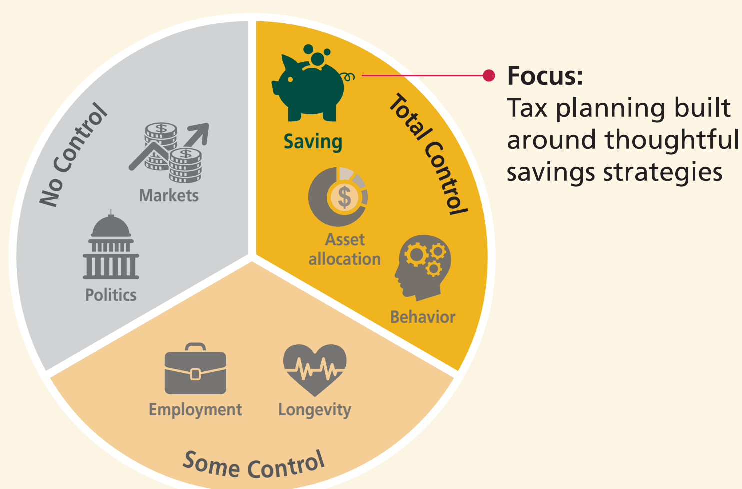




Creating a realistic control hierarchy

All the variables in our financial lives fall into one of these three categories: total control, some control, and no control. We have no control whatsoever over public policy, including tax rates and the treatment of different forms of savings over time, or market returns. On the other hand, we have ***total control*** over saving and deferring consumption versus spending, asset allocation, and our behavior regarding our investments. Since we cover asset allocation and behavior in other publications, the entire focus of this briefing is tax planning built around thoughtful savings strategies.

Drivers of Lifetime Investment Outcomes



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Prioritizing long-term retirement savings

The following illustration is based on a diagram from J.P. Morgan's *Guide to Retirement – 2022*. We describe health savings accounts (items 2 and 5) in our "Health Savings Accounts 101" briefing and defined contribution savings (items 3 and 6) in our "Retirement Plan Fund Selection 101" briefing. For a concrete action plan, start with #1 (emergency reserve) and then work your way through the steps in the order listed.

Prioritizing Long-term Retirement Savings

Start Here

Prioritizing savings

1. Emergency reserve (3-6 months of living expenses)

Maximize employer match

2. HSA (Health Savings Account) if eligible for match
3. Defined Contribution savings to maximize employer match (if available)

4. Pay down higher interest loans (such as credit card debt / student loans with interest > 6.25%)

Maximize contribution

5. Additional HSA (Health Savings Account)
6. Additional Defined Contribution savings

7. Pay down lower interest loans (such as student loans with interest < 6.25%)
8. IRA
9. Taxable account

Getting started

Start with emergency savings and make sure to take advantage of employer matching funds if they are available.

An HSA offers triple tax benefits if used for qualified medical expenses in retirement. Prioritize contributions to an HSA before a Defined Contribution plan if current medical expenses can be funded from low-cost sources.

Source: J.P. Morgan Asset Management

Income and investment tax basics

The tax code is complicated, and most people don't understand how income and investment taxes are calculated. The next three sections, courtesy of *The Wall Street Journal Tax Guide 2022*, are intended to provide a foundational understanding as a starting point for thoughtful tax planning.

Income tax rates and brackets

The tax code currently has seven income-tax brackets for individuals that range from 10% to 37%. The 10% rate

Key Inflation-Adjusted Tax Numbers for 2022

Individual income tax	Taxable income	
RATE	SINGLE	MARRIED, FILING JOINTLY
10%	Up to $10,275	Up to $20,550
12%	$10,276 to $41,775	$20,551 to $83,550
22%	$41,776 to $89,075	$83,551 to $178,150
24%	$89,076 to $170,050	$178,151 to $340,100
32%	$170,051 to $215,950	$340,101 to $431,900
35%	$215,951 to $539,900	$431,901 to $647,850
37%	$539,901 +	$647,851 +

Source: Internal Revenue Service

takes effect at the first dollar of taxable income, after benefits such as the standard deduction are applied. Each tax rate applies to income in that bracket. So a taxpayer whose last dollars are taxed at 24% will likely have portions of income taxed at 0, 10%, 12% and 22%.

The current rates and brackets were set by the 2017 tax overhaul, and they expire at the end of 2025. If Congress doesn't make changes, the top rate will return to 39.6% in 2026. The income-tax rates and brackets are adjusted annually for inflation, although in 2017 Congress switched to an often-slower method for calculating inflation.

Investment tax rates and brackets

Investors with taxable accounts—as opposed to tax-favored retirement accounts such as individual retirement accounts or 401(k)s—are often eligible for lower tax rates and other benefits.

When an investor sells a holding in a taxable account, the result is a capital gain or loss. That is the difference between the investment's original cost (plus adjustments) and its selling price. If an investor buys a share for $3 and sells it for $5, the capital gain is $2. If that person buys another share for $3 and sells it for $2, the capital loss is $1.

Buy and Hold

Long-term capital gains are profits on investments held longer than a year. They are taxed at favorable rates.

A key benefit is that capital losses can offset capital gains. If the investor in this example sells both shares in the same calendar year, he or she would have a net taxable capital gain of $1 after combining the $2 gain and the $1 loss. If total losses exceed total gains, the net losses can offset up to $3,000 of "ordinary" income such as wages per year.

Another benefit is that unused capital losses can be carried forward to offset future capital gains and ordinary income.

Long-term capital gains are profits on investments held longer than a year. They are taxed at favorable rates of 0%, 15% or 20%.

Short-term capital gains are those on investments held a year or less. They are taxed at the higher rates that apply to ordinary income. This is a key distinction frequent traders should be aware of.

The favorable lower rates for long-term gains also apply to dividends that are "qualified," which are most of them. Other dividends are taxed at the higher rates for ordinary income like wages.

The 3.8% surtax

A 3.8% surtax applies to net investment income for most single filers with adjusted gross income (AGI) above $200,000 and most couples filing jointly with AGI above $250,000. This surtax applies only to the amount of net investment income above those thresholds, which aren't indexed for inflation.

For example, say that a single taxpayer has earned income such as wages and bonus totaling $150,000, plus a $60,000 taxable capital gain and $20,000 of dividends. This filer would owe the 3.8% tax on $30,000, which is the amount of his AGI above $200,000.

Key Inflation-Adjusted Tax Numbers for 2022

Taxable income	Taxable income	
RATE*	SINGLE	MARRIED, FILING JOINTLY
0%	Up to $41,675	Up to $83,350
15%	$41,676 to $459,750	$83,351 to $517,200
20%	$459,751 or more	$517,201 or more

**Applies to gains on assets held longer than a year and qualified dividends.*

Source: Internal Revenue Service

Because of the surtax, top-bracket taxpayers typically owe 23.8% instead of 20% on their long-term gains and dividends. Some investors in the 15% bracket for this income owe the 3.8% surtax on part or all of it because their adjusted gross income is above the $250,000/$200,000 thresholds.

Tax implications for retirement savings by account type

The next illustration comes from J.P. Morgan's *Guide to Retirement – 2022* and only applies to federal taxes. (State tax rules may differ.) For individual tax advice, consult your tax professional.

The key takeaway is that many aspects of retirement savings qualify for preferential tax treatment, indicated by + in the diagram. Moreover, all of these items fall into the "total control" category and should be the starting points for a thoughtful tax plan.

Tax Implications for Retirement Savings by Account Type

	Contributions	Investment growth	Withdrawals
Pre-tax 401(k) / Traditional IRA	+	+	− (Taxed as ordinary income)
Roth 401(k) / Roth IRA	−	+	+ (For qualified withdrawals)
After-tax 401(k) / non-deductible Traditional IRA	−	+	− (Investment returns taxed as ordinary income)
Health Savings Account (HSA)	+	+	+ (For qualified health care expenses)

Retirement accounts: Taxes generally apply to contributions or withdrawals. Most withdrawals must be qualified to avoid tax penalties.

If not used for qualified health care expenses, withdrawals after age 65 will be taxed as ordinary income (without penalty).

+ Preferential tax treatment   − Subject to taxes

Source: J.P. Morgan Asset Management

Plan wisely

Thoughtful tax planning is a crucial part of a well-structured financial plan. We will work together with you and your qualified tax expert to ensure that you make the most of your earnings and investment income in the near term and enhance your savings over the long term to meet your overall financial goals.

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