

Taxes At Your Table - Prepping for Tax Season

Tax filing season may be months away, but it's never too early to think about implementing a tax strategy that could save you money.

To see if there are areas where you could improve your tax situation, and maybe even save some money, start by reviewing the following 6 items:

Review withholdings and estimated tax payments

Double check your withholding and estimated tax payments to ensure you aren't having too much, or too little, withheld from your paycheck.

Some people might think withholding too much is a savvy move, as it should make for a bigger refund. However, over-withholding *can* actually cost you. Remember: The IRS doesn't pay interest on the funds you withhold, so if you've withheld too much or overpaid your quarterly estimated tax payments, you've effectively given up a potential opportunity to generate interest or returns.

Of course, withholding too little can lead to a large bill at tax time, as well as potential penalties and interest if the shortfall is too large, an unpleasant surprise if you haven't planned for it.

A better approach would be to withhold or prepay just enough to match your expected tax obligation. You can always adjust when you get a clearer picture of your likely annual income as the year progresses.

Maximize retirement account contributions

If you have the financial means, be sure to maximize your contributions to tax advantage accounts and consider making your contributions sooner rather than later. Even though you have until year-end to make contributions to your 401(k), or Tax Day for your traditional or Roth IRA, making early contributions to your retirement accounts will give your money more time to benefit from potential long-term compound growth.

Do required minimum distributions (RMDs) apply to me?

If you are age 73 or older and have to take RMDs from your retirement accounts, you must do so before the end of the year. Otherwise, you may have to pay a 25% penalty on the amount not distributed. That said, if you correct the issue by taking your full withdrawal, the IRS may lower the penalty to 10%.

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If you turned 73 this year, you have until April 1 of next year to take your first RMD. However, if you wait until next year to start your RMDs, you will have two distributions in the same year, which could make for a much bigger tax bill.

If you are charitably inclined and do not need the RMD for your living expenses, consider making a qualified charitable distribution (QCD) from your IRA directly to your favorite charity. You can use a QCD to donate up to \$105,000 in 2024 and it will not be included in your income.

Understand the cost basis of investments

If you're planning to sell any investments, know your cost basis before you do so. Managing your cost basis can help you save on taxes.

Your cost basis is essentially what you paid for an investment, including brokerage fees and any other trading costs. The size of any capital gain (or loss), on which your tax obligation will be based, is the difference between the asset's cost basis and the sale price (i.e., what you sold it for minus what you paid). In a simple transaction, the cost basis should be easy to calculate.

However, if you buy the same investment over time, such as through a dividend-reinvestment plan, each block of shares purchased is likely to have a different cost basis and holding period. In these situations, you can pick which shares to sell, giving you the ability to sell the ones that will have the least tax impact.

Alternatively, you can go with the default method, which generally requires less effort on your part, but could cost you more in taxes. Unless you specify otherwise, Schwab uses the "first in, first out" (FIFO) cost basis method as the default method for determining which assets were sold. Beginning in October 2024, newly opened accounts that hold mutual funds will also use FIFO as the default method. (For Schwab clients with accounts opened before October 2024, the average cost method was the default for mutual funds.)

Here is an example of how being selective with your cost basis can matter during tax season: Imagine you accumulated 1,000 XYZ shares at various prices over several years, and then sold 100 of them today, when prices are at an all-time high. With the FIFO method, you would be selling your oldest shares first. Assuming you bought the oldest shares at the lowest prices, the FIFO method would lead to the largest capital gains and therefore the biggest tax obligation.

Are my investments tax-efficient?

Make sure your assets are in the most tax-efficient investment accounts.

For example, a regular taxable account can be a good place to hold tax-efficient investments such as stocks or funds that pay qualified dividends, municipal bonds (for those in higher tax brackets), and most index funds and ETFs as these assets tend not to generate a lot of taxable income. That said, timing matters. Holding such investments for over a year means any gains you make from selling will be taxed at the long-term capital gain rates, which are generally lower than the ordinary income tax rates.

Investments you plan to hold for short term (for a year or less) tend to work better in tax-advantaged accounts, such as a 401(k), IRA, or Roth IRA, since those gains are taxed at the higher ordinary income tax rates. Tax-advantaged accounts are also a good place for actively managed mutual funds that may generate significant short-term capital gains, and corporate bonds that pay interest income.

Assets that you expect will appreciate the most tend to make sense in Roth IRAs and Roth 401(k)s, as potential earnings in such accounts can accumulate tax-free, and qualified withdrawals are also tax-free once you reach age 59 ½, so long as you made the first contribution to the account more than five years ago.

Of course, tax-efficient placement presumes you have different account types. If most or all of your portfolio is in tax-deferred accounts, you'll really only need to focus on your asset allocation strategy.

Review charitable contributions

If you are charitably inclined, consider concentrating your donations into a single year. By giving more in one year, you can maximize your itemized deduction for that year. The next year, you can switch and take the standard deduction, which could increase your overall deductions for that two-year period, resulting in a large tax benefit.

In addition, if you are planning to sell a significant amount of long-term appreciated stock, consider donating a portion of those assets directly to a charity. Subject to certain income limitations, you could get a tax deduction for the full fair market value of the donated stock, and you won't have to pay taxes on the gain.

What about cases where charities cannot accept gifts of appreciated assets? A donor-advised fund (DAF) can be useful. When you place assets in a DAF, you potentially get the full deduction for the charitable gift that year, while the DAF can sell those assets without

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realizing a taxable gain. You can then recommend grants to qualified U.S. public charities of your choice at any time. Once the grant recommendation has been reviewed and approved by the DAF, the charity will receive the grant.

The bottom line

After you decide what to do this year, resolve to make tax planning a year-round exercise. By looking ahead, you will find it easier to check your progress, update your plan and, if necessary, take action long before the tax-filing deadline.