INSIGHTS
PACIFIC LIFE
RETIREMENT STRATEGIES GROUP | NOVEMBER 2023 TAX PLANNING

Helping Clients Pursue Better Outcomes for April 15 Starts Now

Tax time is in spring, right? Clients may think so, but you know that after a year of market volatility and a significant rise in interest rates, it may be smart for them to think about taxes at year-end, well before any filings are due.

Why should you and your clients think about taxes now? Equities have rebounded from their 2022 lows, and interest rates have risen significantly, providing hefty fixed-income returns. All of which means your clients may be looking at recognizing taxable gains or, in the case of losses, needing to reposition assets to lock in those losses for tax purposes. What are the options? Let's take a look at both **tax-loss harvesting** and correcting **underwithholding**.

Tax-Loss Harvesting

The process of tax-loss harvesting is simple: Sell portions of a portfolio and recognize a loss. Then, purchase a similar, though not identical, investment to replace it. The losses that are recognized can be used to offset gains on the current tax return plus up to $3,000 in ordinary income. The losses also can be carried forward indefinitely and used on future tax returns. For taxpayers who file as married filing jointly, if a spouse dies, losses not used on the final joint return and attributable to the surviving spouse also may be carried forward on tax returns.

For clients with losses, tax-loss harvesting may be an opportunity to adjust the portfolio and apply the loss against ordinary income, including a Roth conversion.

However, here are some ways to avoid certain tax "gotchas":

- **Remember the "Replacing with Substantially Similar Investment Rule"**—This rule states that the new investment must not be substantially like the one sold. One could sell a hypothetical ABC Growth and Income Fund and replace with XYZ Growth Fund as they are unlikely to hold identical investments. However, one can't sell the ABC S&P 500® Index Fund and replace it with XYZ S&P 500® Index Fund as the indexes are substantially similar. For this reason, actively managed funds, both equity and fixed income, are typically chosen as replacements. With fixed-income securities, it's important to avoid the same CUSIP number.
- **Be Wary of Wash Sales**—A wash sale results when a security is sold for a loss and is replaced with a substantially identical security within 30 days prior to or after the sale. This includes options contracts on said securities. Common errors in wash sales include:
  1. Failure to consider dividend reinvestment.
  2. Failure to consider IRA/Roth IRA accounts; the wash-sale rule will apply even if the substantially identical security is purchased in an IRA or Roth IRA. What this means is that if the client takes the loss in a nonqualified account, the client cannot repurchase the substnatially identical one in an IRA or Roth IRA.

There is no wash-sale rule for gains. An investor is free to sell and repurchase securities immediately. Investors in the 0% long-term capital gains bracket may sell to recognize gains at 0%, then repurchase to raise their basis.

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EXAMPLE: Tax-Loss Harvesting and Wash Sale

John purchased ABC Corporate Fixed Income Fund in January 2022 for $100,000. Today, that investment is worth $85,000. If John sells today, he can recognize a long-term capital loss on his investment. He can then use that loss to offset long-term capital gains, short-term capital gains, and ordinary income taxes up to $3000 this year. Any unused loss may be carried forward against gains on future tax returns. With an understanding of wash-sale rules, John's financial professional suggest another corporate income fund from a competitor.

Correcting Underwithholding

When investors derive most of their income from retirement-account distributions of investment gains, they may not realize that they aren't withholding to prepay their taxes. While working, they undoubtedly had taxes withheld from their paychecks, but many people don't think to do this with distributions or to make the quarterly payments. An annual withholding checkup can help avoid a tax surprise for retirees.

Paying those quarterly estimated taxes can be a surprise, but not nearly as much so as the penalties for underwithholding. Many taxpayers need to make estimated tax payments of 100% of their previous year's tax liability to avoid penalties. For high-income earners, it can be 110%.

For retirees who forget to withhold, a sizable penalty may be waiting because estimated tax payments are required quarterly. They may have a way out if they are eligible to take an IRA distribution. They can elect withholding on their end-of-year IRA distribution. Withholding on IRA distributions is treated as though it had been done evenly throughout the year regardless of when distributions were taken. Many seniors who don't want to bother with quarterly estimated payments elect 100% withholding (prepayment of taxes) on IRA distribution and RMDs.

Tax-Savvy Guidance May Make for a Better Springtime Ahead

As we close out a tumultuous year in the markets, now may be a suitable time to review your clients' holdings and suggest some tax-savvy investment moves that could create better tax situations come spring. We'd be happy to answer any questions as you add further value to the business you do with clients.

ACTIONS YOU CAN TAKE RIGHT NOW

- **Review your clients' taxable investment accounts for possible harvesting of losses or 0% gains.**
- **Review clients' year-to-date withholding and estimated tax to determine if there is associated liability.**
- **Meet with client to make changes.**

Additional Resources and Links

Tax Planning Checklist

IRS: Investment Income and Expenses

Dealing wtih Carryovers When a Spouse Dies

For more information about retirement planning, please contact our Retirement Strategies Group at RSG@PacificLife.com or (800) 722-2333, ext. 3939.

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