CLEARPOINT

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ACT NOW – SAVE LATER

BY TED ROBBINS, CPA, CFP®, DIRECTOR, PRIVATE CLIENT GROUP

October is here, with a reminder that we are closing in on the final few months of the year. As we have neared year-end in prior years, it has been common for us to make our decisions based on the belief that deferral is always better than paying current taxes. Depending on one's circumstances, this year may present a different approach of accelerating income now, instead of deferring it until next year.

The potential outcome of the election should also have anyone interested in passing the maximum amount of wealth on to the next generation thinking of the opportunities that are currently available to them. These opportunities include taking advantage of record-low interest rates and record-high exemption levels before the end of the year.

The Tax Cuts and Jobs Act (TCJA) was signed into law on December 22, 2017 and implemented sweeping changes to the tax code beginning in 2018. The TCJA lowered tax rates across income brackets and raised the estate tax exemption to the highest level in history. Compare the current estate tax exemption levels of $11.58 million for each individual to levels at the turn of the century of a meager $675,000 per individual[1]. In 2026, these changes will revert to the 2017 income tax rates and estate tax exemption levels if there are not changes in legislation.

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An election year always brings possibility for change. Biden has promised to increase tax rates and has hinted towards changes in estate tax laws. At this point, Trump and the Republicans have not discussed increasing tax rates or reducing the estate tax exemption. No matter which way the political landscape tilts after November 3rd, the massive federal stimulus spending over the past year has led us to believe that taxes will increase at some point. It is just a matter of when.

With the uncertainty of future changes in estate tax law, we are advising clients to control what they can and take advantage of today's current income tax and estate tax laws. This ClearPoint article will outline opportunities that individuals should consider implementing before the likely changes in tax and estate law occur.

INCOME TAX

While Trump's tax proposal is somewhat status quo, Biden has discussed meaningful changes such as increasing the top tax bracket from 37% to 39.6%, imposing a 12.4% Social Security payroll tax for wages above $400,000 (in addition payroll tax currently capped at $137,700), phase out of the qualified business income deduction for filers with taxable income above $400,000, eliminating favorable qualified dividend and capital gains tax rates on income above $1,000,000 and getting rid of the $10,000 cap on the state and local tax (SALT) deduction[2]. **Some ways that you can take advantage of the current rates include:**

- **Time the sale of a business or sale of marketable securities to realize a gain before the end of the year.** This will allow you to utilize today's favorable rates of 15% to 20%. If gains are treated at ordinary rates in 2021, they may be taxed as high as 39.6%.
- **Defer deductions, including charitable gifts, or the sale of a business at a loss or investment at a loss until 2021.** These tax deductions and losses may be worth more next year as they would offset income taxed at higher rates.
- **Delay year-end payment of real estate taxes and any state or local estimated income tax payments until 2021.** If Biden reinstates the SALT deduction, you may receive a tax benefit in 2021, whereas many will not in 2020.
- **Consider accelerating your bonus to be received in 2020 instead of 2021** to take advantage of possible lower rates.
- **Consider Roth conversions for both an income and estate tax play before year-end.**
    - Paying taxes at today's low rates may allow individuals to generate greater wealth instead of deferring tax and paying tax at higher rates in the future.
    - If it's not likely that you will need to live on your retirement assets during your lifetime, this is a unique way of "gifting the tax" that your children would end up paying without using any estate tax exemption.
    - If charitably inclined, consider a gift to an organization or donor advised fund to reduce your tax obligation impacted by the Roth conversion.

ESTATE PLANNING

Utilizing Your Exemption

- **Spousal Lifetime Access Trust ("SLAT")**
    - Happily married couples may use this trust to gift assets equal to their remaining estate tax and GST exemptions before year-end. Any future appreciation of trust assets will be excluded from future estate and GST tax.

- In anticipation of the sale of a business or appreciation of an asset, this trust may also be used to gift a business interest or other asset before appreciation occurs to shield future appreciation from tax.
- The trust can be structured so that the spouse of the grantor is the trustee and primary beneficiary.
- Once the beneficiary spouse passes away, assets pass outright or in trust to the beneficiaries of the trust which are often the Grantor's children.
- Structured as a Grantor Trust, the Grantor pays tax on the income earned by the trust. This is a powerful "gift of tax payment" over the term of the trust and does not utilize any estate tax exemption.

• **Domestic Asset Protection Trust ("DAPT")**[3]

- An individual may fund this type of irrevocable trust to utilize their estate tax and GST exemption before year-end. Any future appreciation of the trust assets will be excluded from estate tax.
- In anticipation of the sale of a business or appreciation of an asset, this trust may also be used to gift a business interest or other asset before appreciation occurs to shield future appreciation from tax.
- This trust also allows for divorce and creditor protection.
- This irrevocable trust may be created by an individual in any of the 19 states that allow for self-settled trusts (Ohio included). Rules vary by state.
- The trust must have an independent trustee with distributions from the trust being up to the discretion of the trustee.
- Structured as a Grantor Trust.

Low Rates

• **Intra-Family Loans**

- A simple and low-cost technique that is executed with a promissory note.
- Allows senior generation to get money in the hands of the younger generation at low rates based on the Applicable Federal Rates (AFR) tables without being considered a gift.
- As of October, annual rates were .14% for short-term rates (3 years or less), .38% for mid-term rates (3 – 9 years) or 1.12% for long-term rates (9 years or more).[4]

• **Installment Sale to an Intentionally Defective Grantor Trust ("IDGT")**[5]

- This technique takes advantage of low rates by selling an asset to an irrevocable trust in exchange for an installment sale at today's low AFR rates. Seed money generally funds a portion of the purchase price to being deemed a taxable gift.
- Any income or appreciation on the underlying asset that exceeds the initially stated AFR rate will pass on to the beneficiaries of the trust, free of estate tax and possibly generation-skipping tax (GST).
- Structured as a Grantor Trust.

- **Grantor Retained Annuity Trust ("GRAT")**[6]
    - Generally, a low-risk and low-cost trust to implement.
    - This is an irrevocable trust to which the grantor transfers property in exchange for the right to receive a fixed annuity for a specified number of years.
    - The trust is structured to shield the appreciation of underlying assets owned by the trust from estate tax if the value at the end of the trust term exceeds the 7520 rate (120% of mid-term AFR)[7].
    - A GRAT structured as a Zeroed-Out GRAT will not use any estate tax exemption to pass assets on to the next generation.
    - Structured as a Grantor Trust.
- **Charitable Lead Annuity Trust ("CLAT")**
    - Similar to a GRAT, this is an irrevocable trust to which a grantor transfers property.
    - The trust is structured to shield the appreciation of underlying assets owned by the trust from estate tax if the value at the end of the trust term exceeds the 7520 rate.
    - The difference from a GRAT is that the annuity payments over the term of the trust are made to a charitable organization or donor advised fund.
    - A tax benefit is received by the Grantor equal to the present value of the future annuity payments.

This year has taught us that nothing is predictable. As advisors to individuals and families, we are recommending that clients stay disciplined and control what they can control. This year may be the last year that tax rates are this low and that estate tax exemptions are this high. No one knows for sure, but with massive government spending over the past year, it is logical that the income tax and estate tax landscapes could change before 2026. For individuals with an appetite to take advantage of current legislation before year-end, we recommend acting now to save later.

Notes:

(1) Federal Estate and Gift Tax Rates, Exemptions, and Exclusions, 1916 – 2014: https://taxfoundation.org/federal-estate-and-gift-tax-rates-exemptions-and-exclusions-1916-2014/

(2) Details and Analysis of Former Vice President Biden's Tax Proposals: https://taxfoundation.org/joe-biden-tax-plan-2020/

(3) Ohio Asset Protection Trusts Explained by Cleveland, OH Estate Planning Attorney: https://valente-law.com/2017/03/ohio-asset-protection-trusts-cleveland-oh-estate-planning-attorney/#:~:text=Q%3A%20Who%20can%20I%20appoint,anyone%20you%20employ%20or%20control

(4) Applicable Federal Rates (AFR) for October 2020: https://www.irs.gov/pub/irs-drop/rr-20-20.pdf

(5) Sales to Intentionally Defective Irrevocable Trusts: https://tax.thomsonreuters.com/site/wp-content/private/pdf/specialreports/sales-to-intentionally-defective-irrevocable-trusts.pdf

(6) GRATS – Planning Opportunity in a Down Market: https://www.clearstead.com/planning-opportunity-grat/

(7) Section 7520 Interest Rates: https://www.irs.gov/businesses/small-businesses-self-employed/section-7520-interest-rates

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MARKET BENCHMARK RETURNS

September 30, 2020		1M	3M	12M	YTD
US Large Cap	S&P 500	-3.8%	8.9%	15.1%	5.6%
US Small Cap	Russell 2000	-3.3%	4.9%	0.4%	-8.7%
Developed Intl	MSCI EAFE	-2.6%	4.8%	0.5%	-7.1%
Emerging Intl	MSCI Em Mkt	-1.6%	9.6%	10.5%	-1.2%
Real Estate	NAREIT	-2.5%	1.5%	-13.3%	-13.8%
Core Fixed	BarCap Agg	-0.1%	0.6%	7.0%	6.8%
Short Fixed	BarCap 1-3Yr	0.0%	0.2%	3.7%	3.1%
Long Fixed	BarCap LT G/C	-0.1%	1.2%	12.9%	14.2%
Corp Debt	BarCap Corp	-0.3%	1.5%	7.5%	6.4%

Source: Bloomberg

The performance data shown represent past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.