CIO suggests developing a savings strategy during your working years based on your family's earnings, company benefits programs, and financial goals. (Getty)

How to prepare for (potentially) higher taxes

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Many families are rightfully concerned that higher tax rates could impact their financial plans. CIO discusses what a higher personal tax burden may look like, how this might impact your retirement plan, and shares seven strategies you can use to manage your tax liabilities, regardless of what future tax rates will look like.

What might a higher tax burden look like?

Higher income, capital gains, and dividends taxes

President Biden's budget proposal for fiscal year 2025 aims to keep most of the income tax brackets intact but would seek an increase in the top income tax bracket from 37% up to 39.6% for income above $400,000 for single filers and $450,000 for joint filers.

In addition to increased income tax rates, Biden is proposing a more progressive investment tax structure that would tax capital gains and dividends as ordinary income for the wealthy. Currently, these taxes are mostly "flat" across the income spectrum, going from 0% to 15% for income above $47,025 and from 15% to 20% for incomes above $518,900.

These tax rates don't include the Net Investment Income Tax (NIIT), which is a surtax of 3.8% that kicks in for incomes of above $250,000 (under current law) for those who are married and file jointly. Biden has proposed raising the NIIT rate to 5%.

These proposals would mean that if ordinary tax rates increase to 39.6%, the capital gains and dividend tax could almost double from 23.8% to 44.6% (including the NIIT) for investors with taxable income over $1 million. It's important to note that municipal bond interest income is currently exempt from the Net Investment Income Tax.

A less-accommodative estate tax policy

Under the current law, an individual can give away $13.61 million ($27.22 million for married couples) to others during their lifetime or at death without being subject to gift or estate taxes (which have a top tax rate of 40% for amounts over $1 million). Without congressional action, these amounts are set to continue to increase with inflation through 2025, after which they'll decrease back to about $6.5 million per individual.

We expect Congress to address this expiring Tax Cuts and Jobs Act (TCJA) provision in 2025, but the outcome is uncertain, and much will depend on the degree of control exercised by one party or the other. Absent a unified government under GOP control, we anticipate that the size of the exemption will likely decline in 2026, though it might not revert to the $6.5 million threshold.

What should you do?

1. In your working years, use the "savings waterfall" to enhance flexibility

Tax diversification doesn't come with an optimal ratio of taxable, tax-deferred, and tax-exempt assets. The most important objective is to find a balance. We suggest developing a savings strategy during your working years based on your family's earnings, company benefits programs, and financial goals. To help you with this, our **Savings waterfall worksheet** prioritizes account types based on after-tax growth potential, and it provides a good tool for evaluating key elements on a year-by-year basis, including a summary of the contribution limits for 2024.

2. Use the "spending waterfall" to manage taxes in retirement

Instead of sticking to the required minimum distributions (RMDs) that are mandated by the government, we recommend working with your financial advisor and tax advisor on a dynamic withdrawal strategy that distributes enough from your tax-deferred accounts to fill up your tax bracket each year in retirement.

To the extent that your distributions are needed to fund your spending, you can follow the "spending waterfall," (see page 4 of the **full report** for an illustration of the waterfall) which will help you draw cash flow from your retirement assets in a tax-efficient sequence.

3. Defer capital gains (when it makes sense)

Even if you're sure that capital gains tax rates will go higher in the future, that doesn't necessarily mean that you'll be better off realizing capital gains now to lock in today's long-term capital gains tax rate of 23.8%. That's because the dollars that you would have to give to tax authorities would no longer be growing in your account. The return on deferred long-term capital gains tax payments is likely, over time, to be worth more than the additional taxes that you might pay in the future.

4. Increase after-tax growth with "asset location."

Asset location is the strategy of allocating the right investments (stocks, bonds, etc.) in the right accounts (taxable, tax-deferred, tax-exempt); in our view, this can help to boost your family's after-tax growth potential, especially by holding high-income and high-turnover investments in tax-advantaged accounts where they will not produce a "tax drag" on returns.

5. Revisit your estate plan and consider accelerating lifetime gifting

Looming reductions to the lifetime gift and estate tax exemption create a "use-it-or-lose-it" opportunity to potentially save millions in estate taxes. Strategic lifetime gifting is imperative if you want to protect your assets—and their appreciation—from being included in your taxable estate, so completing gifts today will help you utilize the historically high exemption before it's too late.

6. Give to others, with growth.

Donor advised funds, private foundations, and some trusts can offer the potential to make gifts out of your taxable estate today and grow those assets for years or decades before ultimately disbursing your gift—and any gains—to charities and other nonprofit organizations. These can help to reduce or defer your tax payments and help you to increase the after-tax value of your gifts.

7. Give stocks to charity.

Donate securities that have appreciated in value to charities or to a donor advised fund, rather than realizing capital gains and using a cash to cover the tax cost. Nonprofit organizations are shielded from taxation, so they can benefit from capital gains on prior investments without incurring a liability at year-end.

The US tax code is structured in a way to encourage charitable giving by way of the income, gift, and estate tax charitable deductions. However, the tax rules and limitations around charitable giving can be complex. For a general overview of the tax rules around charitable giving, along with a description of the permissible vehicles available to accomplish your philanthropic goals, please see, **Charitable giving: The rules of the road**.

For more on these strategies, reach out to your UBS Financial Advisor and read the full report **Modern Retirement Monthly: How to prepare for (potentially) higher taxes** 24 April 2024.

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