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VIEWS FROM CAMELBACK MOUNTAIN

Navigating Crazy Tax Laws

At our firm, safeguarding our clients' interests is our highest priority. We strive to achieve strong returns without taking unnecessary risks while prioritizing long-term security. And we, of course, know that the after tax, after fee return is what counts, so minimizing taxes is an important component. Almost everyone we know thinks their tax rate is too high and the tax laws are too complex. While President Trump's "Big Beautiful Bill" has reduced many taxes, ranging from no tax on tips and overtime to reducing tax rates for many older Americans, the overall system continues to get more and more challenging for the average person to follow. Lots of tax benefits get "phased out" for higher income taxpayers and charitable gifting is now much more complicated if you want a tax benefit for your gift.

Let's look back quite a while to President John F. Kennedy. His 1964 Tax Act reduced the top marginal tax bracket from 91% to 70%. While 70% still seems like a very high tax rate, even for wealthy individuals, the change was meaningful to those fortunate enough to be in the top bracket. Prior to the 1964 Tax Act, very high-income taxpayers kept \$0.09 on every additional dollar of income and after they kept \$0.30 on every additional dollar. To those individuals, this was a big deal.

President Reagan's 1986 Tax Act dramatically cut taxes and simplified the tax system. Sixteen prior income tax brackets were reduced to just two, with capital gains taxed at the same rate as ordinary income. The two tax brackets were 15% for those with lower incomes and 28% for higher incomes. The 1986 Tax Act also closed lots of tax loopholes which had incentivized poor investments solely for generous tax benefits.

Fast forward to 2026 tax rates. We now have seven different income tax brackets and a variety of added taxes that go on top of the basic rates. The size of the brackets and increase in rate from one level to the next make no economic or practical sense. For married couples filing jointly, as an example, the first \$24,800 is taxed at 10% and the next \$76,000 is taxed at 12% (12% is pretty similar to 10%). After that, the bracket jumps up to 22% and is applied to the next \$110,600 of income, then 24% (similar to 22%) covering the next \$192,150. From there another jump to 32%, but that rate only applies to the next \$108,900. I think you get the point.

On top of the seven brackets, we have to consider the 3.8% so-called "Obamacare" tax on investment (unearned) income. This applies to married couples with investment income in excess of \$250,000 (\$200,000 for single taxpayers). That normally rides on top of the long-term capital gains tax, which can result in a capital gains tax rate as high as 23.8%. Some taxpayers in the top income tax bracket of 37% will also have to pay the extra 3.8% which has the effect of raising their tax to 40.8%.

Capital gains taxes for married couples filing jointly are 0% on the first \$98,900 of taxable income and 15% on the next \$514,800, with the top rate at 20%. This is with the caveat that the 3.8% investment income tax increases the rates for individuals and couples above the thresholds mentioned. As a result, the capital gains tax rate can be either 0%, 15%, 18.8%, or 23.8%. Clear as mud, right?

Deductions and exemptions have also changed a lot over the past 10 years. The standard deduction used to be low enough that an awful lot of taxpayers itemized their deductions instead. That's no longer the case as north of 80% of returns are likely to claim the standard deduction (\$16,100 for single taxpayers in 2026; \$32,200 for married). Therefore, if a taxpayer takes the standard deduction but gives \$5,000 to charity, then they don't get much of a tax benefit for it. One piece of good news is that standard deduction filers will be able to deduct up to \$2,000 for charitable contributions in 2026. That still punishes taxpayers donating \$5,000 or \$10,000 to charities. For very wealthy people, the rules are more complex. More than in the recent past, charitable giving has been disincentivized by tax policy while essentially raising no additional revenue for our country. This is a horrible result.

One area where President Trump and many of his other predecessors have simplified things is in the area of estate taxes. In 1986 the estate tax exemption was \$500,000, meaning only decedents with estates in excess of \$500,000 had to pay estate tax. And it didn't take much above that for the graduated estate tax rate to reach 55%. Starting in 2026, the estate tax exemption will be \$15 million per decedent, which would let a married couple pass on up to \$30 million of assets to family members without any estate tax. Taxable estates in 2026 and beyond will face a 40% rate.

The irrationality and complexity of the tax system gives rise to very important tax planning opportunities. This is why sophisticated accountants and estate planning attorneys can be very helpful in minimizing taxes. Some of these techniques are complex and need to be executed and administered very carefully. Other planning opportunities are pretty simple and can still yield impactful results.

Fortunately, one of the most important tax strategies for our clients (and ourselves) is still intact. By focusing on buying high quality companies that we can hopefully hold for a very long time, we can defer capital gains taxes long into the future. In some cases, such as when donating appreciated securities or receiving a 'step up' in cost basis after someone passes away, the deferred capital gains tax is avoided altogether.

One fairly simple charitable gifting strategy that we utilize frequently is the qualified charitable distribution (QCD). IRA owners who are 70½ or older who wish to make charitable gifts can do so directly from their IRA to an operating charity without causing a taxable distribution. While there is no charitable deduction, QCDs don't increase taxable income either so the net result is substantially similar to taking a tax deduction from donating after-tax funds. At age 73 an IRA owner is subject to required minimum distributions (RMDs) that would normally increase taxable income. QCDs, limited to \$111,000 per taxpayer in 2026, can count against an RMD, thus holding down modified adjusted gross income which can be helpful at reducing Medicare premiums or qualifying for other benefits.

Outside of an IRA, you can make gifts of highly appreciated investments directly to charities. This avoids anyone paying the capital gains tax and, up to certain limits, the donor still gets the same charitable deduction that they would receive had they gifted cash.

We use a variation on this theme for donors that would like to give \$10,000 or \$15,000 a year to charity (not from an IRA), but now lose most or all those deductions available because they take the standard deduction instead of itemizing. In this technique, the donor may choose to "bunch" together three, four or five years of charitable contributions in one year. If a donor wants to give \$12,000 per year for five years, they could give \$60,000 of appreciated stock and itemize their deductions in the year the gift is made, thus getting a substantial tax deduction. The stock could be gifted to a donor-advised fund at Charles Schwab or another custodian like the Arizona Community Foundation, and then the donor can recommend donations from there to charities at their own pace.

Our firm's portfolio managers are not attorneys and we don't prepare tax returns for clients, even though we currently have two CPAs working with us. We are very knowledgeable in creative charitable giving, as well as in tax and estate planning strategies. Of course, any tax and estate planning information provided in this letter is general in nature and should not be construed as legal or tax advice. We will continue to work closely with accountants and attorneys for each client based on specific circumstances.

2025 has been another very strong year for financial markets worldwide. Given the President's massive tariff policies and ever-changing economic policy actions, few people would have anticipated such a strong year. Roy used to say that if you want equity-like returns, you have to own equities.

We continue to believe that valuations on many companies that are believed to be strong beneficiaries of artificial intelligence are wildly overpriced. We think this could be a bubble, which will not end well for those stocks. We also remain pessimistic about inflation. The U.S. economy has been running strong and is about to experience lots of fiscal and monetary stimulus. We're happy to see good growth, but we expect inflation to increase which could limit the Federal Reserve's ability to cut rates further, at least sustainably, regardless of who President Trump appoints as the next Fed Chair. Later in 2026 or 2027, we think there's a good chance we will be looking at interest rate increases.

Our partner and Chief Compliance Officer Julie Hein is starting a path towards retirement after 35½ years with the firm. We have been fortunate to hire experienced and capable team members to fill in – Anne Haggerty on the compliance side and Anne Ross, CPA for tax-related items. Julie will still be working part-time after the transition to continue as a resource with her invaluable experience and expertise. We greatly appreciate Julie's many years of dedication to our firm and clients!

All of us at L. Roy Papp & Associates, LLP hope you and your families are enjoying a wonderful holiday season. We wish you a healthy, happy, and prosperous new year!

Best Regards,

A handwritten signature in blue ink, appearing to read "Harry Papp".

Harry Papp, Managing Partner
L. Roy Papp & Associates, LLP
December 31, 2025