Bartholomew & Company Monthly

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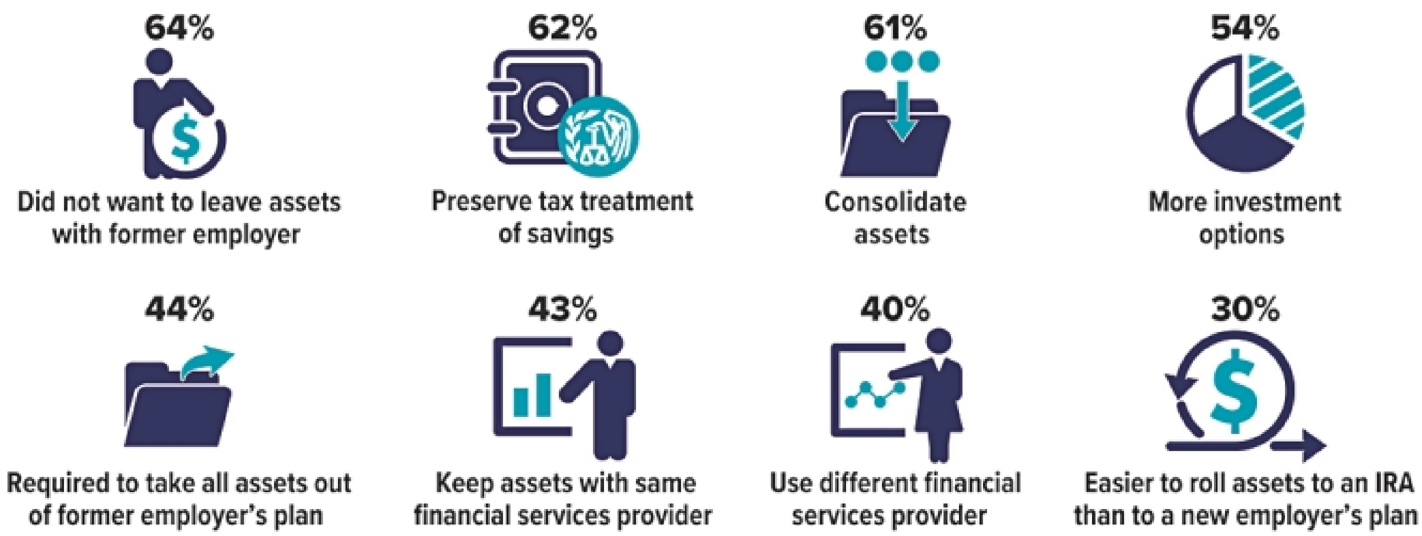
Reasons to Roll

When you leave your job or retire, you have an opportunity to manage your funds in an employer-sponsored retirement plan such as a 401(k), 403(b), or government 457(b) plan. Depending on the situation, you generally have four options.* The approach that typically gives you the most control over the funds is to transfer some or all of the assets to an IRA through a rollover.

Three out of five households who owned traditional IRAs in 2022 had executed at least one IRA rollover from an employer-sponsored retirement plan. These were the top reasons for the most recent rollover.



*Other options may include leaving assets in the former employer's plan, transferring assets to a new employer-sponsored plan, or withdrawing the money.

Source: Investment Company Institute, 2023 (multiple responses allowed)

How Taxes Impact Your Retirement-Income Strategy

Retirees face several unique challenges when managing their income, particularly when it comes to taxes. From understanding how taxes relate to Social Security and Medicare to determining when to tap taxable and tax-advantaged accounts, individuals must juggle a complicated mix of factors.

Social Security and Medicare

People are sometimes surprised to learn that a portion of Social Security income becomes federally taxable when combined income exceeds $25,000 for single taxpayers and $32,000 for married couples filing jointly. The taxable portion is up to 85% of benefits, depending on income and filing status.[1]

In addition, the amount retirees pay in Medicare premiums each year is based on the modified adjusted gross income (MAGI) from *two years earlier.* In other words, the cost retirees pay for Medicare in 2023 is based on the MAGI reported on their 2021 returns.

Taxable, Tax-Deferred, or Tax-Free?

Maintaining a mix of taxable, tax-deferred, and tax-free accounts offers flexibility in managing income each year. However, determining when and how to tap each type of account and asset can be tricky. Consider the following points:

Taxable accounts. Income from most dividends and fixed-income investments and gains from the sale of securities held 12 months or less are generally taxed at federal rates as high as 37%. By contrast, qualified dividends and gains from the sale of securities held longer than 12 months are generally taxed at lower capital gains rates, which max out at 20%.

Tax-deferred accounts. Distributions from traditional IRAs, traditional work-sponsored plans, and annuities are also generally subject to federal income tax. On the other hand, company stock held in a qualified work-sponsored plan is typically treated differently. Provided certain rules are followed, a portion of the stock's value is generally taxed at the capital gains rate, no matter when it's sold; however, if the stock is rolled into a traditional IRA, it loses this special tax treatment.[2]

Tax-free accounts. Qualified distributions from Roth accounts and Health Savings Accounts (HSAs) are tax-free and therefore will not affect Social Security taxability and Medicare premiums. Moreover, some types of fixed-income investments offer tax-free income at the federal and/or state levels.[3]

The Impact of RMDs

One income-management strategy retirees often follow is to tap taxable accounts in the earlier years of retirement in order to allow the other accounts to continue benefiting from tax-deferred growth. However, traditional IRAs and workplace plans cannot grow indefinitely. Account holders must begin taking minimum distributions after they reach age 73 (for those who reach age 72 after December 31, 2022). Depending on an account's total value, an RMD could bump an individual or couple into a higher tax bracket. (RMDs are not required from Roth IRAs and, beginning in 2024, work-based plan Roth accounts during the primary account holder's lifetime.)

Don't Forget State Taxes

State taxes are also a factor. Currently, seven states impose no income taxes, while New Hampshire taxes dividend and interest income and Washington taxes the capital gains of high earners. Twelve states tax at least a portion of a retiree's Social Security benefits.

Eye on Washington

Finally, both current and future retirees will want to monitor congressional actions over the next few years. That's because today's historically low marginal tax rates are scheduled to revert to higher levels in 2026, unless legislation is enacted (see table).

Help Is Available

Putting together a retirement-income strategy that strives to manage taxes is a complex task indeed. Investors may want to seek the help of a qualified tax or financial professional before making any final decisions.[4]

Tax Rates Scheduled to Rise

Unless legislation is enacted, federal marginal income tax rates are scheduled to rise in 2026.

Current rate	2026
10%	10%
12%	15%
22%	25%
24%	28%
32%	33%
35%	35%
37%	39.6%

1) Combined income is the sum of adjusted gross income, tax-exempt interest, and 50% of any Social Security benefits received.

2) Distributions from tax-deferred accounts and annuities prior to age 59½ are subject to a 10% penalty, unless an exception applies.

3) A qualified distribution from a Roth account is one that is made after the account has been held for at least five years and the account holder reaches age 59½, dies, or becomes disabled. A distribution from an HSA is qualified provided it is used to pay for covered medical expenses (see IRS publication 502). Nonqualified distributions will be subject to regular income taxes and penalties.

4) There is no guarantee that working with a financial professional will improve investment results.

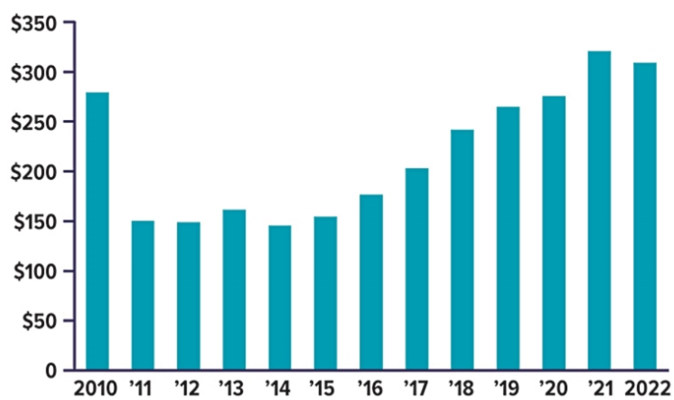
Municipal Bonds: A Tax-Advantaged Way to Put Capital to Work

Municipal bonds are issued by public entities such as state and local governments, health systems, universities, and school districts to help finance the building and maintenance of infrastructure projects such as roads, airports, water systems, and facilities. Despite the higher borrowing costs that resulted from the Federal Reserve's inflation-fighting interest-rate hikes, municipalities issued $308 billion in debt in 2022 to fund capital projects, after selling more than $321 billion in 2021.[1]

At present, many municipalities are in solid financial shape, due to an influx of pandemic stimulus funds and increased income and property tax revenues. Over the longer term, a federal infrastructure bill passed in 2021 is expected to provide additional money for capital projects and help boost municipal credit quality.[2]

This means that investors might be able to tap into the higher yields being offered on muni bonds without taking on greater risk. The yield on the Bloomberg Muni Benchmark 30Y Index, a common benchmark, rose to 3.6% at the end of 2022, after starting the year at just 1.5%.[3]

Municipal bonds issued for new projects, in billions



Source: Refinitive, 2023

Accounting for Taxes

The interest paid by municipal bonds is generally exempt from federal income tax, as well as from state and local taxes if the investor lives in the state where the bond was issued. For this reason, muni bonds and tax-exempt funds have long been a mainstay in the portfolios of income-focused investors who want to manage their tax burdens.

The taxable equivalent yield is the pre-tax yield that a taxable bond must offer for its yield to be equal to that of a tax-exempt muni bond. Tax-free yields are often more valuable to investors in higher tax brackets, and they have become especially appealing in high-cost states now that the federal deduction for state and local taxes is limited to $10,000 a year.

For example, a 5% tax-free yield is equivalent to a taxable yield of about 7.9% for an investor in the 37% bracket and 6.6% for an investor in the 24% tax bracket. Exemption from state income taxes would increase the equivalent yield.

Investors should keep in mind that capital gains taxes could still be triggered if tax-exempt bonds or fund shares are sold for a profit. Also, tax-exempt interest is included in determining whether a portion of any Social Security benefit received is taxable. Some muni bond interest could be subject to the alternative minimum tax.

Reviewing the Risks

Because government entities have the power to raise taxes and fees as needed to pay the interest, muni bonds generally carry lower risk than corporate bonds. From 1970 through 2021, the 5-year default rate for U.S. municipal bonds was 0.08%, compared with 6.8% for global corporates.[4]

Regional economies and the financial strength of issuers can vary widely, so municipal issues are rated for credit risk, as are other bonds. A credit rating ranging from AAA down to BBB (or Baa) is considered "investment grade"; lower-rated or "high yield" bonds carry greater risk.

As interest rates rise, bond prices fall, and vice versa. When redeemed, bonds may be worth more or less than their original cost. Bond funds are subject to the same inflation, interest-rate, and credit risks associated with their underlying bonds. The return and principal value of bonds and mutual fund shares fluctuate with changes in interest rates and other market conditions, which can adversely affect investment performance.

The performance of an unmanaged index is not indicative of the performance of any specific security. Individuals cannot invest directly in any index. Past performance is no guarantee of future results. Actual results will vary.

Mutual funds and ETFs are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

1) Refinitiv, 2023

2) *The Wall Street Journal,* November 15, 2021

3) Bloomberg.com, November 30, 2022

4) Moody's Investors Service, April 21, 2022

Business Owners Should Prepare for Stronger Tax Enforcement

The Inflation Reduction Act of 2022 is providing the IRS with an influx of about $80 billion to modernize outdated technology and rebuild a depleted workforce, which is expected to improve enforcement to the tune of about $200 billion over a decade. Treasury Secretary Janet Yellen directed the agency not to use additional resources to increase audit rates for taxpayers making under $400,000 a year, but the tax returns of high-earning business owners are likely to face more scrutiny than they have in years past.[1]

IRS audit rates for individual, partnership, and S corporation income tax returns have fallen since 2010, a trend that could reverse as the IRS ramps up enforcement. Higher audit rates won't appear overnight, but large investments to upgrade technology could eventually help the IRS develop more advanced enforcement methods.

With that in mind, here are some tips to help you avoid unwanted attention from the IRS.

Understand the process. Tax returns are randomly selected, which means you might be audited even if you do everything by the book. However, when your tax return is processed, a computer program screens for anomalies and compares deductions to those of taxpayers with similar incomes. Your return is more likely to be chosen if there's a higher chance that it would result in the collection of additional taxes, but an audit can also be triggered by a red flag on your return or a simple mistake that leads to additional questions. If selected for a correspondence audit, you may be asked to mail specific information to the IRS. A comprehensive field audit would be conducted at your home, place of business, or accountant's office.

Avoid common traps. Filing an incomplete tax return (with missing forms or schedules) and not making tax payments on time are surefire ways to attract unwanted attention from the IRS. Taking business deductions that are not in line with industry norms, not categorizing transactions consistently from year to year, having a high number of independent contractors relative to full-time employees, and reporting continuous losses are all situations that can look suspicious, even if they are valid.

Step up your record-keeping. Taxpayers are required to keep tax records for at least three years from the date the tax return was filed. Organizing and possibly digitizing your records could make it easier to respond to any requests for information that may come from the IRS — and not being able to provide a requested document could negatively impact your audit results.

A heightened focus on compliance means it may be more important than ever to consult an experienced tax professional for personalized guidance, especially if you receive any type of communication from the IRS.

1) U.S. Treasury Department, 2022