WILL YOUR WEALTHY CLIENTS HAVE A LIFEBOAT IN A SEA OF TAX CHANGE?

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There seems to be one constant when it comes to taxes: they always seem to change. Every year, elected officials introduce new proposals to modify taxes in some way. This is especially true in the run up to a Presidential election, like this year. It is challenging to plan for the uncertain future tax environment, yet failure to plan can have a significant impact on exposure to new or increased taxes. Will your clients have a lifeboat in which to persevere a potential sea of tax change in the future?

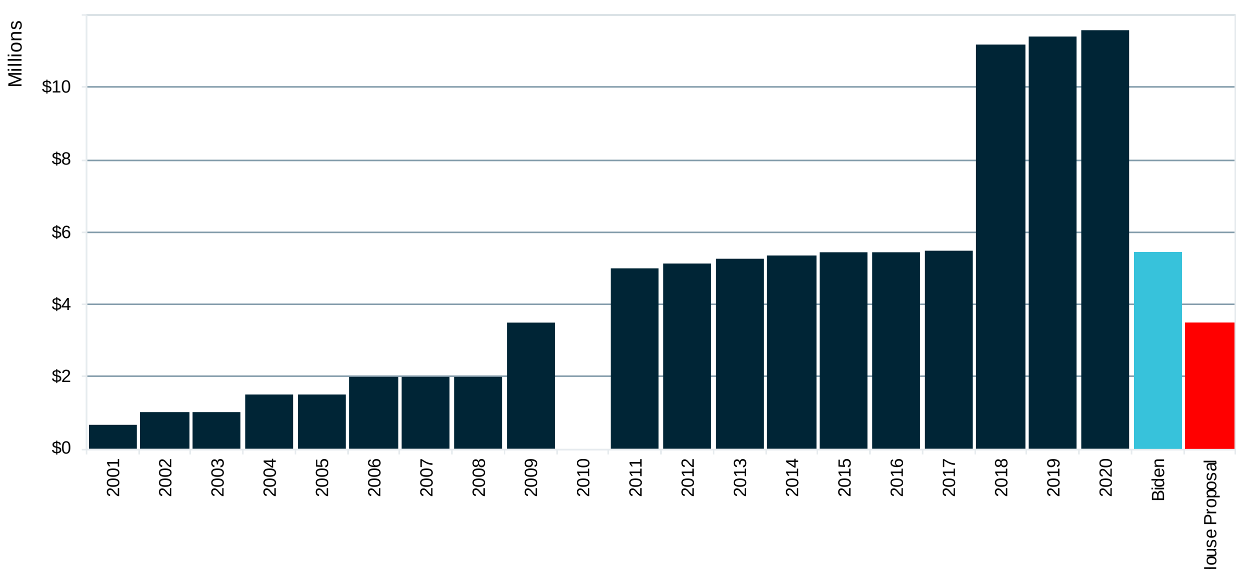
HEIGHTENED TAX CHANGE RISK

COVID-19 has clearly changed the economic trajectory of the world economy. The $2 trillion CARES Act, plus $484 billion PPP & HCE Act will eventually need to be paid for in some way. Other future relief may be required as well. How will the government eventually fund the trillions of dollars of relief and stimulus efforts? Taxes?

CREATIVITY IN TAX PROPOSALS

Taxes come in many forms for wealthy clients including income, capital gains, business taxes, gift taxes, and estate taxes. Even before COVID-19, there were two identical Congressional bills in 2019 (S. 309 and H.R 4857) that proposed lowering the estate tax exemption from $11.58 million per person, down to $3.5 million, while increasing the estate tax rate to 45% (from the current rate of 40%) with further estate tax rate increases up to a staggering 77% for estates with a value over $1 billion.[i] Figures 1 and 2 show a history of federal estate tax exemptions and rates along with a couple of 2020 proposals.[ii]

FIGURE 1 - HISTORICAL AND PROPOSED AND ESTATE TAX EXEMPTIONS[ii]

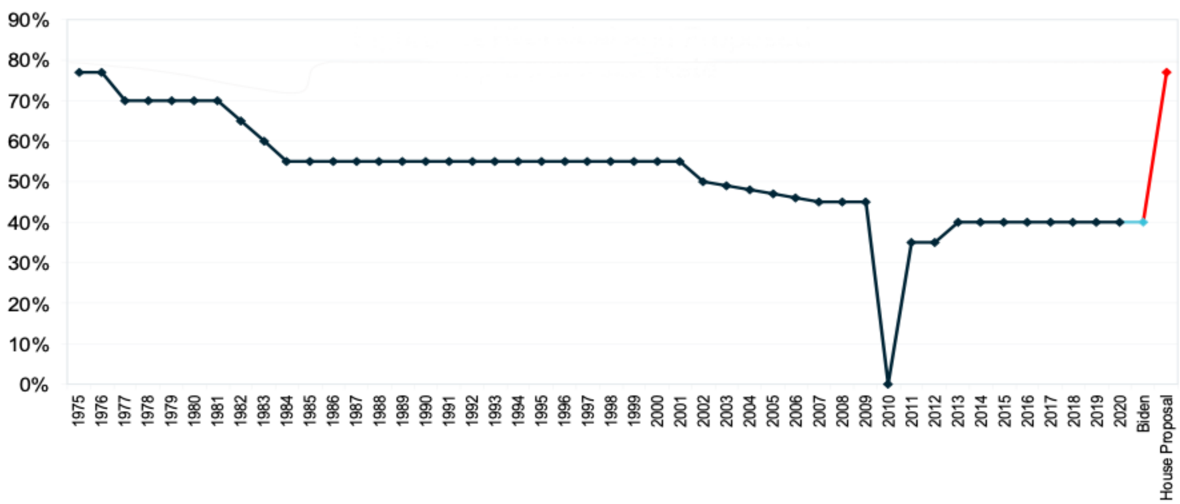


During this year's Presidential debates, numerous tax proposals were released introducing new annual wealth taxes, increased capital gains and ordinary income tax rates, elimination of the cap on the Social Security tax, and elimination of stepped up basis at death.[iii] Some proposals even altered the timing of some taxes to occur at death on appreciated yet unrealized gains. One analysis[iv] of leading Democratic Presidential candidate Joe Biden's tax proposals found that Biden's current proposed plan:

- Could seek to enact a number of policies that would raise taxes, including individual income taxes and payroll taxes, on high-income individuals with income above $400,000 including a 12.4% Social Security tax on income earned above $400,000 and taxation of long-term capital gains at ordinary income tax rates of 39.6% on income above $1 million.
- Is estimated to raise tax revenue by $3.8 trillion over the next decade
- Could lead to 7.8 percent less after-tax income for the top 1 percent of taxpayers, 1.1 percent lower after-tax income for the top 5 percent, and around 0.6 percent less after-tax income for other income quintiles

The breadth and creativity of proposals makes planning challenging, but the impact to wealthy clients is substantial in many proposals. The direction of the elections this November will undoubtedly play a big role in which tax proposals move forward for consideration and the burden that will be shifted to your clients.

FIGURE 2 – HISTORICAL AND PROPOSED TOP ESTATE TAX RATE[ii]



OPTIMAL FLEXIBILITY AND HEDGING AGAINST POTENTIAL CHANGES

To hedge against the potential changes, your wealthy clients may consider strategies that:

- Utilize higher transfer tax exemptions before they are lost
- Get highly appreciated assets out of the taxable estate ("estate freeze")
- Soften the impact of higher tax rates on income
- Integrate tax efficient vehicles, such as life insurance, into planning strategies

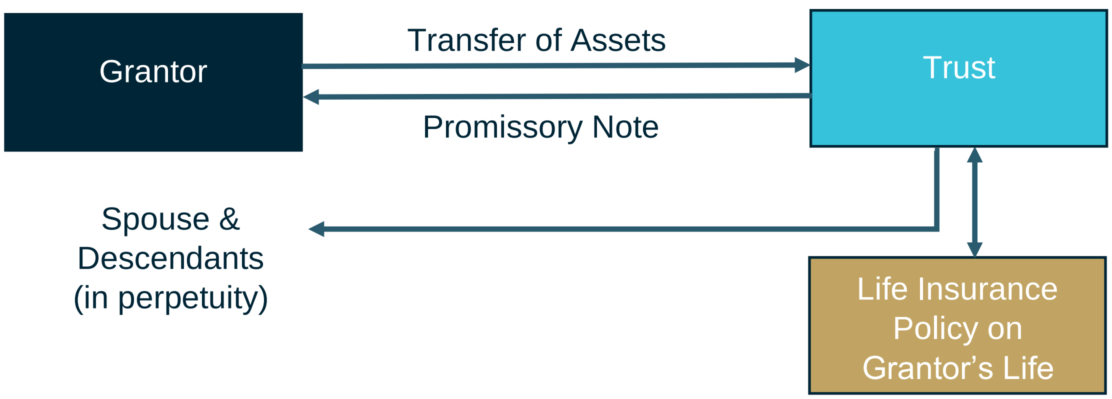
The specifics of a client situation obviously play a key role in what strategies may be best suited. The strategy should fit the type of assets in the estate and available cash flow. Because the exact direction of change is unknown, planning also needs to incorporate flexibility to give the client optimal optionality going forward as additional clarity is gained. For example, a client who wants to use transfer tax exemptions before they are gone may set up an Irrevocable Trust now yet fund it later (if at all). Another tool with tremendous flexibility is the use of promissory notes. Assets could be transferred to a trust for a promissory note. If circumstances dictate, the note could be forgiven down the road via a gift to the trust. Use of the unique tax benefits of life insurance inside trusts provides additional leverage of trust assets whether for the income tax free death benefit proceeds (i.e. to repay a note) or for use as a tax-deferred accumulation asset.

Trust provisions offer additional opportunities to embed planning flexibility. Spousal access provisions may provide access to trust funds if needed. Elements of potential control may be available via Protector or Distribution/Investment Advisor roles in a trust. Swap powers may allow reacquisition of appreciated assets by the grantor if a stepped-up basis regime is still available. So, clients should approach planning as powerful opportunities rather than one-way streets.

A PLANNING EXAMPLE

Assets with currently depressed valuations may be transferred through a gift to an irrevocable grantor trust or exchanged for a promissory note at historically low AFR rates (Figure 3). Additionally, the trust could be structured with spousal access provisions so that the beneficiary spouse could receive distributions from the trustee during life, while children and grandchildren benefit after the beneficiary spouse's death. Using trust cash flow or assets to fund a life insurance policy inside the trust provides a means of repaying the note at death or simply enhancing the ultimate value of assets transferred to future generations.

FIGURE 3 – HYPOTHETICAL PLANNING EXAMPLE



This example structure may give clients options for the future as it relates to income, efficient wealth transfer of highly appreciable assets especially when using currently depressed values, and an opportunity to extinguish the promissory note (if utilized) with future gifts before gift tax exemptions decrease. There can be tremendous leverage also if coupled with assets where minority or marketability discounts are available to reduce the value of assets transferred to the trust.

WHY NOW IS THE TIME TO ACT

Waiting until after the November elections may be too late. Clients may want to start the process now for several reasons.

- Access to legal and tax advisors is often limited after elections or changes in law due to the number of people wanting their services and the time needed for advisors to review and interpret new legislation.
- Customized planning takes time and diligence. Clients will need ample time to weigh options. Social distancing and stay-at-home mandates can also create availability and execution challenges on top of normal timeframes.
- Timing of asset changes can matter if new laws have retroactive start dates.
- Life insurance prices are increasing due to low interest rates and underwriting takes time. Fortunately, underwriting can be done concurrently while planning strategies are hashed out.
- Estate freeze techniques generally work best when interest rates and/or values are low.
    - Many assets may have temporarily depressed values due to the current economic environment which makes them good opportunities to gift before the values rebound. Minority and marketability discounts may also be available.
    - May 2020 hit a historical low intra-family loan rate with the long-term Applicable Federal Rate (AFR) for May 2020 being 1.15%.[v] Prior to 2020, the lowest long-term AFR rate was 1.86% in October 2019.[vi] Assets shifted via a promissory note would only need growth to outpace these shockingly low AFR rates to effectively transfer asset appreciation to a trust.

Failure to plan is a default to higher taxes. Don't let your clients get caught without a lifeboat. The current economic and planning environment won't last indefinitely, and implementation of effective planning takes time. Contact our office today to discuss ways to communicate this important message to your wealthy clients or to discuss planning opportunities that best position clients for the next round of changes in tax laws.

ABOUT THE AUTHORS

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[i] https://www.taxnotes.com/tax-notes-today-federal/estate-gift-and-inheritance-taxes/s-309-would-raise-estate-tax-rate/2019/02/01/293dv

https://www.congress.gov/bill/116th-congress/house-bill/4857

https://www.congress.gov/bill/116th-congress/senate-bill/309

[ii] https://www.irs.gov/pub/irs-soi/ninetyestate.pdf; https://taxfoundation.org/2020-tax-tracker/; https://www.congress.gov/bill/116th-congress/house-bill/4857;

[iii] https://taxfoundation.org/2020-tax-tracker/

[iv] https://taxfoundation.org/joe-biden-tax-plan-2020/

[v] https://www.irs.gov/pub/irs-drop/rr-20-11.pdf

[vi] http://resources.evans-legal.com/?p=2591