The Planning Quarterly

Issue 15 | March 2024

PEAPACK PRIVATE

Welcome to the March 2024 issue of the Peapack Private Planning Quarterly. As tax season is upon us, this is a good opportunity to learn about 2023 tax credit updates and to review your 401(k) contributions to maximize available opportunities. Learn about the pros and cons of Annuities, as well as the 4% retirement rule. Please reach out to our authors—or to any of our investment and planning professionals—with your questions and feedback. Ask your own questions—you may inspire a future article. Our guidance can help you achieve your financial goals.

Click to jump to a desired article

Reviewing Your 401(k)

Sarah Vehap, MBA
Wealth Planning Analyst

If you participate in your company's 401(k) retirement plan, the beginning of the year is a great time to review your contributions to ensure you're maximizing available opportunities. These plans are tax-advantaged, as the employee deferral is deducted from wages on a pre-tax basis, and the investments grow tax-free. Furthermore, the investments can be rolled into a traditional IRA after leaving an employer and continue to grow tax-free.

You should review your company's policy and ensure you are maximizing their match, as it is considered "free money."

Items to review at the beginning of the year include: employee deferral percentage, company match, Roth 401(k), investment selection options, and in-service rollovers.

Employee Deferrals:

The employee deferral is the amount that is excluded from your wages on a pre-tax basis. The IRS sets a maximum for employee deferrals:

- The lesser of 100% of compensation, or $23,000 for 2024 (indexed each year). People over 50 years of age can make a "catch up" contribution of $7,500 for 2024.

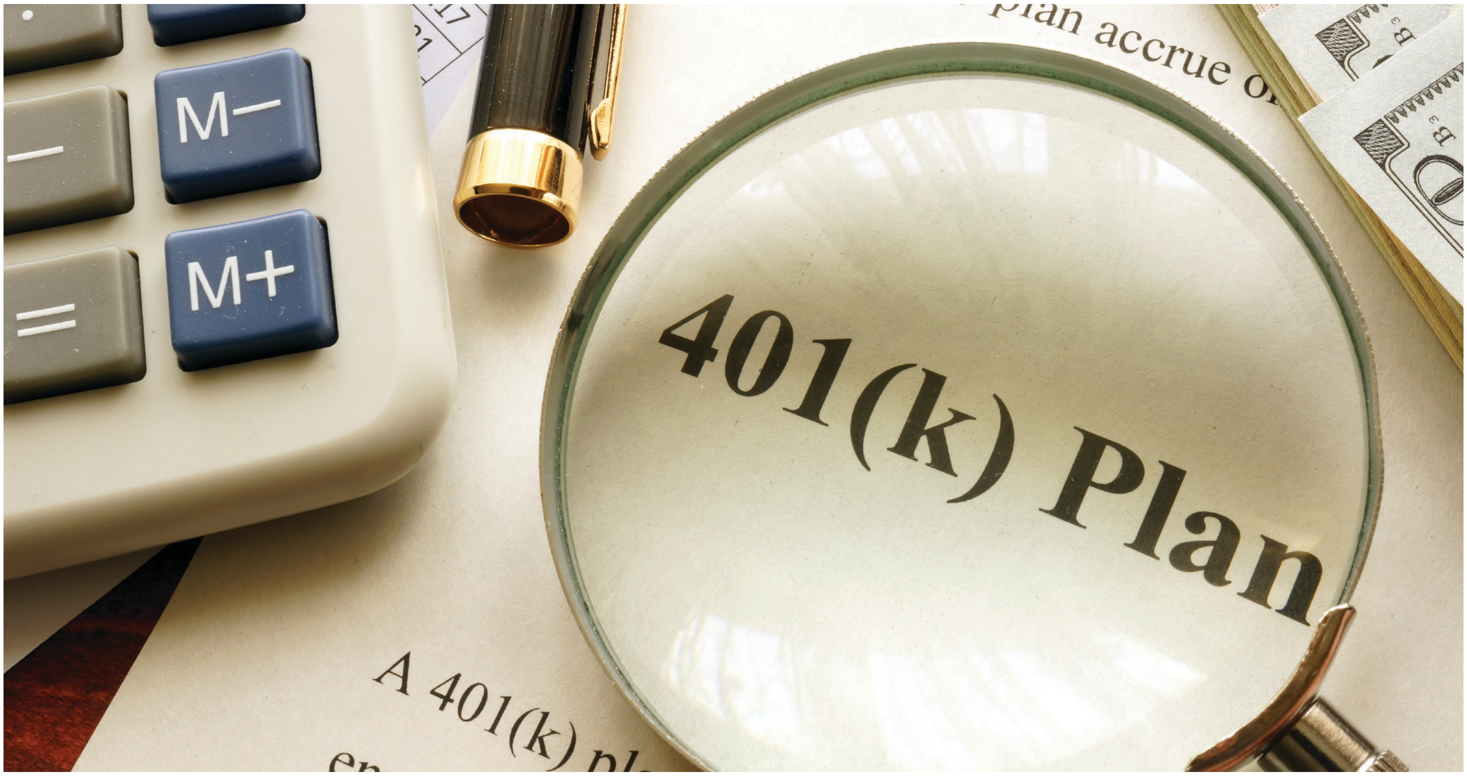
Most employees base their deferral as a percent of their compensation - for instance 6% or 10%. The recommendation is to defer as much as your cash flow permits, staying within the IRS limits. This strategy reduces your taxes in the year you make the deferrals, since they lower your taxable income, increase the investments that grow tax-free, and helps build a retirement nest egg.

Company Match:

Companies have the option to provide a monetary match of the employee's deferral. Although it is not mandatory, employers recognize this feature is a highly sought-after benefit and a significant number of employers offer it. They will use a formula to define their match. For example:

> "50% of the employee deferral up to the first 6% of employee earnings"

This means they will match 50 cents for every one dollar deferred, up to a maximum of 6% of the employee's earnings. You should review your company's policy and ensure you are maximizing their match, as it is considered "free money."



Roth 401(k):

Some, but not all, employers offer a Roth 401(k). Unlike deferrals to a traditional 401(k), contributions to a Roth 401(k) are made on an after-tax basis, rather than on a pre-tax basis, however they grow tax-free, and the big advantage is that qualified withdrawals are tax-free. For people who anticipate that they will be in a higher tax bracket in retirement, this strategy can be beneficial. Employers must have a traditional 401(k) plan in place to offer the Roth 401(k) option. Not all employers provide a Roth 401(k) option because the option has additional administrative expenses over a traditional 401(k).

Investment options:

One of the most important opportunities you have when you review your plan is to understand and evaluate the investment options. Your company's Summary Plan Description (SPD) will list the investment options that are offered, allowing you to research their performance and relative risk. When reviewing performance, be sure to understand the associated fees, as fees will reduce the overall return. Frequently, employee plans offer mutual funds that may have higher fees, as well as ETF funds that may have lower fees. It is a good idea to familiarize yourself with the performance and costs of your investment options.

In-Service Rollovers:

In-service rollovers are direct distributions from your current 401(k) plan while you are still working at the company to a traditional IRA (or Roth IRA) that is managed outside of your company. One of the reasons an employee may want to execute an in-service rollover is to improve investment options, as the IRA would not be constrained by the company's plan options. IRA funds may be invested in most investment vehicles including mutual funds, ETFs, single stocks, REITS, public and private bonds, government securities, etc. Not all plans offer an in-service rollover option, so you must check your SPD first. Additionally, if you decide to take this option, you should confirm that the rollover is a direct transfer from the 401(k) to your IRA and not paid out to you individually, as this may cause tax implications.

Reviewing your 401(k) plan and the options it offers is an important financial activity. Although saving for retirement can feel complicated and overwhelming, taking steps on a regular basis will help you feel empowered to make more decisions and to realize progress toward your goals. It is never too late to start saving, and it is always valuable to review the performance of your holdings and determine what changes make sense for your specific situation. New employees make 401(k) selections at the beginning of their tenure in a new job and may miss the opportunity to review their plan and account on a regular basis. Your cash flow needs may change, the 401(k) plan features may be updated, and investment performance may swing up and down, so an annual 401(k) check-up is in the best interest of your long-term financial health!

If you have questions about your 401(k), please contact one of our wealth advisors.

Contact Sarah Vehap at (908) 227-3773 or svehap@pgbank.com with any questions.

2024 Consumer Tax Credits

Ann Marie Perry, CPA
Managing Director, Client Tax Advisor

Let's talk tax credits. A tax credit is an amount of money that can be offset against a tax liability. Credits are more valuable than deductions since deductions only reduce your income. Credits reduce your tax liability on a dollar-for-dollar basis.

What does it mean when a credit is "refundable" versus "nonrefundable?" A refundable tax credit is a credit you can receive as a refund even if you don't owe any tax. Let's say your tax liability is $1,200 and you are eligible for a $1,400 tax credit. If the $1,400 tax credit is refundable, you will receive a $200 refund ($1,200 tax liability less $1,400 tax credit). If the $1,400 tax credit is nonrefundable, you will break-even…no refund; no balance due. The $1,400 tax credit will eliminate the $1,200 tax liability, but you will not receive the difference of $200.

Let's look at energy credits geared toward vehicles and certain home improvements. These credits are nonrefundable.

Clean Vehicle Tax Credits:

With the passage of the Inflation Reduction Act of 2022, there are changes to the Clean Vehicle Tax Credits as of January 1, 2023. Credits under these rules are available through 2032. The main difference between the 2022 and 2023 credits are that in 2023, the battery capacity must be at least 7 kilowatt hours, EV must undergo final assembly in North America (beginning August 17, 2022), buyers must meet Adjusted Gross Income (AGI) limitations and EV must meet critical mineral and battery component requirements (beginning April 18, 2023). Finally, at the time of sale, the seller must give you information about your vehicle's qualifications and they must report it to the IRS.

Vehicles manufacturer suggested retail price (MSRP) can't exceed $80,000 for vans, SUVs and pickup trucks and $55,000 for other vehicles. You can log on to www.fueleconomy.gov to see if a specific vehicle is eligible for the new clean vehicle credit.

MAGI (Modified Adjusted Gross Income) limitations for 2023 EV Tax Credit:

- $300,000 for Married Filing Joint
- $225,000 for Heads of Household
- $150,000 for all other filers

You can use MAGI from the year you take delivery of the vehicle or the year before, whichever is less.

Credit Calculation for Vehicles Placed in Service from January 1 to April 17, 2023:

- $2,500 base amount
- Plus $417 for a vehicle with at least 7 kilowatt hours of battery capacity
- Plus $417 for each kilowatt hour of battery capacity beyond 5 kilowatt hours
- Up to $7,500 total

The minimum credit will be $3,751 ($2,500 plus 3 times $417)… the credit amount for a vehicle with the minimum 7 kilowatt hours of battery capacity.

Credit Calculation for Vehicles Placed in Service from April 18, 2023 and after:

Vehicles will have to meet all the same criteria noted above, plus meet new critical mineral and battery component requirements for a credit up to:

- $3,750 if vehicle meets critical minerals requirements only
- $3,750 if vehicle meets the battery components requirements only
- $7,500 if vehicle meets both

New for 2024:

Beginning January 1, 2024, Clean Vehicle Tax Credits must be initiated and approved at the time of sale. Buyers are advised to obtain a copy of the IRS's confirmation that a "time-of-sale" report was submitted successfully by the dealer.

USED Clean Vehicle Credit:

Beginning January 1, 2023, if you buy a qualified used electric vehicle or fuel cell vehicle (FCV) from a licensed dealer for $25,000 or less, you may be eligible for a used clean vehicle tax credit. The credit is equal to 30% of the sale price up to a **maximum of $4,000**. Seller must give you information about your vehicle's qualifications at the time of sale and they must register online, giving the IRS the same information. If they don't, your vehicle will not be eligible for the credit. Purchases before 2023 do not qualify. There are MAGI limits on this credit as well:

- $150,000 Married Filing Jointly or Surviving Spouse
- $112,500 Heads of Household
- $75,000 all other filers

You can use MAGI from the year you take delivery of the vehicle or the year before, whichever is less.

Other Key Takeaways for Used Clean Vehicle Credit:

- The model year of the used EV must be at least 2 years earlier than the calendar year when you buy it. For example, a vehicle purchased in 2023 would need a model year of 2021 or older.
- GVW less than 14,000 pounds
- Not have already been transferred after August 16, 2022 to a qualified buyer
- 7 kilowatt hour battery capacity minimum
- For use primarily in the United States
- You buy the vehicle from a dealer only

Energy Efficient Home Improvement Credit:

2023 through 2032:

30%, up to a maximum of $1,200 (heat pumps, biomass stoves and boilers have a separate annual credit limit of $2,000), no lifetime limit.

What improvements qualify for this credit:

- Exterior doors, windows, skylights and insulation materials
- Central air conditioners, water heaters, furnaces, boilers and heat pumps
- Biomass stoves and boilers
- Home energy audits

Residential Clean Energy Credit:

What improvements qualify for this credit:

- Solar, wind and geothermal power generation
- Solar water heaters
- Fuel cells
- Battery storage (beginning in 2023)

2022 to 2032: 30%, no annual maximum or lifetime limit

2033: 26%, no annual maximum or lifetime limit

2034: 22%, no annual maximum or lifetime limit

The Energy Efficient Home Improvement (EEHI) and the Residential Clean Energy Credits (RCEC) must be claimed in the year that the qualifying improvement is made. The EEHI is available only on principal residences; RCEC is available for principal residences as well as 2nd homes unless it is fuel-cell equipment. Fuel-cell equipment only qualifies if installed in your principal residence.

Contact Ann Marie Perry at (908) 719-7816 or aperry@pgbank.com with any questions.

Annuities

Lisa McKnight, CFP®
Managing Director

Annuities are an investment that triggers both confusion and debate. They can be both a great source of income and a complex financial vehicle, but at its simplest an annuity is an insurance contract. You pay a monthly premium (or lump sum) now and in return you are guaranteed a stream of income later. The income benefits vary from contract to contract and are typically associated with your age. You will often have the choice of a lump sum or annuitized payments. Some annuities pay out until death while some only pay for a predetermined length of time. All of this is determined when you buy your annuity contact.

There are basically two types of annuities, with many variations.

Fixed Annuities:

These annuities provide a guaranteed fixed rate of return and stream of income. The interest rate is predetermined and does not change during the accumulation phase. It generally guarantees against a loss of principal. When an immediate fixed annuity is purchased, the amount deposited is essentially a purchase of a pension-like payment for a specified period.

Variable Annuities:

These annuities allow you to choose from a variety of investment options, such as stocks, bonds, and mutual funds. The return on investment is not guaranteed and may fluctuate based on market performance. No guarantees here and there is a degree of downside risk.

As noted, annuities come in many flavors, with various features and options called riders. It would take an entire book to outline and compare all of the annuity types, a combination of potential benefits and significant pitfalls make them difficult to analyze.

Let's explore the pros and cons.

Pros:

1. Fixed annuities provide a reliable and steady stream of income during retirement, ensuring that you have a consistent source of income to cover your living expenses. This guaranteed income is the biggest attraction to a fixed annuity. It may not necessarily be a high level of income, but it provides peace of mind that some level of income will be received.
2. Annuities can provide for longevity protection against the risk of outliving your assets. With a lifetime annuity you receive income for as long as you live, regardless of how long that may be.
3. Annuities can be used as a tool for estate planning, allowing you to pass on any remaining funds to your beneficiaries after your death.
4. Earnings on annuities grow on a tax deferred basis, meaning you don't pay taxes on the growth until you withdraw (best if used in a taxable account vs. a retirement account).
5. Annuities can allow for customization and can be tailored to specific needs, offering options like lifetime income, death benefits, and inflation protection.

Cons:

1. Annuities have limited liquidity as they often have surrender periods during which early withdrawals can incur significant penalties. Your need for liquidity should be a key consideration when considering an annuities purchase. Annuities contracts have different rules about withdrawals, and they typically carry surrender charges if you need access to your funds within the first few years of purchase. (Some annuities do give you the option to withdraw a portion of your funds each year).
2. Annuities typically have high fees and expenses, including administrative fees and investment fees. Generally, the more customization, via riders and other options, the higher the fees. These fees can eat into the overall returns. If you purchase a variable annuity, ongoing investment management and other fees often amount to 2% to 3% a year. These fee structures can be complex and unclear. Insurance agents and others who sell them may tout the positive features and downplay the drawbacks, so make sure that you ask a lot of questions and carefully review the annuity plan first. Before you invest, you should compare that fee structure with a regular no load mutual fund, which has no sales commission or surrender charge and have average annual expenses of less than 0.5% (for index funds) or about 1.5% (actively managed funds) and determine whether you might be better off going that route.
3. Annuities can be complex financial products, with various features and options, making it important to fully understand the terms and conditions before investing.
4. Fixed annuities may have inflation risk as they may not keep pace with inflation, potentially eroding the purchasing power of the income over time. Just because an income is guaranteed doesn't mean it is inflation proof.

Taxes can be both a pro and a con. For that reason, it is important to understand the tax treatment of annuity withdrawals. If the annuity consists of assets that have never been taxed, for example, you purchased the annuity with rollover IRA assets it is considered qualified, and any payments you receive from it are fully taxable at your ordinary income tax rate, which today has a top tax rate of 39.6%. If the annuity was funded with after tax dollars, the tax due is subject to an exclusion ratio, meaning that any funds you've already paid taxes on aren't subject to taxes, but amounts over and above that level are subject to ordinary income tax. The opportunity for tax deferral means that annuities have some tax benefits relative to saving in a plain-vanilla brokerage account, but they're not necessarily better. While a brokerage account doesn't supply tax deferral in the same way as an annuity does, the appreciation on assets in a taxable account are taxed a more favorable capital gains rate.

Every benefit you receive from an annuity can have a commensurate risk, tradeoff, or real or potential cost. Make sure you ask questions about the risks and tradeoffs based on the benefits your annuity offers. While you gain the benefit of guaranteed monthly payments with a fixed immediate annuity, you give up access to your money and potential growth. You also accept that your purchasing power will decline over time (unless you pay extra for an inflation-adjustment option).

It is important to carefully consider your individual financial goals, objectives and risk tolerance before deciding if an annuity is suitable for you. You should work with your advisor who can help you determine if an annuity aligns with your retirement planning needs.

Can Retirees Rely on the 4% Rule?

Cynthia Aiken, MBA, CFP®
Senior Managing Director, Head of Wealth Planning

You may be familiar with the often cited 4% rule for retirement spending. It suggests that during retirement, 4% of retirement savings can be withdrawn annually for the duration of a thirty-year retirement.

History – The 4% rule was introduced in 1994 by financial planner, William Bengen, in the Journal of Financial Planning. Using historical market return information for thirty-year periods from 1926 to 1994, he studied withdrawal rates from a hypothetical retirement portfolio of 50% equities and 50% bonds. He found that when using a 4% initial withdrawal rate and annually adjusting the withdrawal rate for inflation, there was a high probability that the retirement portfolio would not be fully depleted by the end of the thirty years. In other words, a retiree could withdraw 4% annually with the inflation adjustment for thirty years and not run out of money.

Although Bengen's rule appeared to be successful even during the worst thirty-year period for markets - 1968 to 1998, there are reasons to question its relevance and accuracy today.

Since Bengen published his findings, there have been adjustments to his 4% rule in the last few years. Morningstar, the financial research and investment management firm, published their own updated research in 2021 and cited 3.3% as the magic number and revised it to 3.8% in 2022. In 2023, they raised the withdrawal rate to 4% due to higher interest rates and moderate inflation

expectations. They found that portfolios with lower exposure to stocks were able to support a 4% withdrawal rate, while those with higher stock exposure had a 3.3% safe withdrawal rate. However, portfolios with higher stock exposure tended to have higher ending balances at the end of thirty years.

As economic landscapes and life expectancies have changed, many planning professionals are questioning the 4% rule and noting that there are many variables involved with retiree withdrawals. Some issues to consider:

1. Spending in retirement – Typically, spending in retirement is not consistent year after year. Many retirees spend more in their early retirement years – the go-go years when they are active and travel. Spending decreases during the slow-go years when travel is reduced, and they stay closer to home. Following that period, they enter the no-go years when they may need health care support. Retirees may also face unexpected large expenses in some years.
2. Low-interest rates – When Bengen proposed the 4% rule in the 1990's, the interest rate environment was markedly different than those during 2009 to 2023. During the 1990's the ten-year US Treasury yield bounced between 6% to 8%. Following the recession of 2008 – 2009, the same security had a yield below 4% from 2009 to 2023 and only in the last sixteen months has this security returned a yield above 4%. Bengen's theory relies on the relative stability of a 50% equity and 50% bond portfolio due to the bond exposure but also on the interest income provided by the bond allocation which is reduced when the US Treasury yield is below 4%.
3. Longevity risk – When the original 4% rule was researched, a thirty-year retirement was the norm. Today people are generally living longer, and many are entering retirement earlier, so retirement savings need to last forty or more years.
4. Sequence of returns risk – The premise behind the 4% rule is a consistent portfolio rate of return resulting from the equal allocation of equities and bonds. In reality, stock and bond markets do not hand investors consistent returns year after year. Rather, they can swing widely from year to year. If a retiree begins retirement withdrawals during a market correction, the retirement accounts may be depleted more quickly than anticipated. The withdrawals could create a deficit that may be difficult to overcome even if markets bounce back in later years.
5. Inflation – Although the 4% rule has an inflation adjustment, retiree expenses, particularly health care and long-term care may increase faster than the national inflation rate.
6. Legacy goals – Does the retiree plan to leave significant assets as bequests?
7. Taxes and investment fees – The 4% rule includes taxes and investment fees as an element in retiree expenses – so take note.

Considering those considerations, here are a few other approaches to distributions in retirement:

1. Bucket or ladder strategy – The retiree identifies different buckets for various retirement time frames and investment goals. Specifically, funds for near term living expenses are invested in cash or other safe assets and longer-term needs will be funded from investment accounts allocated toward growth.
2. Dynamic withdrawal strategies – This is a flexible approach to withdrawing from different accounts based upon tax status and market return.
3. Guaranteed income – Retirees with Social Security and pension income can count on these income sources to continue regardless of market returns. Those without these tools can purchase annuities to provide this stable income.
4. Equity exposure – Those retirees willing to take increased risk through a higher equity exposure, may see more growth in their investment portfolios.

The 4% rule may be an extremely simplistic rule of thumb, but there are a lot of factors to consider, and every retiree has a different mix of personal financial goals, investment accounts, risk tolerance, income sources and spending needs.

Retirees should work with their financial planner to create a financial plan that includes anticipated income, personalized expenses, investment portfolio and risk tolerance and they should update their plan on a regular basis.

Contact Cynthia Aiken at (973) 276-0843 or caiken@pgbank.com with any questions.