Feeling Taxed? Select Strategies Can Make a Difference

No matter what the interest, inflation, or market environment is, planning can be done to capitalize on current conditions. Some taxes are voluntary, and good planning can minimize their impact on a family's wealth accumulation and transfer goals.

1. 2022 Market Performance creates ideal estate transfer opportunities

YTD, the S&P 500 index is down 17.13% while the NASDAQ index is down – 29.53% (as of 11/21/2022). That means most investors' portfolios are also down for the year. While negative market performance can be frustrating, HNW investors who have a long-term investment horizon may consider some estate planning opportunities when the market is down.

- Gift assets. Still, have leftover lifetime gift tax exemption? It's likely that a gift of a marketable security today will use less of your lifetime gift exemption.

- Lend assets. Make a low-rate loan to an irrevocable grantor trust (including a GST-exempt trust), which invests the proceeds. Any positive arbitrage on the difference between the investment returns and the amount of interest to be paid on the loan stays in the trust and is not subject to estate or gift tax.

- Sell assets, which have a significantly lower-than-usual fair market value in today's environment, to an irrevocable grantor trust in exchange for a promissory note. Lower asset value = lower promissory note value and is – better for estate transfer planning.

- Swap assets. Assets may be exchanged between the irrevocable grantor trust and the grantor tax-free if allowed under the terms of the trust instrument. Given the market performance in 2022, it makes sense to review assets that are directly owned as well as those in irrevocable grantor trusts to determine whether those with high basis and higher growth potential should be swapped into the trust, in exchange for lower-basis assets out of the trust.

2. Interest Rates are High Again

Many estate planning strategies are more appealing in a low-interest rate environment. However, you may be able to capitalize with strategies whose benefits are greater in a high interest rate environment. Two notable strategies are:

- Qualified Personal Residence Trust (QPRT): A QPRT is a trust used to transfer a personal residence to trust beneficiaries – typically children. The QPRT lasts for a term of years, during which the grantor may continue to use the residence as his or her own. After the initial QPRT term, the residence passes to remainder beneficiaries. 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 value of the remainder interest, calculated using the IRC §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 value of the gift of the future remainder interest.

So as the §7520 rate increases, the taxable gift decreases, making the QPRT a more attractive strategy with higher interest rates.

• Charitable Remainder Annuity Trust (CRAT): 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 IRS requires that the value of the remainder reach a minimum threshold; the higher the §7520 rate, the higher the value of the charitable interest and the more likely that the CRT will pass IRS review. CRTs must also make a minimum annual payment to the grantor; younger grantors who want to create certain CRTs sometimes can have a hard time meeting this minimum payment if rates are too low.

3. The dark cloud of inflation has a silver lining

As we enter the winter season, energy prices remain sky high. Nearly everything in the world of finance is impacted by inflation. Sometimes that's a good thing - and that certainly includes these areas:

• Estate and Gift Tax exemptions: Federal Estate Tax exemption increases from $12.06 Million in 2022 to $12.92 Million in 2023.
• Annual gift exclusion increases from $16,000 to $17,000 in 2023.
• Standard Deduction for married couples filing jointly for tax year 2023 rises to $27,700 up $1,800 from 2022. For single taxpayers and married individuals filing separately, the standard deduction rises to $13,850 for 2023, up $900, and for heads of households, the standard deduction will be $20,800 for tax year 2023, up $1,400 from the amount for 2022.

The other rates are:

- 35% for incomes over $231,250 ($462,500 MFJ);
- 32% for incomes over $182,100 ($364,200 MFJ);
- 24% for incomes over $95,375 ($190,750 MFJ);
- 22% for incomes over $44,725 ($89,450 MFJ);
- 12% for incomes over $11,000 ($22,000 MFJ).

• Social Security: Social Security and Supplemental Security Income (SSI) benefits for approximately 70 million Americans will increase 8.7% in 2023.

4. MA Millionaires' Tax (Fair Share Tax) Bill becomes Law

On November 8th, Massachusetts voters approved a 4% tax on annual income above $1 million, on top of the state's current 5% flat income tax. Annual income includes capital gains from the sale of assets – including real estate. Effective in 2023, the new levy aims to fund public education, roads, bridges and public transportation. Expect MA taxpayers to look for ways to avoid this tax, such as:

- Spreading out gains from sales of assets via installment payments
- Accelerating income into 2022 before the tax takes effect
- Deferring income deductions into 2023
- Creative use of non-grantor trusts located outside of MA
- Charitable income deduction "bunching" using Donor Advised Funds
- Moving out of MA.

5. Don't Forget Charity!

We wrote extensively about charitable planning in our last newsletter. As a reminder, Qualified charitable distributions (QCDs) remain a great tax opportunity. IRA owners and beneficiaries who are at least 70½ can transfer up to $100,000 tax-free to charities directly from their IRA. The QCD not only satisfies the IRA owner's RMD, but the QCD also drives down Adjusted Gross Income (AGI), which then provides other tax benefits to the taxpayer.

Remember to do the QCD well in advance of the year-end as the money has to be out of the account and the check needs to be cashed by the charity by December 31.

6. IRS Eliminates Penalty Tax on Required Minimum Distribution (RMD) Shortfalls for Certain Inherited IRAs for 2021 and 2022.

A new 10-year distribution rule introduced under the 2019 SECURE Act contained confusing language that led many to believe that there was no annual RMD during the first nine years of this 10-year period.

However, it became clear that is not the case for some beneficiaries when the Treasury Department and the IRS published proposed RMD regulations in February 2022. In response to all of the confusion, the IRS issued Notice 2022-53, which explained that the 50% excise tax on RMD shortfalls would not apply to affected designated beneficiaries and successor beneficiaries who failed to take annual RMDs for 2021 and 2022.

> However, the proposed RMD regulations explained that the "no annual RMD" rule applies only if (a) the owner of the retirement account died before the Required Beginning Date (RBD – generally either age 70 ½ or 72), and (b) the beneficiary is a designated beneficiary or an eligible designated beneficiary that is subject to the 10-year rule by election or under the terms of the plan document.

Notice 2022-53 clears the path for those qualifying beneficiaries by ensuring they have no requirement to play catch-up or pay the excise tax for 2021 and 2022 RMDs. However, all other beneficiaries who fail to take their 2021 and 2022 RMDs must consult with their advisor regarding taking corrective steps. To be sure, all beneficiaries with inherited retirement accounts should consult their tax advisors regarding their RMD obligations.