Key Tax Data and Financial Planning Updates for 2023

It's the beginning of a new year, and so now is the to time review some of the key tax changes for 2023, including tax rates, thresholds, limitations, and exemptions for 2023. We'll also offer important planning considerations in light of this information.

We also want to flag a key feature of the recent SECURE 2.0 Act that will connect college 529 account funding and retirement accumulation objectives through a Roth IRA.

Click here for key tax changes for 2023

Due to the surge in inflation, many tax figures annually adjusted for inflation have increased at a historic pace in 2023. For example, the unified gift and estate lifetime exclusion increased by almost $1 million per person for 2023 (from $12,060,000 to $12,920,000). Additionally, the annual gift exclusion limits increased to $17,000 per donor and recipient.

Here's a look at some of the key tax figure changes for 2023:

	2022	2023
Standard Deduction	$12,950 Individual Filers $25,900 Joint Filers	$13,850 Individual Filers $27,700 Joint Filers
Maximum elective deferral to retirement plans	$20,500	$22,500
Limit on annual additions to defined contribution plans	$61,000	$66,000
Health Savings Account (HSA) Contribution limit	$3,650 Individuals $7,300 Family	$3,850 Individuals $7,750 Family
Annual Gift Exclusion Limit	$16,000	$17,000
Unified Gift/Estate Tax Exclusion	$12,090,000	$12,920,000
Maximum Compensation subject to Social Security Payroll Tax	$147,000	$160,200

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Six Planning Strategies to consider:

1. REVIEW ESTATE PLANNING DOCUMENTS AND STRATEGIES

The increase in the lifetime exclusion amount for gifts and estates ($12.92 million per individual in 2023) may lead you to believe that you don't have important estate planning needs. Remember several states (including Massachusetts) have separate estate and inheritance taxes, with a much lower exemption level than the Federal estate tax exemption. Also, remember to consider important documents such as a power of attorney or health care directive.

2. FOR THOSE WITH CONSIDERABLE ASSETS

Consider large gifts now based on the current lifetime gift/estate exclusion before the sunset provision takes effect at the end of 2025. Under current law, at that time the lifetime amount is slated to be roughly cut in half.

Consider using the higher annual gifting limit to transfer wealth to other family members, including 529 plans that allow five years of gifts to be made up front.

Develop a strategy for low cost-basis assets: Ensure stepped-up cost basis is maintained when property is transferred at death. For example, careful consideration should be made around lifetime gifts that may jeopardize a step-up in cost basis on property at death. In the case of a lifetime gift, the cost basis of the property generally carries over to the person receiving the gift.

3. HIGHER CONTRIBUTION LIMITS

for retirement accounts and health savings accounts allows savers to build their tax-advantaged savings.

4.CONSIDER ROTH IRA CONVERSIONS

A thoughtful strategy utilizing Roth conversions that takes into account the increased income tax bracket limits can be an effective way to hedge against higher taxes in the future. In fact, tax rates are scheduled to increase after 2025 when most of the current tax law provisions expire. Lower tax rates now translate to a lower cost for converting.

5.EXPLORE THE "BACK DOOR" ROTH IRA CONTRIBUTION

Taxpayers at higher income levels are prohibited from contributing directly to Roth IRAs. One option is to consider funding a non-deductible (i.e., after-tax) IRA and then subsequently converting to a Roth IRA. For those that have existing IRAs funded with pre-tax dollars, it's important to understand that after-tax and pretax IRA funds must be converted to a Roth IRA on a pro rata basis.

6. CONSIDER THE CHARITABLE ROLLOVER OPTION IF YOU ARE A RETIREE

IRA owners (age 70½ and older) may benefit from directing charitable gifts tax free from their IRA. Since most retirees claim the standard deduction, they will not benefit taxwise from making those charitable gifts unless they itemize deductions.

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SECURE 2.0 -Roth IRA Gamechanger?

Effective in 2024, catch-up contributions to 401(k), 403(b), and governmental 457(b) plans by employees whose wages exceed $145,000 (as indexed) must be made on a Roth basis. This Roth treatment of catch-up contributions is mandatory for any plan that makes catch-up contributions available. Contributions to a Roth retirement plan are made after tax, after which earnings can grow tax-free. While this rule change is clearly a means to provide immediate tax revenue, it also provides a huge opportunity for higher earners to build up their tax-free accounts.

Also beginning in 2024, section 126 of the SECURE Act allows unused funds from a 529 college savings account to be transferred to a Roth IRA free of tax or penalties. For many parents this provides an answer to the question of what to do with a 529 plan if not all the funds were used.

HERE ARE THE RULES AROUND THIS PROVISION

The 529 must be established for at least 15 years before a transfer to a Roth IRA can occur.

The Roth IRA must be established in the name of the 529 beneficiary.

The aggregate, lifetime amount eligible for transfer from a 529 plan to a Roth IRA is $35,000 per beneficiary.

The amount that can be rolled over to a Roth IRA is limited each year based on annual contribution limitations (currently, $6,500 for 2023 or $7,500 if age 50 or older), which will apply to the aggregate of any rolled-over amounts from 529 plans plus any other contributed funds.

The 529 beneficiary who is receiving the transferred funds in a Roth IRA is subject to the same earned income requirement that applies to all IRA contributions (i.e., in order to make an IRA contribution you, or your spouse, must have employment income).

Any contributions to the 529 plan within the last five years (and the earnings on those contributions) are ineligible to be rolled over to a Roth IRA. This is meant to deter someone from making a large contribution into an existing 529 plan and trying to transfer funds to a Roth IRA immediately to avoid income limits associated with Roth IRA contributions.

Wondering if you should help your child or grandchild with either education savings or retirements savings? Now, you may be able to do both at the same time. For example, if a 529 account is established during the first year of a child's life, the parent could begin transferring funds from the 529 to a Roth IRA when the child is roughly 16 years old, assuming the child has earned income from working.

The language in the legislation ties the $35,000 lifetime limit to the beneficiary level, so a parent could transfer that amount for each child. This may allow time for contributions to appreciate tax free within the 529 and eventually be transferred to the Roth where it could be withdrawn tax free if requirements are met. Don't forget that several states also provide an income tax advantage when contributions are made to the state-sponsored 529 account.

It gets even better when you consider that a parent could allocate some funds to a 529 while naming themselves as the beneficiary. If those funds are needed for higher education in the future, the parent could change the beneficiary to the student. If not, the parent could remain the beneficiary and begin transferring funds to a Roth IRA for themselves once the 529 account has been established for 15 years. However, one imagines that Congress could be concerned with perceived abuses of this new rule and what is ultimately allowed may be impacted by future interpretation and guidance from the IRS.

Speaking of interpretation, it remains to be seen whether a change in the 529 beneficiary would trigger a reset of the 15-year clock requirement for transferring funds to a Roth IRA. Additionally, would the 15-year clock reset if the 529 owner rolls from one state's qualified tuition plan to another? Yes, guidance from the Treasury Department will be needed.

Seek professional advice

A new year always brings with it new opportunities, and that is certainly the case when it comes to personal financial planning. Personal circumstances vary widely, so individuals should consult a qualified tax or legal professional and a financial advisor to discuss how these strategies could be used to accomplish their objectives around wealth accumulation, preservation, and transfer.