Wealth Planning Year-End Planning Considerations

PATHSTONE
THE FAMILY OFFICE℠

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With the current makeup of Congress, we feel confident we will not see another major catalyst for tax policy change until the 2024 general elections. Accordingly, this year-end planning note focuses on current law and provides a framework of considerations and opportunities to explore as part of traditional year-end planning. It is also not too early to start planning for the sunsetting of several provisions of the 2017 Tax Cuts and Jobs Act (TCJA) in 2026.

In our Highlights section below we summarize the key points and offer links to a fuller explanation for those who want to dive into the details.

As always, please engage your Pathstone advisory team to help assess opportunities and their potential application and appropriateness to your family's unique planning situation.

PLANNING HIGHLIGHTS

Income tax - Tax rates and deduction structures for 2024 mirror those of 2023 but for annual inflation adjustments. **Jump to this section**.

Income tax planning - Whether you should defer or accelerate income and deductions between 2023 and 2024 depends to a great extent on your projected marginal (highest) tax rate for each year. **Jump to this section**.

Transfer tax year-end checklist - Before the end of 2023, consider:

- ☐ Making annual exclusion gifts
- ☐ Direct payments for medical and tuition expenses
- ☐ Creating a two-year GRAT before anticipated GST tax exemption sunset
- ☐ Reviewing buy-sell agreements

Jump to this section.

Preparing for lifetime exemptions sunsetting - Planning now in anticipation of legislative changes at the end of 2025 cannot be stressed strongly enough.

- ☐ Review objectives and impact
- ☐ Review structures and jurisdictions
- ☐ Decide what assets to transfer
- ☐ Evaluate addition options after exemptions are fully used

Jump to this section.

Ensuring your planning works for your family – The human impact of wealth and estate planning should not be overlooked

- ☐ Choose the right starting place for you and your family
- ☐ Explore how your planning impacts those around you
- ☐ Communicate, communicate, communicate

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Income Tax Overview

Tax rates and deduction structures for 2024 mirror those of 2023 but for annual inflation adjustments:

- Top marginal ordinary income tax rate remains at 37% (sunsetting to 39.6% in 2026).
- Graduated long-term capital gain tax brackets of 0%, 15%, and 20%.
- 3.8% Net Investment Income Tax on investment income of higher-income investors.
- 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 the disallowance of miscellaneous itemized deductions. All of these provisions will sunset in 2026 and the AMT will once again become a major factor in tax planning.
- Corporate tax rate is 21%, and pass-through businesses still enjoy a 20% Qualified Business Income (QBI) deduction.
- QBI deduction begins to phase out at taxable income of $182,100 (single) / $364,200 (married filing jointly) for 2023. It is fully phased out for owners with >$464,200 (married filing jointly).

The IRS is waiving the 25% excise tax for beneficiaries who inherited IRAs in 2020, 2021, or 2022 who missed required minimum distributions in 2021, 2022, or 2023 due to confusion surrounding the 10-year rule.

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 2023 and 2024 depends to a great extent on your projected marginal (highest) tax rate for each year. Consider the following actions:

- Develop a multi-year approach to quantify the effect of your current and future tax liability. This is particularly relevant for:
  - IRA distributions and Roth conversions where it is easy to time income for multi-year income smoothing purposes; and
  - Charitable planning as bunching multi-year contributions into a single tax year might help maximize itemized deductions. Utilizing a Donor Advised Fund (DAF) can be very useful for this purpose.
- While cash contributions enjoy higher deductibility thresholds (up to 60% of AGI in 2023-24), gifts of appreciated marketable securities (limited to 30% of AGI) may still enhance tax benefits as the unrealized capital gain is never taxed.
- IRA account owners aged 70½+ should consider Qualified Charitable Distributions (QCDs) of up to $100,000 annually, which can be distributed directly to charity and never be subject to ordinary income tax.
  - The tax benefit of a QCD should be compared to the tax benefit of giving appreciated securities, which can in some cases yield a larger tax savings.
  - Starting in 2023, taxpayers can use up to $50,000 of their QCD for a once-in-a-lifetime gift to a Charitable Remainder Trust (CRT) or Charitable Gift Annuity (CGA). The legal costs of establishing a CRT may make this option impractical, but a gift to a CGA may be appealing for some.

- All charitable contributions, regardless of size, must be properly documented and substantiated to claim the deduction.
- With no immediate tax rate increases on the horizon, consider accelerating 2023 capital gains only when coordinated with broader loss-harvest, multi-year income smoothing or other prudent portfolio rebalancing/risk mitigation strategies.
- Consider reinvesting eligible 2023 capital gains into Qualified Opportunity Zone Funds to defer tax until 2026 and eliminate future tax if held more than 10 years.
- Weigh the benefits of whole or partial Roth IRA conversions.
    - Temporarily depressed asset valuations or opportunistically 'filling up' lower graduated tax brackets can provide longer-term tax savings.
    - In 2026, the top federal tax bracket will return to 39.6% (from 37% at present). In addition, the $10,000 cap on deductions for state and local taxes will be lifted. This may present an opportunity to do a Roth conversion in 2025 at 37% and pay the state taxes in 2026 to take the deduction when they will again be able to reduce federal income. Note however that the effect of TCJA sunsets on AMT calculations may eliminate some or all of the benefits of the tax deduction.
- Maximize contributions to tax-deferred retirement plans, SEP IRAs (if you are self-employed), and Health Savings Accounts (HSAs) including catch-up contributions for those over age 50.
- Pay year-end accrued margin or other deductible investment interest expenses.
- For existing discretionary family trusts, explore making trust distributions to optimize lower individual beneficiary tax rates.
- For closely held businesses, review year-end compensation and distribution policies (it may be beneficial to retain more corporate income given lower rates) and explore bonus depreciation and expensing opportunities on necessary purchases.
- Administer annual required trust or retirement account 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 lifetime exemption and generation skipping transfer (GST) tax exemption are $12,920,000 per person (increasing to $13,610,000 in 2024).
- Under current law, the beginning of 2025 will bring an additional inflation adjustment to these exemptions. Then, at the beginning of 2026, these historically high exemption levels will be reduced to roughly $7.5 million per person (the level prior to the 2017 TCJA level of $5.0 million, adjusted for inflation).
- The annual gift exclusion is $17,000 (increasing to $18,000 in 2024).

Transfer Tax Planning Considerations

Actions to take by year end:

- Make annual exclusion gifts ($17,000 per person or $34,000 per married couple per beneficiary), taking into account amounts previously gifted to the same beneficiary this year. If paid by check, the beneficiary must deposit it this year.
- Consider direct payments for medical and tuition expenses for children and grandchildren (these payments are nontaxable and do not use exemptions).
- If you have excess GST tax exemption over your lifetime exemption, consider creating a two-year GRAT before the end of the year and then you will be able to allocate GST tax exemption to the trust at the termination of the GRAT, before the anticipated reduction in GST tax exemption in 2026 (discussed more below).
- Review buy-sell agreements to confirm that required valuations are up-to-date.

Actions to consider (well) before 2026:

Pathstone continues to recommend that clients with taxable estates make lifetime gifts now if in line with their legacy planning goals and they have gifting capacity. There is little downside to locking in the current higher exemptions, even if the law does not sunset in 2026, and transferring appreciating assets out of large, potentially taxable estates.

Given that transfer tax changes are slated to happen soon, if you have not already done so, it is important to begin your planning as soon as possible. Rushed planning is usually not the best planning. In addition, estate planning attorneys and appraisers will be very busy as more people focus on these coming changes, so it is important to start soon, even if you prefer not to complete your gifting until 2025. If you have made significant gifts, consider how you wish to use your increased exemptions over the next two years.

- First, review your wealth transfer objectives and the financial impact of gifting on you and your beneficiaries.
- Second, determine what vehicle is best to accomplish your goals.
  - Review provisions of existing trusts or consider new trusts that better meet your legacy planning goals.
    - Include flexible planning options that may adapt to multigenerational family needs and the changing legislative environment, such as trust protectors, powers of appointment and modification language.
  - Use grantor trusts to increase transfer tax benefits through your ability to pay taxes on the trust's income. This allows you to make additional gift-tax-free transfers for the benefit of your descendants (or other beneficiaries), while reducing the size of your estate.
  - Establish trusts in jurisdictions that allow so-called dynasty trusts and have favorable state income taxes.

- Third, decide what assets you wish to transfer.
    - Consider assets that may receive valuation discounts and that are expected to appreciate in value, for example, equity or voting interests in family business entities.
    - This could be an opportunity to potentially enhance or even "clean up" prior planning. For example:
        - Forgive inter-family loans or mortgages.
        - Equalize prior lifetime gifts.
        - Allocate GST tax exemption to existing non-exempt trusts.
- Fourth, evaluate additional planning options after you have used your exemptions:
    - Even with higher interest rates (which remain historically low), it may still be advantageous to implement so-called "estate freezing" techniques such as intra-family loans, grantor retained annuity trusts (GRATs) and installment sales to defective grantor trusts.
    - Increased interest rates may make other techniques more attractive, such as qualified personal residence trusts or charitable remainder trusts.
    - Review retirement plan beneficiary designations to confirm they are still appropriate (especially where trusts are named, in light of changes made by the 2019 SECURE Act and subsequent regulations).
    - Review existing wealth transfer planning structures to assess if modification might be prudent and beneficial.

Ensuring Your Planning Works for Your Family

Talking about your estate and financial wealth transfer plans with the people they will affect can be tricky and uncomfortable. It provides transparency into your relationships, raises the unknowns of impact, and may conjure specters of entitlement. For some, estate planning is an unwelcome acknowledgment of their own mortality. Stressful and emotional for sure, yet the unintended consequences of not talking with the impacted people can forever change families and legacies. We see two areas of risk that are commonly increased when financial wealth transfer plans are created in secret.

One potential risk is that the estate plan could be created solely around tax efficiencies and not based on the goals and aspirations you have for your family, or on thoughtful consideration of the impact of the financial wealth (or lack thereof) on future generations — including those not yet born. We are not suggesting that financial wealth should or shouldn't be passed down through the generations, or how it should be passed along to various family members. But if the estate plan process begins with the sole goal of pushing as much money as far into the future as possible—and is created without any input from the family and other affected players—the plan is less likely to reflect the values, priorities, and aspirations of the family. What is the purpose of wealth? To perpetuate for perpetuation's sake? To enhance lives and realize personal potential? To make the world a better place?

The second area of risk from plans being created in secret occurs when the creators of an estate plan assume they know how affected people will interpret and respond to their plan.

> *"Why was this money given to me? Do you not believe I can stand on my own two feet?"*
>
> *"Why was I lied to and never told these financial resources were here to help me?"*

> *"I have to ask for my money from a trustee? Don't you trust me?"*
>
> *"I would have agreed she needs the support more, so why did you go around me?"*
>
> *"They may be your grandkids, but they are my children! How could you make such an important decision without consulting me?"*

While discussing an estate plan may be hard, it provides a forum for opening up complex issues such as: Whose wealth is it? What is fair across siblings? Is it healthy to gift wealth to a grandchild without his or her parents' permission? Where is the line between enhancing and enabling? How can you predict the impact of wealth on unborn generations?

Opening a dialogue around estate planning also creates an opportunity to talk with your family about the meaning of your wealth—its purpose, your hopes for the impact it can have on the family, and your fears for potential harm. Moving beyond a focus on the transfer of assets, these conversations should include the priceless gifts you hope will live on: your memories, your lessons learned, and your vision of a life well lived.

As you and your family celebrate the holidays and look forward to 2024, we encourage you to work with your Pathstone team, attorney, and tax advisors to further explore these issues and opportunities considering your unique tax situation.