CHIEF INVESTMENT OFFICE

Tax Alert 2023-02

Beginning of Year Tax Planning

January 2023

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INTRODUCTION

Tax planning and tax decisions are not, and should not be, exclusive to the final weeks of the calendar year. Year-end does offer an opportunity to assess one's tax situation with a nearly complete set of facts. But by then it may be too late to plan and make timely decisions.

Beginning-of-the-year tax planning should not be overlooked and in some instances may be even more important than year-end planning. As we begin a new year, we want to draw your attention to some important tax items that should be considered early in the year, not only because they have the potential to maximize savings and minimize taxes, but also because some are time sensitive as well. The following is a non-exclusive list of items to be considered by taxpayers early in the year, some time-sensitive, some based on common sense.

TAX CONSIDERATIONS FOR THE BEGINNING OF THE YEAR

What if?

It is said that "an ounce of prevention is worth a pound of cure." Upfront tax planning can prevent unpleasant future surprises and, more importantly, potentially result in tax savings as well. An early-in-the-year assessment of projected income can lead to better and more informed decision making.

Rather than waiting for the end of the year, taxpayers should look at their prospective tax planning early in the year. If compensation or investment earnings have increased from the prior year, various tax benefits could be lost as income exceeds certain thresholds or phase-out ranges. For instance, an increase of $50,000 of investment income could cause the qualified business income deduction to be fully phased-out for some taxpayers. In such case, would it be better for investment income to be tax-exempt to preserve the deduction? Alternatively, consider whether increasing taxable interest income would result in a charitable gift being more tax-efficient by the charitable deduction offsetting ordinary income otherwise taxed at 37% versus long-term gains or dividends taxed at 20%. It may make sense to allocate investments to taxable bonds to generate a possible higher yield and gain greater tax efficiency from making a charitable gift.

Of course, a taxpayer could consider these tax decisions at year end, but by then the taxpayer would not be in a position to alter the character of income previously recognized during the year or rearrange investments to generate taxable or non-

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taxable income. Taxpayers could be well served by running base-case, best-case, and worst-case financial and tax projection scenarios at the beginning of each tax year, with periodic updates throughout the year.

FUNDING RETIREMENT PLANS

Contributions to retirement accounts, such as a 401(k) or IRA, can be made throughout the calendar year, or in the case of an IRA (and solo 401(k) plans for the first plan year) even in the following tax year, if made on or before April 15 of such following year (the un-extended due date for filing a tax return). However, in a rising investment market, funding a retirement account early in the year has the benefit of permitting those funds to grow tax deferred for a longer period of time. A taxpayer who funds an IRA in January of 2023 rather than April of 2024, will enable those funds to potentially grow and compound for an extra 15 months. However, for an employer sponsored plan such as a 401(k), if your employer offers a match to your contributions, you will want to consider the implications of fully funding your account early in the year. In some instances, if your contributions stop, so will the company's match.

Beginning in 2023, individuals who employ domestic employees will be eligible to fund SEP retirement plans for their employees. SEP plans allow for contributions of up to 25% of compensation (limited to $66,000 per year). These plans are funded entirely by employer contributions, and any contributions would be excluded from the domestic employee's income and payroll taxes.

REQUIRED MINIMUM DISTRIBUTIONS (RMDS)

New Commencement Age for RMDs. Since 2020, age 72 has been the age at which individuals were required to start taking annual distributions from their retirement accounts such as traditional IRAs. However, for those who will be turning 72 in 2023, an 11th hour change in the tax laws, as part of the SECURE Act 2.0, increased the age for starting RMDs to 73 effective January 1, 2023. Therefore, these individuals will be permitted to delay their distributions an additional year. The required minimum distribution age will increase yet again to age 75 starting January 1, 2033.

Qualified Charitable Distributions. IRA owners over the age of 70.5 may direct up to $100,000 per year to be distributed directly from their IRA to a charity as a Qualified Charitable Distribution (QCD). Such distributions are not taxable to the account owner. Additionally, a QCD may be used to offset a taxpayer's required minimum distribution for the year.

When a taxpayer who is subject to RMDs takes funds from an IRA, any amount withdrawn is first assumed to satisfy the RMD. Therefore, an IRA owner who is considering making a QCD for the year may want to do this earlier in the year to satisfy their RMD using the QCD before making an any other distributions from the account. This not only includes distributions directly to the account owner, but also rollovers and Roth conversions. Otherwise, the account owner may generate a tax liability that could have been avoided simply by doing transactions in a different order.

INFLATION REDUCTION ACT: CONSUMER TAX CREDITS

The Inflation Reduction Act of 2022 included several new and expanded tax credits intended to encourage energy efficient improvements to residences and broaden electric vehicle adoption among consumers. Many of these changes will take effect in 2023, making the beginning of the year an opportune time to consider taking advantage of these new tax benefits.

Nonbusiness Energy Property Credit (Section 25C)—A tax credit may be available for certain energy-efficient improvements made to a taxpayer's principal residence. This credit, which originally expired at the end of 2021, was extended through 2032 and expanded for improvements made beginning in 2023. The expanded credit increases the $500 lifetime limitation to a $1,200 annual limitation beginning in 2023. The amount of the available credit is equal to 30% of the cost of improvements including: exterior windows and doors, insulation, and heating and air conditioning equipment meeting efficiency standards. The Inflation Reduction Act also added the cost of home energy audits as a credit-eligible expense.

Each category of property is also subject to specific limits. For example, the credit for exterior doors is limited to $500, while windows are eligible for a maximum credit of $600. Generally, this means that obtaining the full $1,200 credit requires multiple categories of property to be placed into service in a tax year. However, given that the credit is now subject to an annual limit rather than a lifetime limit, taxpayers might consider spreading such improvements over multiple tax years. Finally, the new law provides a special limitation for qualifying heat pumps, heat pump water heaters and biomass stoves and boilers. For these types of property, the maximum credit is $2,000.

Residential Clean Energy Credit (Section 25D)—Property eligible for this credit includes solar water heating and electrical equipment, fuel cells, small wind energy property, geothermal heat pumps and battery storage. The Inflation Reduction Act extended this credit, which was set to expire at the end of 2023, through 2034 and added battery storage as a credit-eligible expenditure. The credit was also increased from 26% to 30% of the cost of eligible property placed in service from 2022 through 2032. The credit then drops back to 26% in 2033 and 22% in 2034.

Clean Vehicle (CV) Credit (Section 30D)—The Inflation Reduction Act made several changes to the existing credit for purchases of vehicles powered by clean energy, with some limitations eliminated, and additional requirements and phase-outs added. Remaining the same, is a maximum credit amount of $7,500, which is now extended through the end of 2032. Beginning in 2023, the eligibility cap limiting the credit to the first 200,000 electric vehicles sold by a manufacturer, will be eliminated. However, several new limitations have been added.

First, a requirement that final assembly of all vehicles eligible for the credit must occur in North America has been added. This provision took effect on August 16, 2022; most other newly introduced limitations take effect in 2023. A second change

for 2023 is that eligibility for the credit is now income limited. Married taxpayers with income exceeding $300,000, and single taxpayers with income over $150,000 for either the current or immediately prior tax year will not be eligible for the credit. Eligibility for the credit may also be limited based on the price of the vehicles. Cars with an MSRP exceeding $55,000 and SUVs, vans, and trucks with an MSRP exceeding $80,000 will not qualify for the credit beginning in 2023.

Finally, the availability of the credit will be dependent on the country of origin of the minerals and components used in the vehicle's battery. Under the new tax credit requirements, a percentage of minerals used for the vehicle's battery must be sourced from the United States or countries that have a free trade agreement with the United States, and a percentage of other battery materials must be manufactured or assembled in North America. These percentages increase gradually over the next several years to give manufacturers time to adapt to the new requirements. Meeting both the mineral and other components requirements will qualify the vehicle for the full $7,500 credit (i.e., $3,750 for meeting each).

In late December 2022, the Treasury announced that it will delay its plan to issue proposed regulations on material sourcing and manufacturing until March 2023. The restrictions on tax credits are effective only after the proposed regulations are issued. This change therefore means that some electric vehicles that are not expected to comply with the new standards will still be eligible for the tax credits during the first quarter of 2023. The new income caps and vehicle pricing rules will continue to apply.

Previously Owned Clean Vehicles (Section 25E)—In addition to the modifications to the Clean Vehicle Credit, a new credit was added for purchases of used vehicles between 2023 and 2032. The credit is equal to the lesser of $4,000 or 30% of the price and is permitted for vehicles with a sales price of $25,000 or less. Eligibility for this credit is also limited based on the taxpayer's income for the current and prior year. Married taxpayers with income exceeding $150,000 and single taxpayers with income exceeding $75,000 will not qualify. Qualifying used vehicles will not be subject to the assembly or battery requirements that new vehicles must abide by.

NEW ACTUARIAL TABLES

Due to recent improvements in U.S. mortality rates (i.e. as of 2010, individuals were living longer than they were in 2000), in 2021 the IRS issued new actuarial tables that reflect this improved mortality picture, resulting in longer payout terms for a variety of retirement plan participants and beneficiaries, relating to distributions in 2022 and after.

Also related to recent improvements in mortality rates, on May 5, 2022, the IRS issued proposed regulations (as required by IRC §7520) containing new actuarial tables for use in valuing life estates, remainder interests, or annuities. Until these proposed regulations are published in final form, for any transfer on or after January 1, 2021, taxpayers will be allowed to value transfers for gift, estate and income tax purposes using either (1) the currently existing tables based on 2000 census data ("old tables") or (2) the finalized version of these proposed regulations based on 2010 census date ("new tables").

The option of using the "old" or the "new" tables, means that taxpayers should calculate the values of various gifts using both the "old" and the "new" tables so that they can decide whether the "old" or "new" tables offer a better tax result. Generally speaking, using the new mortality rates will result in lower values for remainder interests and higher values for income interests.

Observations

- Because most Grantor Retained Annuity Trusts (GRATs) are typically term interests with no mortality element, these new tables should not have any impact.
- While Qualified Personal Residence Trusts (QPRT) are primarily based on a term of years, most QPRTs also include a mortality element (referred to as a reversionary interest). These new mortality tables could affect the value of the gift of the remainder interest to children or others.
- A variety of other estate planning techniques could also be affected by this option ("old" or "new" tables). The impact will depend on the degree to which such techniques rely on mortality assumptions.

There is no way to predict when the IRS will "finalize" the proposed regulations (although these final regulations have not yet been issued as of December 2022). There will be an indeterminate window of opportunity for taxpayers to choose between the old and the new tables, in order to reduce the estate, gift and income tax consequences of those transactions. At some point in 2023, the final regulations will be issued and taxpayers will be required to use only the "new tables."

TIMING MATTERS

A host of tax decisions and elections are time-sensitive and must be considered within the first few months of the year, if not sooner. Some decisions have a retroactive effect and could affect taxes for the prior calendar year, and yet others are prospective in nature.

Trust/Estate Distribution Planning—One important tax planning decision must be made by early March. That decision allows a trustee to elect to treat trust distributions made during the first 65 days of the current tax year as distributions made during the immediately preceding tax year. This decision could save significant income taxes by pulling income away from a trust (which is subject to top ordinary and capital gains tax rates at income levels as low as about $14,000) and pushing that income into the hands of individual beneficiaries who may be in much lower tax brackets (the 2023 top income tax bracket for married taxpayers begins at approximately $690,000). While the trustee must make the distribution soon after year end, the election to treat the distribution as occurring in the preceding tax year is made on the trust's income tax return. An executor may make a similar election on the estate's income tax return during the first 65 days of the estate's current tax year.

Pass-Through Entity Taxes—Another important tax election relates to the new pass-through entity ("PTE") taxes enacted by a majority of states within the last year or two. In many states, this is an optional tax that allows partnerships (including LLCs) or S-corporations to annually elect to pay state income tax on certain income at the entity level rather than at the partner or member level. The intent of this tax is to indirectly provide the individual with an unlimited federal income tax deduction for state and local taxes paid. Generally, if a partnership or S-corporation elects to pay an entity level tax, the partners, members, or shareholders of the electing entity which is subject to the tax may be eligible for a tax credit on their state income tax returns and reduce the amount of income that passes through to them at the federal level.

The rules for electing this treatment vary among states. New York, for instance, permits the annual PTE tax election to be made on or after January 1 but no later than March 15, for tax years 2023 and later. New Jersey and California permit the PTE annual election to be made on an original, timely filed tax return, while North Carolina and Minnesota permit the PTE annual election to be made on the due date of the return, including extensions.

For those operating as a sole proprietorship or single member LLC, consideration should be given to incorporating as an S-corporation or adding another member to avail themselves of the benefits of state PTE rules.

Federal Elections: S-Corporations—For taxpayers who have converted a C-corporation into an S-corporation, the change in tax status will be recognized for federal tax purposes retroactive to the beginning of 2023 only if the taxpayer makes a timely election. That election must be made by March 15, 2023 (with limited exceptions), otherwise the S-corporation status will be prospective in nature, taking effect in the following tax year.

Gift Tax Returns—With the scheduled decrease in the federal estate and gift tax exemption set to take effect in 2026, many taxpayers have sought to take advantage of the temporarily increased exemption by making large lifetime gifts. Taxpayers who made gifts in 2022 will need to file a federal gift tax return by April 18, 2023. Taxpayers can request an automatic six-month extension of time to file a federal gift tax return in two ways, provided they take timely action. First, a taxpayer can request an automatic extension to file a gift tax return by also applying for an extension of time to file their federal income tax return. Second, if a taxpayer is not requesting an extension to file their income tax return, then a separate request to extend the time to file a gift tax return should be made on IRS Form 8892.

For 2022 gift tax returns, some taxpayers may want to avoid extending the deadline to file their return. For situations in which the value of gifted assets has declined, donors who wish to allocate Generation Skipping Transfer (GST) exemption may benefit from a late allocation of their exemption rather than a timely allocation on their 2022 gift tax return. The benefit being that the amount of GST exemption required to shelter the gift will be based on the value of the assets at the time the late allocation is made instead of the value at the time of the gift. In this case, an extension could delay the ability to make a late allocation. If asset values subsequently recover during the period of the extension the late allocation opportunity may be diminished or lost.

INCENTIVE STOCK OPTIONS

Exercising incentive stock options early in the year can provide tax benefits and flexibility not otherwise available for late-year exercises. Incentive Stock Options (ISOs) have special tax benefits which can result in long-term capital gains treatment if you exercise your options and then hold the underlying stock for more than one year. While the exercise of ISOs is not a taxable event for regular federal income tax purposes, the gain upon exercise is considered income for Alternative Minimum Tax purposes. If the underlying shares are sold within one year of exercise, then it results in a disqualifying disposition, and options are treated as non-qualified stock options: the gain at the date of exercise is taxable as compensation income (and there is no resulting AMT income).

Exercising ISOs early in the year provides significant flexibility because it gives you almost a full year to determine if the resulting shares should be sold: If the stock prices goes up, a taxpayer should continue to hold the underlying stock to attain long-term capital gain treatment; however, if the stock price goes down the taxpayer should consider disposing of the shares (in the same calendar year as the exercise) to negate the AMT income and turn the tax treatment into non-qualified options.

For example, assume an incentive stock option is exercised on January 20, 2023 with a strike price of $10 and the underlying stock is valued at $25. If the stock is then held for over a year, there will be no ordinary income tax due on the $15 difference between the $10 strike price and the $25 stock value at the time of exercise. A future sale of the stock at a price above the $10 strike will result in a long-term capital gain. For the purpose of calculating the potential AMT, the $15 will be considered income for 2023 regardless of what happens to the price of the stock for the remainder of 2023 if the stock continues to be held by the taxpayer through year end.

Now assume that 11 months after exercising the option (December 20, 2023) the share price declines to $10 and, without expecting a near-term recovery of the share price, the taxpayer decides to sell the shares thereby disqualifying the option from the special tax treatment permitted for ISOs. For ordinary income tax purposes, this would result in taxable income being due based on the difference between the strike price and the lower of the price on the date of exercise or the price on the date of sale of the shares. In this case, with the sale price equal to the $10 strike price, there would be no ordinary income tax due.

However, for AMT remember that the tax would be calculated and due for the calendar year of the option exercise. If the disqualifying disposition occurs in 2023 (the same calendar year as the ISO exercise) there would not be any AMT income resulting from the exercise. However, if the taxpayer delayed the sale by two weeks and the disqualifying disposition occurs in 2024, the taxpayer would have already calculated their AMT due for 2023

based on the difference between the strike and the exercise price. A sale occurring in 2024 would not change that. This could leave the taxpayer with a large AMT liability bill for 2023 based on the $25 price at the time of exercise, despite the current $10 stock price. The bottom line is that exercising earlier in the year would give the taxpayer more time to decide whether to disqualify shares acquired through an ISO exercise prior to year-end and avoid a potential 2023 AMT liability based on a higher price if the stock price declines.

ESTATE PLANNING

Annual exclusion gifts. Like contributions to retirement plans, there are benefits to making annual exclusion gifts early in the tax year. An early gift gives the recipient more time to invest the funds, which will hopefully appreciate in the recipient's hands, rather than in the donor's estate. For 2023, the annual exclusion is $17,000 per recipient.

Exemption gifts. While there has been much talk about the possibility of the estate, gift and GST exemption going down, it has steadily been going up each year due to the inflation adjustment. In 2022, the exemption was $12,060,000 per donor. In 2023, the exemption went up to $12,920,000—an increase of $860,000, or $1,720,000 for a couple. Just as with annual exclusion gifts, a gift of the full amount of the exemption gives the recipient more time to invest the funds, which will result in a greater amount of property removed from the donor's estate. In fact, there is an even greater incentive to make an exemption gift early in the year. This is because of the possibility that the exemption amount may go down, even before the scheduled reduction in 2026. By making a full exemption gift now, it would presumably lock-in not only appreciation, but also the full exemption amount as well. For more information, see our *Tax Alert 2022-05: Proposed Anti-Abuse Clawback Regulations*.

Taxable gifts. When gifts exceed the annual exclusion amount and the lifetime exemption amount, it could result in the payment of gift taxes. Those gifts have an effective federal tax rate of 28.6%, if the donor survives for three years after the gift is made, otherwise the effective rate jumps to 40%. The earlier such a taxable gift is made, the more likely the donor will survive the three years and the less likely the gift will be taxed at 40%. By way of comparison to the estate tax, the top estate tax bracket is 40%.

INFLATION AND TAXES

High Inflation can be mixed news for taxpayers. Inflation is often viewed as an additional figurative "tax" since it decreases purchasing power. However, it can also have a real impact on actual tax payments on the federal and state levels.

The good news is that federal tax brackets and many federal tax benefits are adjusted for inflation. For instance, thresholds for determining ordinary income and capital gains brackets all increased in 2023, and the standard deduction, IRA contribution limits, and retirement contribution caps were all adjusted upwards. But that adjustment, itself, did not keep pace with the inflation taxpayers feel. Due to a 2017 change in the manner the tax code determines inflation, the increase generally will not be reflective of the actual change in the Consumer Price Index.

There are also many tax items which are not adjusted for inflation, which can result in an increase in actual taxes paid. That is the dark side of inflation. For instance, the threshold for determining if a taxpayer is subject to the 3.8% net investment income surtax is set at $250,000 ($200,000 for single taxpayers) and not adjusted for inflation. With interest income pushed up by higher yields, more taxpayers and more income could be subject to the surtax. Consideration should be given to any additional taxes when determining the appropriate amount of estimated tax payments for 2023.

CONCLUSION

Tax planning and tax decisions are not, and should not be, exclusive to the final weeks of the calendar year.

Beginning-of-the-year tax planning should not be overlooked and in some instances may be even more important than year-end planning. Potential tax legislation as part of a slimmed down Build Back Better bill could close some tax planning opportunities on a prospective basis. Taking action before such changes should be considered by some taxpayers. Absent any changes in tax law, other opportunities exist to change tax consequences on a retroactive basis, but are generally elective in nature and time sensitive to early in the calendar year. Tax planning is always a year-round endeavor, with particular emphasis on not only year-end planning but on beginning-of-year planning, too.

—National Wealth Strategies, Chief Investment Office

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