CANAL CAPITAL MANAGEMENT

Tax & Planning News
Year-End 2022

Year-End Tax Planning

With five weeks left, in what has been a roller coaster of a year for financial markets, deadlines are quickly approaching to implement strategies for 2022 to reduce your income tax liability. Further, the market has also presented new opportunities to structure portfolios for tax-efficiency as we head into 2023. Below we have outlined a few planning thoughts. Happy reading!

Moves to Make Before Year-End

- Make sure you paid enough taxes for the year – now is the best time to see if you have withheld enough taxes and, if not, make a final estimated payment due by January 15, 2023.
- Maximize annual contributions to retirement plans, traditional IRAs, Roth IRAs, HSAs, and other tax-efficient vehicles (October 2022 Blog).
- Review your charitable giving strategy to determine if it is beneficial to make additional donations in 2022 or establish a Donor Advised Fund (DAF) to accelerate deductions or wait until 2023.
- If you are self-employed, you may be able to defer income into 2023 and accelerate deductions into 2022. Since 2017, bonus depreciation allows businesses to deduct up to 100% of the cost of certain asset purchases in one year but starting in 2023 the bonus depreciation will be reduced to 80% first year deduction (then 60% in 2024, 40% in 2025, etc.). Additionally, the 2022 General Assembly passed a bill that may yield significant tax savings for Virginia business owners this year – this strategy is outlined in the "Virginia PTE" section below.
- Review your estate plan – significant changes to the current estate tax exemption are expected in 2025 and the most effective gifting plans take years to implement.
  - The 2022 annual gift exclusion is $16,000 per person and will increase to $17,000 per person in 2023.
- Know your tax bracket, as certain planning strategies outlined in more detail within this letter are most effective at specific tax brackets and involve tax "bracket management" (see below).

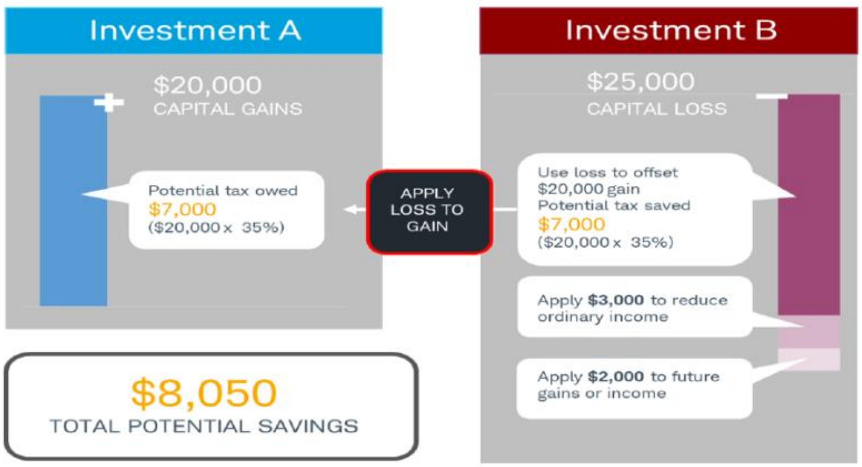
Individual		
Income up to	Ordinary income tax rate	Qualified dividend & capital gain tax rate
$10,275	10%	0%
$41,676	12%	
$41,775		15%
$89,075	22%	
$170,050	24%	
$215,950	32%	
$459,750	35%	20%
$539,900		
$539,900+	37%	

Married Filing Jointly		
Income up to	Ordinary income tax rate	Qualified dividend & capital gain tax rate
$20,550	10%	0%
$83,351	12%	
$83,550		15%
$178,150	22%	
$340,100	24%	
$431,900	32%	
$517,200	35%	20%
$647,850		
$647,850+	37%	

Turn a Loss into a Tax Win

The volatility of financial markets this year has provided significant opportunities to tax loss harvest within investment portfolios, using losses for a tax break. Capital losses can offset capital gains from stock sales, the sale of real estate, or other asset sales. If losses exceed gains, up to $3,000 of capital losses annually can also be used to reduce ordinary income, including wages, interest, and business income. Any unused net losses carryforward to the next tax year to offset future capital gains, for the potential to reduce taxes for many years.

The chart below illustrates how losses from one investment, Investment B, can offset both the gains from another investment, Investment A, and $3,000 of ordinary income resulting a signifcant tax savings.



When tax-loss harvesting is done effectively, a position is sold for a capital loss then proceeds are used to purchase a replacement holding for 30 days. On day 31, the investor can sell the replacement holding and repurchase their original holding.

We know that there will be future gains in stock, bond, and real estate investments, so "harvesting" any capital losses available will reduce taxes in both 2022 and future tax years.

Investing for Tax-Advantaged Income

With interest rates rising over the first nine months of this year faster than any other rate increase in modern history, one silver lining is that investors now can earn yields on bonds not seen in over a decade. Within fixed income, there are distinct differences in how various types of bonds (Treasuries, corporate bonds, and municipal bonds) are taxed. It is also important to understand the taxation of bonds compared to taxes on qualified stock dividends, which for almost 20 years have been taxed at a lower rate than many other types of income.

- **Treasuries** – Bonds issued by the U.S. Department of the Treasury to finance the government's spending activities. Treasuries are fully taxable at the Federal level (ordinary rates) and **tax-exempt** at the state level.
- **Corporate Bonds** – Bonds issued by corporations to finance ongoing operations, M&A, or to expand business. Corporate bonds are fully taxable at the Federal and state levels (ordinary income).
- **Municipal Bonds** – Bonds issued by states, cities, counties, and other governmental entities to fund ongoing obligations and finance capital projects such as schools, highways, and infrastructure. Municipal bonds are **tax-exempt** at the Federal level but may be subject to state income tax if the bond was sourced from a state other than the taxpayer's resident state.

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- **Qualified Dividends –** Dividends issued by domestic companies and certain foreign companies that meet the criteria to receive preferential tax treatment. Most of your "blue chip" stocks pay qualified dividends. Qualified dividends are subject to a **maximum Federal tax rate of 20%** and fully taxable at the state level.

The chart below compares the maximum Federal and state (Virginia) tax rates for each of the four types of income investments outlined above, with treasuries and corporates being less tax-efficient and better suited for tax-deferred vehicles (such as IRAs) and municipal bonds and qualified dividends being more tax-efficient.

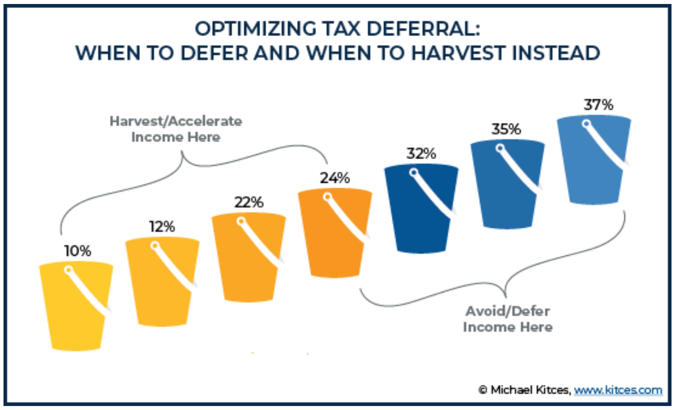
	Income Source:			
Subject to...	Treasuries	Corporate Bonds	Municipal Bonds	Qualified Dividends
Federal Tax	Yes	Yes	No	Yes
State Tax	No	Yes	Yes (if non-resident state)	Yes
Federal Tax Rate (maximum)	37%	37%	0%	20%
Virginia Tax Rate	0%	5.75%	5.75%	5.75%
Maximum Tax Rate (%)	**37%**	**42.75%**	**5.75%**	**25.75%**

Rates above exclude 3.8% Medicare Surtax

In the current environment, particularly in light of the increase in interest rates during 2022, we continue to review portfolios and structure investments and asset location to take advantage of lower tax rates of certain bonds and qualified dividends, as well as other asset classes with tax-efficient income streams such as real estate.

Evaluate Roth IRA Conversions for Tax-Free Growth

Lastly, market downturns have another silver lining from a tax planning perspective as they create better opportutnities for Roth IRA planning. Converting assets from tax-deferred IRAs to Roth accounts while account balances are down could minimize the income tax impact of a Roth conversion, and when assets recoup the recent loss, they provide some additional tax-free growth and withdrawals over time.



Roth IRA conversions are simply transferring some or all the assets from a retirement account (such as a 401(k), traditional IRA, rollover IRA, SEP IRA, or SIMPLE IRA) to a Roth IRA account. This conversion or transfer generally results in a recognition of current income and therefore current income tax. We can make a strong case that Roth IRAs are the best assets because growth is tax-free and there are no Required Minimum Distributions (RMDs). In other

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words, once in a Roth IRA there is no future tax on the investments, providing an incredible long-term opportunity to reduce taxes.

Roth IRA conversions are most advantageous when (1) the funds can grow in the Roth IRA for more than five years, (2) a taxpayer is subject to a 24% or lower tax bracket (see chart above – this involves "bracket management") or in a tax bracket that is significantly lower today than expected to be in the future.

Make Energy Efficient Improvements

The Inflation Reduction Act (IRA) passed over the summer extended many energy efficient tax breaks that have been around for years and also created a number of new tax breaks. A lot of attention has been given to the new clean vehicle credit, but we have found that due to price limits and purchaser income limits many are not eligible for this credit when purchasing an electric vehicle.

However, with the passing of the Inflation Reduction Act most taxpayers can take advantage of the following credits:

- **Energy Efficient Tax Credit** – Since 2006 a credit has been available for taxpayers who make energy efficient improvements to their home (heat pumps, air conditioners, insulation, windows, doors, etc.). The credit is subject to a lifetime maximum of $500. The Inflation Reduction Act replaces the old $500 lifetime credit with a $1,200 **annual credit** beginning in 2023. If you have not previously taken advantage of the $500 credit over the past 15 years and you make energy efficient improvements, you can still claim the credit in 2022.
- **Solar Tax Credit** – If you install solar panels on your home, instead of a 26% credit for solar or small wind installations in 2022, it is now a 30% credit and has been extended through December 31, 2032.

Virginia PTE Tax

Earlier this year Virginia passed a bill allowing pass-through entities (PTEs), partnerships and S corporations, to pay state income taxes at the business level in order to take a federal tax deduction for the state taxes paid, thus reducing the taxable income of PTE members and shareholders (April 2022 Blog).

This presents a significant tax saving opportunity for many business owners. Virginia issued draft guidelines for making the election and paying taxes at the business level on October 31st, but we expect final guidance in the coming weeks. For businesses that qualify for the new PTE tax, we will be in touch soon with next steps.

Conclusion

Thank you for taking the time to read this letter. As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall situation. This is a great time to setup a review meeting and review your tax projection.

Sincerely,

Canal Capital Management

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