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All Things Financial Planning

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SUMMARY:

- Introduction: Inflation; Tax Law Update; CARES ACT and SECURE ACT updates
- Spousal Lifetime Access Trusts (SLATs) – Advanced Estate Planning

Dear Clients,

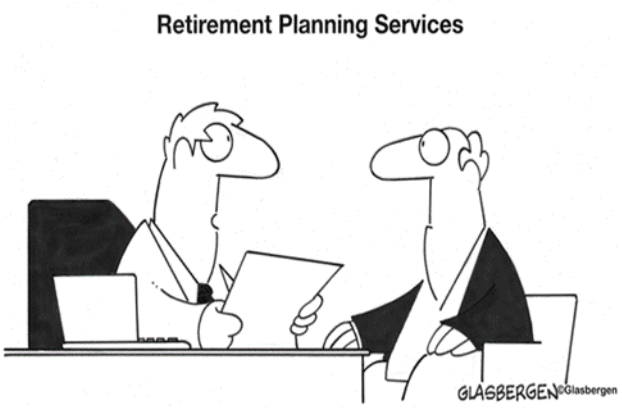
In my last newsletter, I mentioned our changing office policies revolving around COVID. With the rise of the Delta variant, we are currently following Boulder County protocol in our offices, which requires masks when we are in common places and when we are meeting with clients. The situation is fluid so changes could be forthcoming, and we'll let you know as we schedule meetings with you if we have made adjustments to our policies. We'll continue to be vigilant in wiping down surfaces and maintaining cleanliness. Your safety is always our top priority.

Is Inflation Transitory? In reviewing one of Kiplinger's most recent reports, there is an expectation that for 2021, inflation will land somewhere in the 5.5% range, but that by the end of 2022, inflation will end up 3% for the year. Although that prediction seems to point to the idea that any large inflationary increase year-over-year will be short-lived, an 8.5% decline in purchasing power would be impactful to the economy, and likely will be felt as we work through client budgets and cash flow considerations on the planning team.

Gas prices have led the way – up 40% through August 2021, and Kiplinger predicts they will continue to climb by another 5 to 10% in 2022. Electricity rates have been 4.7% higher this year than in 2020 with another 4 to 5% increase in costs predicted through 2022.

On the healthcare front, there was an actual drop in the costs of employer sponsored health care plans in 2021 due to employer's efforts to minimize the Covid effect on their employees. Experts expect that number to reverse significantly in 2022 to a 7% increase by year's end as employers change course. Prescription drug prices are expected to rise 7% as well, with dental insurance up by 3 to 4% in 2022.

One last item of note from Kiplinger: 30-year fixed mortgage rates could rise to 3.8% by the end of 2022. As of the date of this publication, average rates were still hovering around 3%. To put this into context, a $400,000 mortgage at 3% for 30 years will result in a $1686/month payment (not including taxes and insurance). With the same terms at 3.8%, homeowners will pay $1864/month. I would anticipate rising rates to have a major impact on what has been a red-hot housing market.



"I'm recommending an egagtrom. It's basically the same thing as a reverse mortgage."

Penalty Free Distributions from IRAs/401Ks. If you are under 59 1/2 and took a distribution from your retirement account before June 25, 2021, you may have the ability to claim this as a penalty free distribution by filing IRC Form 8915-E per the CARES Act passed by Congress last spring. Typically, there is a 10% penalty for any distributions from your retirement account prior to age 59 1/2, plus ordinary income tax rates attach to the distribution. This is an opportunity to avoid this penalty.

To qualify for penalty free status, either you or a household member must have been diagnosed with COVID, or you would have needed to experience financial hardship related to the pandemic, which is explained further in IRS Notice 2020-50. Note: penalty free status does not mean tax free status, but you can elect to pay these ordinary income taxes over 3 years, or repay the distribution itself within 3 years (as of the day of distribution) to avoid taxes altogether.

The IRS interpretation of the 10-year payout for heirs on an inherited IRA under the SECURE Act was wrong. In a previous newsletter, I noted an IRS opinion that indicated most non-spousal heirs would have to take RMDs for the first 9 years of the 10-year payout, and then drain the remaining inherited IRA balance in the 10th year. Most interpretations of the new law were contrary to this, believing Congress meant for heirs to have flexibility within the first 9 years and could opt to take nothing in any given year if they wanted, and then in the 10th year the inherited IRA would need to be emptied.

Turns out the IRS was wrong and has changed its position. Heirs who are subject to the 10-year rule will have the ability to plan during the first 9 years of the 10-year payout, possibly taking distributions only in lower income years to reduce the overall tax hit in the 10th year. For those that become beneficiaries of these accounts, retirement planning will be impacted as the net effect of distributions from all accounts will need to be analyzed to make sure income distribution planning is as tax efficient as possible. This could result in retirees taking heavily from these accounts during their first few years of retirement assuming they are in a lower tax bracket, prior to their own RMDs kicking in. It will be an exercise in financial planning, with a number of factors to consider, and we would be happy to assist you during the 10-year payout period with a tax planning strategy that makes sense.

Tax Legislation Update. The House Ways and Means Committee came out with proposed tax law changes in a bill introduced on September 13, 2021. As of the date of this publication, Congress has been debating the efficacy of this bill and its details, thus much could change between now and enactment. Below are some of the more notable provisions:

- Top marginal tax rate increase from 37% to 39.6% for income greater than $400K (single filers) and $450K (joint filers)
- Top capital gains tax rate increase from 20% to 25% for income greater than $400K/ $450K (effective date is 9/13/2021)
- Roth conversion prohibition for taxpayers in the highest ordinary income tax bracket (starting on 1/1/2022)
- Roth conversion prohibition of after-tax funds in retirement accounts for all taxpayers, eliminating the backdoor Roth as a planning strategy (starting on 1/1/2022)
- Reduction in the estate and gift tax exemption to $5.85M (single) and $11.7M (couples) (starting on 1/1/2022)
- Elimination of valuation discount planning and meaningful trust planning strategies, such as grantor trusts (effective upon enactment)
- Corporate income tax rate increase from 21% to 26.5%

In all likelihood, the current version of this proposal will not be the final version, but many of its features could become law in some form or another. What is also important (as noted above) is that different tax provisions become effective on different dates, including on the date of enactment for some proposals, so quick action may be required to take advantage of the current law. We have been active in talking clients through how these changes could impact them from a short- and long-term tax planning perspective, and we will pay close attention to any updates that come out of Washington DC in the coming weeks.

Investments and Financial Planning

"If you had taken tomorrow's advice yesterday, you'd be rich today!"

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Spousal Lifetime Access Trusts: An Advanced Estate Planning Technique
by Jason Foster, JD
Director of Financial Planning

With the current estate and gift tax exemption levels at all-time highs, many high net-worth clients are considering utilizing some or all of their exemption amount through lifetime gifting and transfers to pass along a greater portion of their assets tax free to heirs. **These thresholds currently sit at $11.7M per person and $23.4M for couples in 2021.** Any amount transferred over these values during life or at death will be subject to an estimated 40% tax levy.

Certainly the $11.7M/$23.4M thresholds are significant, and assuming this is the exemption level applicable upon death, most people will be able to pass along their net worth without incurring any such tax. But Congress is currently considering lowering the exemption threshold to $5.85M/$11.7M by 2022 (see the previous section on the House Ways and Means Committee proposal), which would broaden the reach of the federal estate tax. We must wait and see whether this potential change gains momentum and passes as proposed, but even if it fails to become law, the current exemption levels are scheduled to lower automatically to approximately $6.5M for individuals and $13M for spouses in 2026, without any legislative action.

Thus, if your net worth is currently above these reduced thresholds, it might be worth considering some advanced "removal" or gifting strategies. You would have the potential to **"capture" any lost exemption** by utilizing your exemption at these high levels now, without the ability of the IRS to pursue the amount of the used exemption over the new thresholds once it drops. For example, if a single client has the ability to gift $8M now, and the exemption drops to $6.5M in 2026, the $1.5M difference would not be subject to the aforementioned 40% tax levy because it was gifted when the individual had the higher exemption amount. And it follows that if the exemption drops to $5.85M next year, and the client makes the same $8M gift here in 2021, $2.15M more in assets would avoid estate tax that would otherwise apply starting in 2022.

Obviously, we are contemplating large amounts here, so any significant gifting must make sense from a financial planning perspective. You must be careful not to gift assets you will need at some point later in your life, and finding the right amount, the appropriate gifting strategy and proper technique is a complex analysis, involving a thorough review of objectives and factors specific to the client.

Spousal Lifetime Access Trusts. One popular advanced estate planning option some spouses are considering in this high estate and gift tax exemption environment is a Spousal Lifetime Access Trust. A "SLAT" is an irrevocable trust involving the transfer of assets during one spouse's lifetime for the benefit of the other spouse. Property transferred into a SLAT is subject to the terms of the trust, but generally speaking, the income and principal of the trust are available to the beneficiary spouse (and indirectly, the transferring spouse, at least during the beneficiary spouse's lifetime) when needed. This flexibility and accessibility to income and assets from a SLAT alleviates some of the concern with making large, irrevocable gifts of property that one might otherwise need access to in the future.

Assets transferred into the SLAT reduce the size of the estate of the transferring spouse and beneficiary spouse, and have the potential to capture some of the lost estate and gift tax exemption while it is still high, assuming a forthcoming reduction is inevitable. There is the added benefit of **removing the future appreciation** associated with these transferred assets as the client utilizes other non-SLAT resources first for budgetary purposes to avoid distributions from the SLAT being reintroduced back into the taxable estate of the couple. Thus, from a planning perspective, although SLAT assets and income are available, it is still ideal for the beneficiary spouse to allow the assets and income produced within the trust to grow outside of the joint estate.

One point to remember is that although a SLAT can assist in avoiding estate tax, yearly taxes on income generated by the trust would still need to be paid. One strategy is to draft these trusts as "grantor" trusts, and as long as the trust maintains this status, **SLATs would not pay these income taxes or file tax returns.** The transferring spouse would need to pay any income tax generated by the SLAT on the joint tax return due, even if no distributions from the trust are made. While paying taxes on income that is not received is not necessarily welcome, it is a savvy estate and tax planning technique to allow the growth within the trust to compound tax free over time, while the grantor further reduces the value of the joint estate through paying SLAT taxes on their yearly tax return.

These trusts also enjoy the indirect benefit of **asset protection**. Because the assets transferred in are no longer owned by the spouses, if either spouse is subject to personal liability, these trusts can create a layer of protection from judgments and creditors.

Complexities, Formalities and Risks Concerning SLATs. The spouse is typically named the initial beneficiary. After the beneficiary spouse passes away, other heirs can be named beneficiaries going forward, or the trust can dissolve and go directly to these beneficiaries outside of trust. The **beneficiary spouse can also be the trustee** of the SLAT, as long as they are accessing the trust for targeted, yet standard needs (typically for health, education, maintenance and support related expenditures). As the trustee, this gives the beneficiary spouse some discretionary control over distribution decisions. But there are certainly formalities that must be observed, as there is no broader distribution scheme typically allowed if the trustee and beneficiary spouse are one in the same. **An independent trustee may be needed** for broader distribution discretion beyond the basic standard discussed above.

If the transferring spouse survives the beneficiary spouse, they would not be able to access the trust as a surviving beneficiary. This is an important consideration and potential risk in the formation of SLATs. The surviving spouse who transferred assets into the SLAT must be able to outlive the remaining non-SLAT assets because they **no longer will have indirect access to trust assets after the beneficiary spouse passes.**

The possibility of **divorce can also be a risk** for the transferring spouse, although this risk can be mitigated if provisions are placed in the trust document to terminate the beneficiary spouse's interest in the event the marriage is dissolved.

Assets transferred into the SLAT also lose the ability to "step up" in basis under the current law when the trust dissolves. Because transferred assets are considered an irrevocable gift during life, the basis for any such assets carries over. When these assets appreciate over time, the basis will stay the same, and when the trust is dissolved, even after the death of the beneficiary spouse, there will be a carry over in basis and not the step up in basis that assets typically receive when a person who owns them dies. If the beneficiary heir then sells these assets after the SLAT dissolves, they may have to pay significant capital gains tax.

There is a strategy to **alleviate the loss of this step up, however. "Swapping" powers** within the trust document can be created that allow the transferring spouse the ability to replace property in the trust with property outside of the trust. It would permit the swapping or exchanging of high basis assets outside of the trust for low basis assets inside the trust, so when the transferring spouse dies, these low basis assets now owned by the transferring spouse again can receive a step up in basis. These assets can then be sold by heirs and little or no capital gains tax would be due.

If it makes sense from a planning perspective, both spouses can create a SLAT for the benefit of the other spouse. This allows both spouses to take advantage of the higher exemption amount, and allows more assets to appreciate outside of the joint estate. This plan can also lessen the concerns about death and divorce discussed previously. But careful planning must take place.

If the IRS interprets the trusts as constructively similar or interrelated, the trusts could then be "undone" and included in each spouse's respective estate, under the **Reciprocal Trust Doctrine.** In order to avoid this result, certain drafting differences between the trusts should be considered, such as creating and funding the trusts at different times, having different beneficiaries, trustees, and distribution schemes, giving one spouse a withdrawal right, and/or avoiding having one spouse be the beneficiary at creation and instead opting for a "springing" beneficiary power after a certain number of years or following a certain event. There are other differences to consider as well, and an experienced estate planning attorney should be consulted at all times during the process.

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One reminder when contemplating SLATs and other types of sophisticated estate planning techniques: We will only recommend them when the right factors are present. When we model out and illustrate how SLATs function and how they can further estate and tax planning objectives, we utlize planning software as part of a comprehensive estate plan review for our clients. It is a complex financial planning process requiring an analysis in cash flow projections, a balance sheet review, and income and estate tax exemption planning. For example, our modeling capabilities could involve some combination of the following:

- Toggling income on and off in various years to show the effect of receiving distributions or allowing them to grow within the SLATs
- Choosing different assets on the balance sheet in which to fund a SLAT as we analyze available liquidity in future years
- Illustrating the effect of the beneficiary spouse passing first in a one SLAT scenario, leaving the transferring spouse without access to income and principal from the trust
- Adjusting the rate of return on assets still owned by the transferring spouse, to show how this will impact the net worth in future years
- "Stress" testing the SLAT scenario with other variations, including the possibility of elevated living expenses, or a long term care event that needs funding in future years

The variants utilized are always specific to clients and are designed to make sure they are comfortable in making the choice to pursue, create and fund one of these types of trust vehicles.

CFM can continue to manage the assets within the SLAT and partner with trustees in directed trust arrangements, if this option is appealing from a financial and investment planning perspective. As always, considering the size of the anticipated transfer, we work with trusted outside attorney and CPA resources to make sure we are covering all aspects of this unique strategy so you can have confidence in the process and end result.

A Spousal Lifetime Access Trust can be a very effective wealth transfer strategy to consider. With the control and management of income and principal available to the beneficiary spouse, and the flexibility of simply allowing the transferred assets to grow tax free outside of the joint estate, it can be a powerful advanced planning tool for clients who have enough wealth to consider it. Feel free to contact us if you have questions, or if you think this might be a good planning opportunity for you and your spouse. We would be happy to have this discussion and do the analysis. As always, take care and stay safe!

The Financial Planning Department
And Your Entire Colorado Financial Mgmt. Team

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