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Dear Clients,

As year-end approaches, taxpayers generally are faced with a number of choices that can save taxes this year, next year or both years. Employees too are faced with these choices. However, employees have some special considerations to take into account that retirees and other nonworking individuals don't face. To help our clients who are employees take advantage of these special tax saving opportunities, we have put together a list of items to consider.

Health flexible spending accounts. Many employees take advantage of the annual opportunity to save taxes by placing funds in their employer's health flexible spending arrangement (health FSA). A pre-tax contribution of $3,050 to a health FSA is permitted in 2023. You save taxes because you use pre-tax dollars in the health FSA to pay for medical expenses that might not be deductible. They would not be deductible, for example, if you don't itemize deductions. To avoid any forfeiture of your health FSA funds because of application of the use-it-or-lose-it rule, you must incur qualifying medical expenditures by the last day of the plan year (Dec. 31 for a calendar year plan), unless the plan allows an optional grace period.

Dependent care FSAs. Some employers also allow employees to set aside funds in dependent care FSAs. A $5,000 maximum annual contribution is permitted ($2,500 for a married couple filing separately). A dependent care FSA allows employees to use pre-tax dollars to pay for dependent care. In particular cases, participating in a dependent care FSA (for a dependent-qualifying child under age 13, or a dependent or spouse who is physically or mentally incapable of self-care and who has the same principal place of abode as the taxpayer for more than half of the tax year) can yield greater tax savings than foregoing participation and claiming a dependent care credit. However, like health FSAs, dependent care FSAs are subject to the use-it-or lose it rule, but only the grace period relief applies, not the up-to-$570 forfeiture exception.

Adoption assistance FSAs. Under an adoption assistance FSA, adoption reimbursement accounts are established in connection with an employee's adoption of a child, if the amounts are paid or incurred through the employer's adoption assistance program. For taxable years beginning in 2023, employees can contribute, pre-tax, a maximum of $15,950 for amounts paid or expenses incurred for qualified adoption expenses furnished under the employer's adoption assistance program. The limit applies to the adoption of each child and is cumulative over all tax years (rather than applying an annual limit).

Health savings accounts. A health savings account (HSA) can be established only for the benefit of an "eligible individual" who is covered under a "high deductible health plan" or "HDHP." The HSA funds may be used to pay the "qualified medical expenses," including long-term care expenses, of an "account beneficiary." For purposes of determining whether the HSA has been established for the benefit of an "eligible individual" who is covered under an HDHP, an HDHP is (for 2023) a health plan:

(1) that has an annual deductible which is not less than-

(i) $1,500 for self-only coverage, and

(ii) $3,000 for family coverage, and

(2) for which the sum of the annual deductible and the other annual out-of-pocket (OOP) expenses required to be paid under the plan (other than premiums) for covered benefits does not exceed-

(i) $7,500 for self-only coverage, and

(ii) $15,000 for family coverage.

The maximum contribution an individual may make to an HSA, in 2023, is $3,850 for an individual with self-only coverage under an HDHP and $7,750 for an individual with family coverage under an HDHP. A "catch-up" contribution will increase each of these limits by $1,000 where the taxpayer is 55 or older by the end of the year.

Within the IRS dollar limits, an "above-the-line" tax deduction (that is, not requiring the itemization of deductions) is allowed for an individual's contribution to a HSA. Contributions are deducted from the individual's total income in arriving at the individual's adjusted gross income (AGI).

Qualified transportation/parking benefits. The exclusion from income for "qualified transportation fringes," which includes mass transit passes, parking, and vanpooling reimbursement, allows the benefit to be paid tax-free by the employer, under a bona fide reimbursement arrangement, or through a salary reduction arrangement funded on a pre-tax basis by the employee. For 2023, the aggregate fringe benefit exclusion amount for transportation in a commuter highway vehicle (i.e., vanpooling), any transit pass and qualified parking is $300 per month.

Adjustments to state withholding. If you expect to owe state and local income taxes when you file your return next year, ask your employer to increase withholding of state and local taxes, by amending your state withholding form (or pay estimated tax payments of state and local taxes) before year-end to pull the deduction of those taxes into this year. If you become married or single in 2023, or have added or lost a dependent, you should be sure to provide your employer with an updated state tax withholding form that reflects the new filing status or changed exemptions.

***Adjustments to federal withholding*.** If you face a penalty for underpayment of federal estimated tax, you may be able to eliminate or reduce it by increasing your withholding by amending your Form W-4. You should especially review your withholding to ensure that enough tax is withheld if you hold multiple jobs, you and your spouse both work, or you can be claimed as dependent by another person. If you become married or single in 2023, or have added or lost a dependent, or expect increased deductible itemized deductions, you should be sure to provide your employer with an updated Form W-4 that reflects the new filing status or changed exemptions.

***Increase 401(k) contributions*.** The pre-tax and Roth 401(k) contribution limit for 2023 is $22,500. Employees age 50 or older by year-end are also permitted to make an additional contribution of $7,500, for a total limit of $30,000 for 2023. If your employer makes a matching contribution to your contribution, your total retirement savings will increase even faster. Review and make appropriate adjustments to the contributions you make to your employer's 401(k) retirement plan for the remainder of this year, and next year. It's also a good idea to review your investment elections, and their periodic performance. Keep in mind the amount you need to save for the age at which you plan to retire and consider seeing a financial planner to set, and keep to, your savings goals.

***Make Roth IRA contributions*.** The ability to make a Roth IRA contribution (which is a special after-tax contribution) continues even if you're participating in an employer savings plan (like a 401(k)), so it is not subject to the "active participant" rules that may prevent employees who participate in an employer plan from making a deductible contribution to a traditional IRA. The benefit of the Roth IRA is that earnings on the IRA will not be taxable to you on distribution (provided, generally, that distributions are made to you after you attain age 59 1/2). The 2023 Roth contribution limit is $6,500, rising to $7,500 if you're age 50 or older by the end of the year. Your ability to make a Roth IRA contribution will be reduced if your adjusted gross income (AGI) in exceeds:

(a) $218,000 and your filing status in 2023 is married-filing jointly, or

(b) $138,000, and your filing status in 2023 is that of a single taxpayer.

Your ability to contribute to a Roth IRA will be eliminated entirely if you are a married-filing-jointly filer and your 2023 AGI equals or exceeds $227,999. The cut-off for single filers is $152,999 or more.

***Consider converting your traditional IRA to a Roth IRA, or making an "in-plan" Roth conversion*.** Amounts held in your traditional IRA may be converted to a Roth IRA. The "conversion" of a traditional IRA to a Roth IRA is treated as a distribution from the traditional IRA to the Roth IRA, and will result in taxable income (except to the extent of after-tax contributions made to your traditional IRA). The same may be done for amounts that you may hold in a SEP IRA or a SIMPLE IRA. If your employer plan permits and has a "qualified Roth contribution program," you may direct an "in-plan" conversion of taxable amounts in your employer plan to a designated Roth account in

the same plan. Like the conversion of the traditional IRA to a Roth IRA, this conversion will result in a taxable distribution to you for the taxable amounts that are converted.

Consider taking out a 401(k) plan loan instead of taking a distribution, if you need funds. If you need money, you may be tempted to take a plan distribution, to the extent permissible, to satisfy an imminent financial need. If you are under age 59-1/2, this distribution may not only constitute taxable income, but it also will be subject to the 10% premature distribution tax. Thus, if your effective Federal and state income tax rate totaled 25%, you'd have a total tax rate of 35% and would only get use of 75 cents for every $1 distributed from your 401(k) account. A better way to get financial assistance is to borrow from your 401(k) plan, if your 401(k) plan has a loan feature. The amount that you can borrow is subject to certain plan and IRS limits, but you'll generally have five years to repay the loan (or longer, for a home loan), and the interest that you pay will go back into your account. This is a sound way to avoid immediate income taxation on the amount that you require to satisfy your financial need.

We hope these ideas can help you with your tax planning. If you'd like to make an appointment to review any of these items, please don't hesitate to contact us!

Sincerely,

Seby & Associates, Ltd.

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