PALLAS CAPITAL ADVISORS

Planning Commentary

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2019 Year End Tax Planning

As we approach the end of the year, the window of opportunity for many tax-saving-moves begins to close. It's important to evaluate your tax situation now, while there's still time to affect your bottom line for the 2019 tax year.

Income tax concerns for higher-income individuals

- The top Federal marginal tax rate (37%) applies if your taxable income exceeds $510,300 in 2019 ($612,350 if married filing jointly, $306,175 if married filing separately).
- Your long-term capital gains and qualifying dividends could be taxed at a maximum 20% tax rate if your taxable income exceeds $434,550 in 2019 ($488,850 if married filing jointly, $244,425 if married filing separately, $461,700 if head of household).
- Additionally, a 3.8% net investment income tax (unearned income Medicare contribution tax) may apply to some or all of your net investment income if your modified AGI exceeds $200,000 ($250,000 if married filing jointly, $125,000 if married filing separately).
- High-income individuals are subject to an additional 0.9% Medicare (hospital insurance) payroll tax on wages exceeding $200,000 ($250,000 if married filing jointly or $125,000 if married filing separately).

Income tax law changes to note

Modified Provision: Recent legislation has modified many provisions, generally for 2018 to 2025.

- Personal exemptions were eliminated.
- Standard deductions have been substantially increased to $12,200 in 2019 ($24,400 if married filing jointly, $18,350 if head of household).
- The overall limitation on itemized deductions based on the amount of adjusted gross income (AGI) was eliminated.
- The AGI threshold for deducting unreimbursed medical expenses has returned to 10% in 2019, it was reduced from 10% to 7.5% for 2017 and 2018.
- The deduction for state and local taxes has been limited to $10,000 ($5,000 if married filing separately).
- Individuals can deduct mortgage interest on no more than $750,000 ($375,000 for married filing separately) of qualifying mortgage debt. For mortgage debt incurred before December 16, 2017, the prior $1,000,000 ($500,000 for married filing separately) limit will continue to apply. A deduction is no longer allowed for interest on home equity indebtedness. Home equity used to substantially improve your home is not treated as home equity indebtedness and can still qualify for the interest deduction.
- The top percentage limit for deducting charitable contributions was increased from 50% of AGI to 60% of AGI for certain cash gifts.

Expired Provisions: Several provisions are extended periodically. The following provisions have expired and are not available for 2019 unless extended by Congress.

- Above-the-line deduction for qualified higher-education expenses
- Ability to deduct qualified mortgage insurance premiums as deductible interest on Schedule A of IRS Form 1040
- Ability to exclude from income amounts resulting from the forgiveness of debt on a qualified principal residence
- Nonbusiness energy property credit, which allowed individuals to offset some of the cost of energy-efficient qualified home improvements (subject to a $500 lifetime cap).

Like a GRAT, the §7520 rate must be used for this structure and asset appreciation over the §7520 rate passes to the trust beneficiaries gift tax free. A CLAT works best in a low interest rate environment because any investment performance in excess of the hurdle rate passes tax free to the family members at the end of the trust's term. The lower the rate, the larger the potential tax-free transfer.

Strategies less effective in a low interest rate environment

- Qualified Personal Residence Trust (QPRT): You transfer your personal residence to a trust, retaining the right to live in the home for a period of years, after which the residence passes to your designated beneficiaries, such as family members. (If the grantor wants to continue to live in the home, the trust or its beneficiaries can rent it to the grantor.) The initial transfer to the QPRT is a taxable gift of the remainder interest, calculated using the §7520 rate. The higher the rate, the higher the value of the grantor's right to use the residence as his or her own during the term of years, and the lower the future remainder interest. So as the §7520 rate increases, the taxable gift decreases, making the QPRT a more attractive strategy at higher interest rates.

- Charitable gift annuity: You transfer property to a charity in return for the charity's promise to make annuity payments for your life (or for the lifetimes of you and your spouse). You receive a current charitable deduction for the gift of the remainder interest. The lower the interest rate, the lower the amount of your charitable deduction. Also, charities have generally been forced to reduce payout rates offered because of economic uncertainties and the low-interest-rate environment.

- Charitable Remainder Annuity Trust (CRT): The grantor receives an annuity from the CRT for a term of years, and charity receives whatever remains at the end of the term. Here, the value of the remainder, calculated using the §7520 rate at the time the grantor creates the trust, gives the grantor an income tax charitable deduction.

  The present value of the remainder that will pass to the charity -- which must be at least 10% of the value of the transferred assets as determined using the §7520 rate -- is deductible as a charitable contribution for income tax purposes. The higher the §7520 rate, the higher the value of the charitable interest and the more likely that the CRT will pass IRS review.

  Transferring highly appreciated assets to a CRAT will make it most effective, since a CRAT's tax status will allow the deferral of capital gain recognition.

Strategies generally less impacted by low interest rates

- Charitable remainder unitrust: You transfer property to a trust, retaining a stream of payments for life or a number of years, after which the remainder passes to charity. You receive a current charitable deduction for the gift of the remainder interest. Interest rates have no effect if payments are made annually at the beginning of each year, and low interest rates have only a minimal detrimental effect if payments are made in any other way.

Conclusion

Different estate planning techniques work better when interest rates are at different levels (high vs. low) or on different trajectories (rising vs. falling). Knowing what techniques are appropriate for which environments can make your planning more efficient.

During this health crisis, we continue to focus on helping our clients obtain their estate planning objectives. Of course, there are many factors to consider when deciding on any of these types of strategies – and they are too numerous to review in this brief summary. Please contact the financial planning team at Pallas Capital Advisors to discuss estate planning in the current interest rate environment or any other aspect of your financial planning objectives.