2020 Year-End Planning Considerations

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At Pathstone, we continue to look ahead to potential changes and how they may impact our client families. 2020 ends amidst a global pandemic, a presidential transition, historically low-interest rates, high gift and estate tax exclusions, and volatile financial markets. With the Biden win and growing likelihood of a divided Congress, sweeping 2021 tax reform seems unlikely. However, smaller incremental and focused tax and regulatory changes are almost a certainty as the government's pandemic related costs continue to mount. While predicting which tax policies may gain traction in this environment is highly speculative, the following outlines existing law, highlights select President-elect Biden tax proposals impacting individuals and business owners, and provides a framework for year-end planning. Please engage your Pathstone team to help navigate the potential opportunities and pitfalls of this fluid tax planning environment.

Income Tax Overview

- Top marginal ordinary rate remains at 37% (sunsetting to 39.6% in 2026).
- Graduated long-term capital gain brackets of 0%, 15%, and 20%
- The 3.8% Net Investment Income Tax (NIIT) applies to investment income of higher-income investors.
- The Alternative Minimum Tax (AMT) applies to fewer people due to higher exemptions, higher phase-out levels, the $10,000 cap on state and local tax deductions, and disallowance of miscellaneous itemized deductions.
- Charitable deduction limits remain elevated for cash gifts to certain charities.
  - CARES Act further incentivized charitable giving in 2020 by uncapping deductibility of cash gifts to public charities for itemizers and creating a $300 above-the-line deduction for non-itemizers.
- The standard deduction is $12,400 (single) / $24,800 (married filing jointly) for 2020.
- The corporate tax rate is 21%, and pass-through businesses continue to enjoy a 20% QBI deduction.

President-elect Biden's tax reform platform primarily targets corporations and high-income individuals.

- Individuals with income levels >$400k could see restoration of the 39.6% top marginal rate, additional social security taxes, further limitations on itemized deductions to a 28% maximum tax benefit, and the elimination of preferred capital gains rates for incomes of $1mm+.
- Additionally, corporate rates could be raised to 28%, and the QBI deduction could be phased-out for owners with >$400k taxable income.

Income Tax Planning Considerations

Deferring income and accelerating deductions continues to be the foundation of year-end income tax planning. Whether you should defer or accelerate income and deductions between 2020 and 2021 depends to a great extent on your projected marginal (highest) tax rate for each year. Consider the following:

- Develop a multi-year approach to quantify the effect of your current and future tax liability.
- This is particularly relevant for charitable gifting. It may be to your advantage to bunch your charitable gifts into a particular tax year in order to maximize your itemized deductions.
- Cash contributions to public charities are deductible up to 100% AGI for 2020 only (60% limit in 2021).

- Qualified Charitable Distribution (QCD) from IRAs for clients >70½ up to $100k (ordinary income never taxed)
- Utilize Donor Advised Fund to bunch multiple years of charitable contributions to maximize itemized deductions.
- Donating highly appreciated marketable securities further enhances tax benefit (capital gain never taxed).
- All charitable contributions, regardless of size, must be properly documented/substantiated to receive a deduction.
- Avoid accelerating capital gains into 2020 if done **solely in anticipation of higher 2021 tax rates.**
- Consider accelerating capital gains only when coordinated with broader loss-harvest, gain-deferral, deduction-acceleration, or portfolio rebalancing/risk management strategies.
- Consider reinvesting 2020 capital gains into Qualified Opportunity Zone Funds to defer and partially eliminate tax.
- Weigh the benefits of whole or partial Roth IRA conversions to lock-in potentially lower tax rates.
- Maximize contributions to a retirement plan, SEP IRA (if you are self-employed), and HSAs.
- Consider delaying state and local tax payments into 2021 (could benefit if SALT deduction cap lifted).
- Pay year-end accrued margin or other deductible investment interest expenses.
- For existing discretionary family trusts, consider trust distributions to take advantage of lower beneficiary tax rates.
- For closely-held businesses, consider year-end compensation and distribution policies (may be beneficial to retain > corporate income) and explore bonus depreciation and expensing opportunities on necessary purchases.
- Administer annual required distributions and other required formalities of family business, estate planning, and charitable planning entities. The IRS has taken an increasingly hostile view towards improper entity documentation and administration.

Transfer Tax Overview

- The Estate, Gift, and GST tax exemption is $11,580,000 per person (indexed for inflation).
- The current law sunsets 1/1/2026, and the exemption returns to $5 million per person (indexed for inflation)

President-elect Biden's platform proposes raising transfer taxes to a 'more normal' level and possibly eliminating income tax basis 'step-up' to decedent's date of death market value for inherited assets.

- This implies both a reduced exemption to as low as $3.5mm-$5mm and a possible increase in the transfer tax rate from the current 40% to possibly 45%-55%.
- Loss of basis 'step-up' at death implies a new system of forced gain recognition upon gift or death.
- Whether by 2026 sunset or more accelerated adverse tax legislation, transfer tax change seems imminent, making lifetime exemption planning a seemingly "use it or lose it" proposition.
- Loss of basis 'step-up' introduces many new variables to the transfer tax planning calculus (asset selection, timing, rate selection, etc.).

Transfer Tax Planning Considerations

Pathstone continues to recommend clients make lifetime gifts now if they have both legacy planning goals and gifting capacity. There is little downside in locking in the current higher exemptions, even if the law remains status quo post-election for some period. It is always beneficial to transfer appreciating assets out of large, potentially taxable estates. Consider transfer tax planning opportunities in the following order:

- First, consider this an opportunity to potentially enhance, finalize, or even "clean up" prior planning.
    - Forgive inter-family loans or mortgages.
    - Equalize prior lifetime gifts among family lines (where desired).
    - Divest senior generation of equity or voting interests in family business entities such as FLP/LLC/S-Corps.

- Infuse premiums into existing Irrevocable Life Insurance Trusts or terminate existing split-dollar or other life insurance funding arrangements.
- Accelerate or complete 529 plan funding.
- Allocate GSTT exemption to existing non-exempt trusts (where appropriate).

- Second, consider whether more substantial gifts or wealth transfers are desired and feasible.
  - Re-examine wealth transfer objectives and financial impact of accelerating charitable and family gifts.
  - Based on comfort level, assess whether outright gifts vs. trusts or family entities might be more appropriate.
- Third, lock in remaining elevated exemptions utilizing flexible planning entities intentionally designed to adapt to multi-generational family needs and the changing legislative environment.
  - Utilize Grantor Trusts to amplify planning benefits through ongoing payment of income taxes
  - Establish trusts in jurisdictions allowing perpetual durations (Dynastic Trusts)
  - Consider including spousal and charitable discretionary beneficiaries.
  - Include special trustees, trust protectors, powers of appointment, and modification language
- Note that many state transfer tax laws do not conform to the new federal law, so close coordination with your advisors and tax counsel is essential.
- Make annual exclusion gifts ($15,000 per person per beneficiary) by year-end. Also, consider direct payments for medical expenses and tuition of children and grandchildren as these payments are nontaxable and do not consume exemptions.
- Continued low-interest rates create a favorable environment for implementing a number of estate planning techniques. These include simple intra-family loans, Grantor Retained Annuity Trusts, Installment Sales to Defective Grantor Trusts, and Charitable Lead Trusts.
- Review beneficiary designations of retirement plans in light of 2019 SECURE Act law changes.
- The holidays are a great time to reflect on planning goals and conduct annual family business entity meetings. Activities may include financial reviews, educational activities, officer elections, appointment of committees, and ratification of actions for the coming or prior year.

As you and your family look forward to 2021, we encourage you to work with your Pathstone team, attorney, and tax advisors to consider these issues and opportunities in light of your unique tax situation.

Disclosure