



INVESTMENT STRATEGY UPDATE

Provided by the BTR Team

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Tax Cuts and Jobs Act – Sunset in 2026?

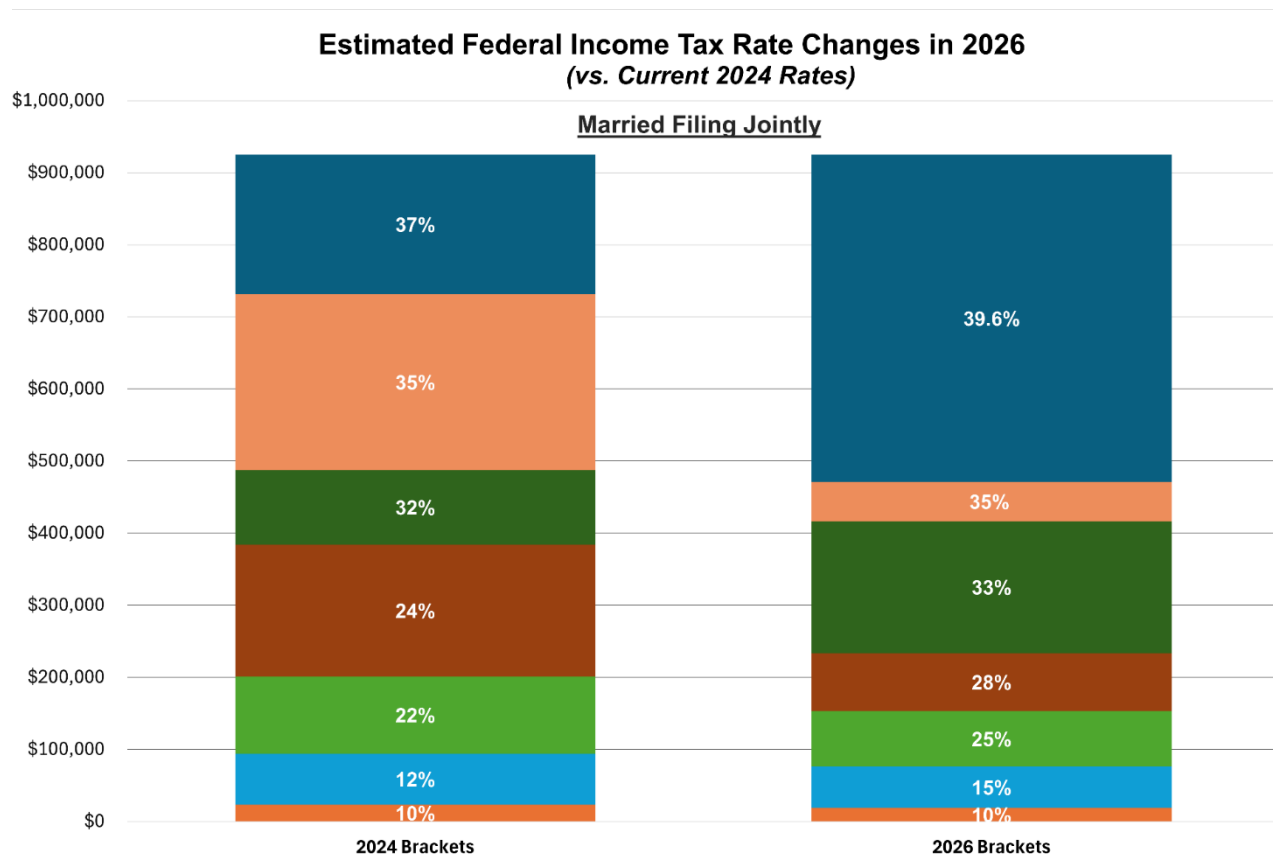
“The hardest thing in the world to understand is the income tax” ... Albert Einstein

The Tax Cuts and Jobs Act (TCJA) of 2017 represented a landmark overhaul of the U.S. tax code, ushering in significant changes to individual and corporate tax law. While the changes on the corporate side were signed into law and made permanent, the changes on the individual side came with a countdown clock.

Unless Congress takes specific action on or before December 31, 2025, to extend or make permanent the individual provisions, those tax laws will expire and revert back to the pre-2018 levels, adjusted for inflation. In other words, taxes will be going up for most people. This ‘sunset provision’ is a crucial aspect of the TCJA and a key element of financial planning opportunities in the coming years. This Investment Strategy Update will explore the implications for taxpayers should Congress take no action and allow the individual provisions of the TCJA to expire.

Tax Bracket Changes

As shown in the chart below, should the TCJA expire, significant bracket changes along with substantial tax rate increases are on the horizon for most taxpayers beginning in 2026.



For married couples with taxable income between \$100,000 to \$500,000, the current Federal tax brackets span a range of 22%, 24%, 32%, and 35%. The impact of returning to pre-TCJA tax rates would be substantial. For these same couples, the Federal tax brackets would jump to 25% (on \$100,000 of taxable income) and scale up with brackets ranging from 28%, 33%, 35% to a maximum of 39.6% (just below \$500,000 of taxable income). These bracket jumps are estimated to cost this cohort an additional \$16,000 - \$27,000 in income taxes, excluding additional considerations.

The planning opportunity here is classical income shifting. This is done by pulling income forward into 2024 and 2025 and paying taxes now at lower rates versus the potential of paying taxes at higher rates in 2026 and beyond. Or taxpayers could try to postpone deductions until after 2025, where they may offset higher tax rates. One idea that would pull income forward and should be explored particularly in the next two tax years is making Roth conversions. This concept will be explained in more detail below.

Itemized Deductions

First, however, keep in mind that State and Local Tax (SALT) deductions were capped at \$10,000 under the TCJA. This actually caused most taxpayers to forego itemized deductions because the standard deduction was more beneficial. Should the TCJA sunset and tax rates go up, the silver lining is that the return of SALT deductions would be a source of relief for taxpayers in states with high taxes. These states include California, New York, and Connecticut, among others. In most cases, the amount of taxes paid will still be higher in 2026 and beyond even after this helpful offset.

As an illustration, consider a married couple filing jointly in California with a combined household income of \$450,000, an estimated home value of \$1.5 million, and no mortgage. An additional \$13K in deductions could be available in 2026 if SALT returns, as follows: Assuming the couple is in the 24% federal tax bracket and the 9.3% California bracket, they would be subject to an estimated \$12K in property tax and \$34K in California state income tax in both 2024 and 2026 assuming no income or property value growth over that two-year period.

Under the current tax law, where the couple would only be able to deduct \$10,000 of the property and income tax figures mentioned, they would most likely want to take the standard deduction amount of \$29.2K. Applying the couple's tax rate to the standard deduction, the available reduction in tax liability on a 2024 return would be an estimated \$7K.

By comparison, should the TCJA sunset in 2026 and the unlimited deduction on state and local taxes return, the couple would be eligible to deduct the \$46K of property and income tax mentioned above on their return at an elevated 28% federal tax bracket for an estimated reduction in tax liability of \$13K, resulting in a \$6K benefit versus the current tax structure. The overall liability may be higher, but this benefit will help defray it.

The tax planning thought here is to wait until 2026 to pay final state income tax estimates and the second half of the property tax bill.

The Roth Solution

One strategy that could be effective for reducing future income AND estate taxes would be converting funds in traditional IRAs into a Roth IRA, known as a Roth Conversion. Conversions into a Roth IRA with after-tax dollars grow completely tax-free and have no required minimum distributions. Although income restrictions exist on direct Roth contributions, conversion strategies are only limited by the amount of tax one is willing to pay on a conversion. The general guideline here is to try to do the Roth conversion (and pay the ordinary income tax) while in lower tax brackets to avoid payments in higher tax brackets later. That certainly seems to be a possibility in 2024/2025 vs 2026. For those nearing retirement or currently in retirement with an extended time horizon, a Roth Conversion strategy could be an option for managing future tax bills more

efficiently. Gradually converting traditional retirement savings into a Roth IRA over the coming years can reduce future income taxes in retirement and provide advantageous estate planning for heirs.

Before moving forward with a conversion strategy, several conditions need to be considered. To avoid taxes or penalties on early withdrawals, an individual must be at least 59 ½ years old when making the first account transfer. In addition, the Roth account must also have remained open for at least five years after the last conversion before any transfers can be made penalty-free. It's important to assess how traditional IRAs or other savings accounts fit into cash flow needs in retirement to understand if the post-conversion five-year tie-up period presents a cash flow challenge. Additionally, taxes must be paid on any balance converted at ordinary income rates in the year(s) when funds are converted. It is also beneficial to have sufficient liquidity available to cover the taxes, ensuring that additional funds do not need to be pulled from retirement accounts, which could deplete the principal or push you into a higher tax bracket.

When it comes to estate planning, performing a single or multi-year Roth conversion can reduce the value of an estate by the amount of income taxes paid on the conversion in those years. The advantages for heirs is that the Roth or income earned by the Roth will never be taxable to them. They could withdraw the entire amount immediately in a tax-free lump-sum withdrawal (assuming the account meets the five-year test mentioned above). Or they would have the ability to let the account grow (subject to complex RMD rules) for up to 10 years, withdrawing the funds over the 10 years and still paying no income taxes at the later dates.

Estate Tax & Gifting

In 2017, individuals could transfer up to \$5.49 million tax-free to heirs using their lifetime estate tax exemption. The TCJA doubled this amount and adjusted it for inflation so that it currently totals \$13.61 million for a single filer, and \$27.22 million for a married couple. Assets transferred over and above the current exemption limits are subject to the federal estate transfer tax of approximately 40%.

As with the other TCJA provisions, the higher estate tax exemption could expire at the end of 2025. If it does, the exemption will revert to an inflation-adjusted estimate of \$7 million per individual (\$14 million for married couples) starting January 1, 2026.

In addition to the above sunset, the IRS issued a regulation in 2019 known as the Anti-Clawback Rule. This rule clarified that individuals or estates will not be taxed on gifts made under the higher limits before 2026, and that a decedent's exemption amount will be the greater of the previously gifted amount or the amount stated in the current laws at the time of death. Together this presents an important opportunity for individuals and families to initiate plans for transferring wealth across generations.

The time for action is closing in for those with estates that could benefit. Only two tax years remain to take advantage of the elevated lifetime exemption limits. If no action is taken, a significantly larger portion of an estate could be subject to taxes at the time of death, leaving a reduced value available for the next generation.

In addition to the estate tax exemption, current estate law also allows for tax-free transfers through annual gifting. These gifts are part of the "unified gift and estate tax system," where the lifetime exemption and annual gifting are interconnected. In 2024, the annual gifting limit is \$18K for individuals and \$36K for married couples. Gifts can be given up to these amounts each year to as many recipients as the donor wishes. While these totals may not seem to have much of an impact to one's wealth transfer goals, if done consistently over periods of time, the compounding of returns can have a substantial impact on the recipients' own estates. Gifts that fall within the annual exclusion amount do not affect the lifetime estate tax exemption.

Conclusion

There is no guarantee that the TCJA will expire but based on history, future changes are inevitable. Therefore, it will be beneficial to plan ahead and consider potential future adjustments not only for one's own financial well-being but also that of one's heirs. Understanding the current provisions of the TCJA and how they might change by 2026 can be helpful in creating a comprehensive financial plan that aligns with your goals.

To make the most informed and effective decisions, starting discussions early is important so that all strategies and plans have enough time for consideration. If multiple experts are required, ensuring all are on the same page is important. Working closely together, advisors can effectively guide from initial plan development to implementation. At the very least, it's advisable to review all estate planning documents to ensure they reflect all goals accurately. Proper financial and estate planning today can help to minimize future taxes and allow the passing of a larger estate on to subsequent generations and other beneficiaries.

Traditional IRA account owners have considerations to make before performing a Roth IRA conversion. These primarily include income tax consequences on the converted amount in the year of conversion, withdrawal limitations from a Roth IRA, and income limitations for future contributions to a Roth IRA. In addition, if you are required to take a required minimum distribution (RMD) in the year you convert, you must do so before converting to a Roth IRA. Investing involves risk, including possible loss of principal.

This information is not intended as a recommendation. The opinions are subject to change at any time and no forecasts can be guaranteed. Investment decisions should always be made based on an investor's specific circumstances.

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