A world of investing.®

Putnam INVESTMENTS

# Year End Tax Planning and Beyond, With or Without a Change in Who is President!

Not FDIC insured
May lose value
No bank guarantee

**Chris Hennessey**
**Lawyer and CPA**
**Professor Emeritus of Law at Babson College**
**Member of Putnam's Business Advisory Group**

# Topics for today

2020 results update and consequences to client!

Year end planning considerations

Estate planning post election



320930 7/20

A world of investing.®

Putnam INVESTMENTS

# 2020 election results and surprises

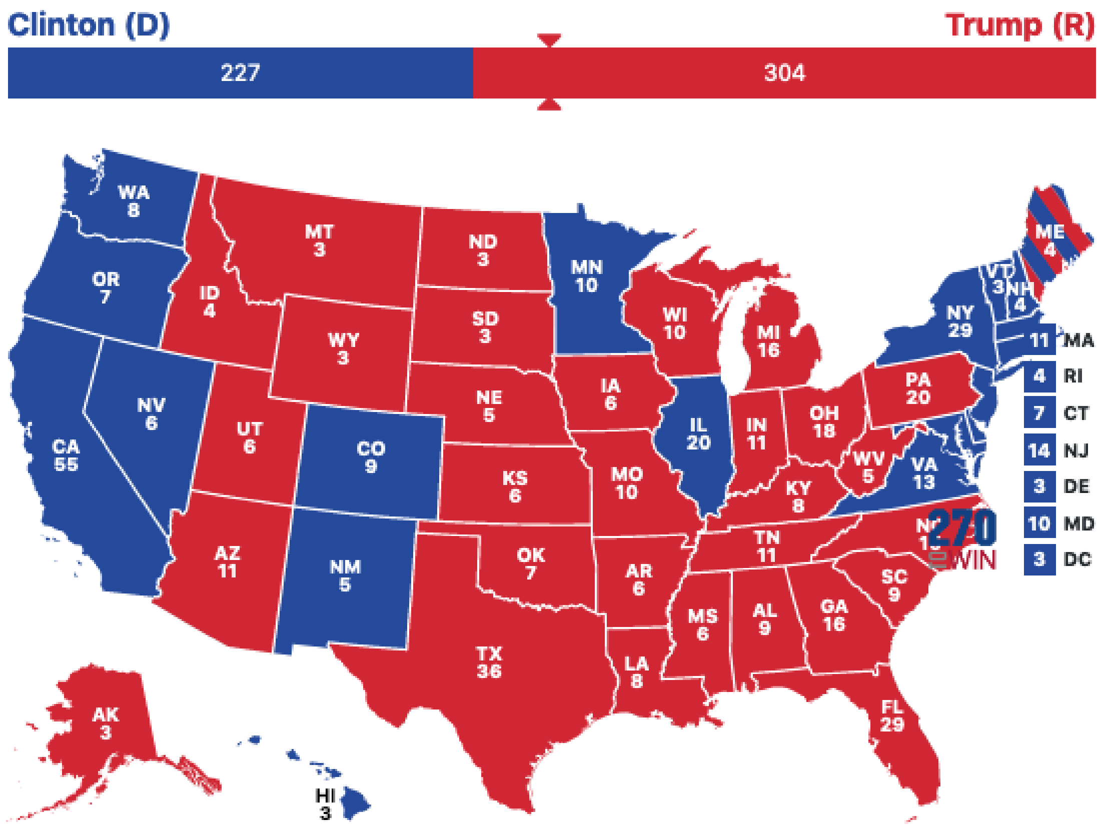
# Results President as of Nov. $4^{th}$ at 4P

- Trump 214 Electoral Votes
- Biden 248 Electoral Votes
- Lawsuits filed by Trump in WN and PA and recount in WN
- States still not decided:
  - NC 15
  - GA 16
  - NV 6
  - AK 3
  - PA 20
  - MI 16



320930 7/20

# 2016 electoral college map




Source: www.270towin.com/2016_Election/interactive_map



320930 7/20

# Key battleground states in 2020

## 2016 election: 10 closest electoral college races

| | State | ECVs | Trump | Clinton |
|---|---|---|---|---|
| 1 | MI | 16 | **47.6%** | 47.3% |
| 2 | NH | 4 | 47.2% | **47.6%** |
| 3 | WI | 10 | **47.9%** | 46.9% |
| 4 | PA | 20 | **48.8%** | 47.6% |
| 5 | FL | 29 | **49.0%** | 47.8% |
| 6 | MN | 10 | 44.9% | **46.4%** |
| 7 | NV | 6 | 45.5% | **47.9%** |
| 8 | ME | 4* | 45.2% | **47.9%** |
| 9 | NC | 15 | **49.9%** | 46.1% |
| 10 | AZ | 11 | **49.3%** | 45.4% |

* Electoral college votes in Maine are split by allocating two electoral votes to the state popular vote winner, and then one electoral vote to the popular vote winner in each of two Congressional districts. In 2016, Clinton won 3 electoral votes while Trump won 1 electoral vote.



320930 7/20

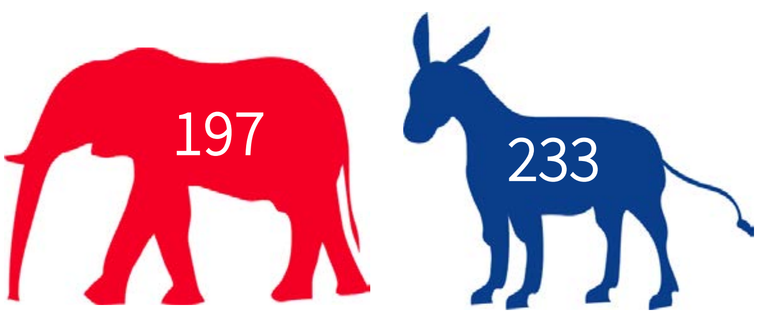
# update on results

**Nov. 4th 10AM: Republicans lost CO and AZ, picked up AL, LOOKS LIKE Perdue avoids run off in GA and Tillis wins NC, Collins holds ME and maybe James Republican gets MI; Run off for second**

**Senate seat in GA. So either a 52-48 Republican Senate or 51-49**

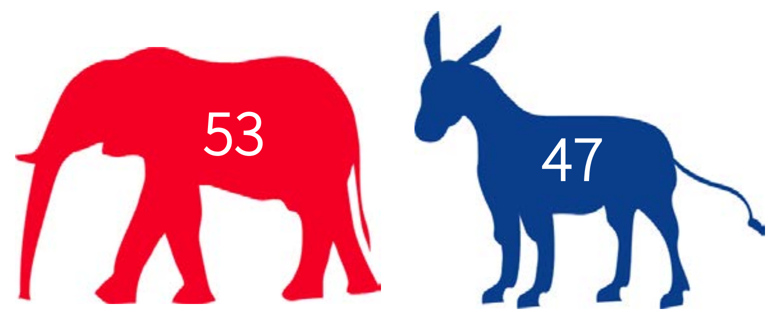
## House of Representatives*

Republicans need net gain of 18 seats to take control




## Senate**

Democrats need net gain of 4 seats to take control (or 3 with a Democrat winning presidency)




* Currently there are four vacant seats (all formerly held by Republicans). One former Republican member (Justin Amash – MI) is now Libertarian.

** There are two independents in the Senate who caucus with Democrat members (Angus King – ME, Bernie Sanders – VT).

Source: U.S. House of Representatives, Press Gallery.

# What had an election impact?

- COVID
- Voter turnout and new registrations
- Mail in ballots
- Equity market performance 3 months leading up to the election
- Since 1900 the incumbent party has won three times and lost eight when there was a 20% decline in the DJIA or a recession in an election year. Both have already happened in 2020!
- No Blue Wave
- Polling wrong
- Economic factors
  - Unemployment, housing prices, gas prices, personal income, GDP growth

# Will election make a difference on the markets?
# And what if tax rates go up?

- Dow Jones has historically posted stronger nominal returns under a Democratic president
- Since 1901 the Dow has returned 7.80% per annum with a Democratic president and 3.28% with a Republican
- Putnam research tax rate data back to 1913 and stock return data starts in 1926
- Looking at past 94 years of stock market returns and U.S. tax rate data there is no clear relationship between the two
- Markets so far like status quo if Biden wins and Senate is Republican
- Effective tax rates have dropped, in 1945 marginal top rate of 94% top 1% had effective rate of 40% which was 26% in 2015

# Secure Act planning still needed

# Secure Act considerations

- Review beneficiary designations on retirement accounts because of “10 year rule”, play the tax brackets

- Explore leaving non-spouse beneficiaries a Roth

- Explore withdrawing IRA early (say age 60) and using after tax amount to buy life insurance owned by an ILIT

- Review conduit and accumulation trusts

- Review beneficiary of IRA as a CRT (charitable remainder trust)

- Use of disclaimers

A world of investing.®

Putnam INVESTMENTS

# Wealth planning considerations post election

# Favorable tax environment for most taxpayers right now

- Tax Cuts and Jobs Act (TCJA) lowered marginal rates across all brackets
- Doubling of standard deduction and scale-back of popular deductions means the overwhelming majority of taxpayers claim the standard deduction on their tax return
- Alternative minimum tax (AMT) no longer an issue for most taxpayers
- Attractive estate and gift tax environment — each individual can shelter over $11 million from estate/gift taxes
- Uncertainty on tax rates after 2025 when the TCJA expires … or before? Will Senate flip to Democratic in two years if Biden is President

# Year end planning

- Review NUA (net unrealized appreciation) for company stock in retirement plans since cost basis is income
- Reset cost basis for NUD (net unrealized depreciation)
- Roth conversion explore with NOL net operating loss
- Use of QCD qualified charity deduction for over age 70 ½

# Tax savings realized by using the charitable rollover option known as QCD

Assumptions:

- Charitably-minded retired couple over the age of 70½ with income of $100,000
- Required distributions from IRA totaling $10,000
- Claiming the standard deduction on tax return
- Annual charitable gifts of $10,000

| | Donate from IRA | Write check |
|---|---|---|
| Income | $100,000 | $100,000 |
| RMD | $0 | $10,000 |
| Total income | $100,000 | $110,000 |
| Standard deduction | ($27,000) | ($27,000) |
| Taxable income | $73,000 | $83,000 |
| **Tax bill** | **$8,372** | **$9,977** |

Tax savings of approximately $1,600



320930 7/20

# Changes to net operating losses (NOLs)

- Beginning in 2018, taxpayers are no longer able to carry back NOLs, but instead may carry forward NOLs for an unlimited number of years
- Taxpayers are allowed to deduct NOLs only up to 80% of taxable income in that year
- For calendar year 2020 can use NOL against 100% of taxable income
- New limits are imposed on deducting “excess business losses”*

* The TCJA introduces a limitation on “excess business losses,” meaning business owners are restricted from deducting business losses in excess of $250,000 per taxpayer (individuals) or $500,000 (married couples filing a joint return). Business losses above this limit must be carried forward to the following tax year. This new limit and other changes related to NOLs apply to businesses other than C corporations from 2018 through 2025.

# Use non-grantor trusts to maximize deductions
# useful if SALT limit continues

Primary residence owned by couple

SALT deduction of $10,000 + mortgage interest deduction

Vacation home owned by irrevocable (non-grantor trust)

SALT deduction of $10,000 + mortgage interest deduction

Utilizing the trust ownership structure results in an additional deduction for SALT and mortgage interest and may be useful in legacy planning for subsequent generations. To benefit from the SALT and mortgage interest deduction, the trust must generate enough income to utilize the offsetting deductions. Note that property owned by a non-grantor trust would not generally qualify for § 121 capital gains exclusion upon sale.

Note that the use of multiple trusts would be subject to the anti-abuse provisions for multiple trusts under § 643(f) for trusts having substantially the same grantors and primary beneficiaries if the principal purpose of the trusts is to avoid income tax. Consult with a qualified tax advisor for more information.



320930 7/20

# Biden taxes being proposed but without Senate? think about 2 years out

- Raise income tax rates at upper brackets top rate 39.6%
- New and expanded credits – Child Tax, Child and Dependent Care, First

  Time Homebuyer and Caregiver
- Eliminate QBI Section 199A if over $400,000 of total income
- Increased Social Security payroll taxes at higher incomes
- Qualified dividends and capital gains at 39.6% if over $1 million +

  and 3.8% surtax; Sect. 1031 gone if over $400,000 of income
- 26% credit for contribution to IRA, 401K or 403B, eliminates the deduction
- Value of itemized deductions capped at 28% bracket and phase outs restored

  If more than $400,000 of income and SALT limit eliminated
- Broaden federal estate and gift tax by lowering the lifetime

# Biden tax planning before year end

- The 2017 threshold amounts were $418,000/$470,000 for 39.6% but Biden plan applies that rate at $400,000 so push income into 2020
- Pass through business keep total income below $400,000 so push deductions into 2021 and income into 2020
- If in 32%, 35%, 37% or new 39.6% then take itemized in 2020 such as charity and maybe the fourth quarter state estimated payment in Jan. of 2021 due to SALT limit
- Year end of 2020 Roth conversions should be considered and do NOL planning
- Harvest capital gains in 2020 and save capital losses for 2021 and consider muni's and non dividend producing assets; smooth out future cap gains to stay under $1 million
- Contribute $20,000 to 401K should save $7,920 in 39.6% bracket but only save $5,200 so use a Roth or after tax contribution

# Year end planning if you want more income in 2020

- Made withdrawals from retirement and non-Roth IRA accounts

  -avoid 10% penalty if pre age 59 ½ Cares Act waiver or borrow from plan

- Skip or defer retirement plan contribution so income is higher in 2020

- Elect to use 5 or 7 year depreciation and/or sell depreciable assets and buy replacements

- Defer charity deductions into 2021 except for the $300

- You can withdraw cash from an IRA (more than $100,000) pre age 70 ½ prior to Dec. 31 since taxpayers can deduct charity

See: Alan Gassman, Brandon Ketron & Wesley Dickson: 2020 Year-End Tax Planning – With or Without a Regime Change

“

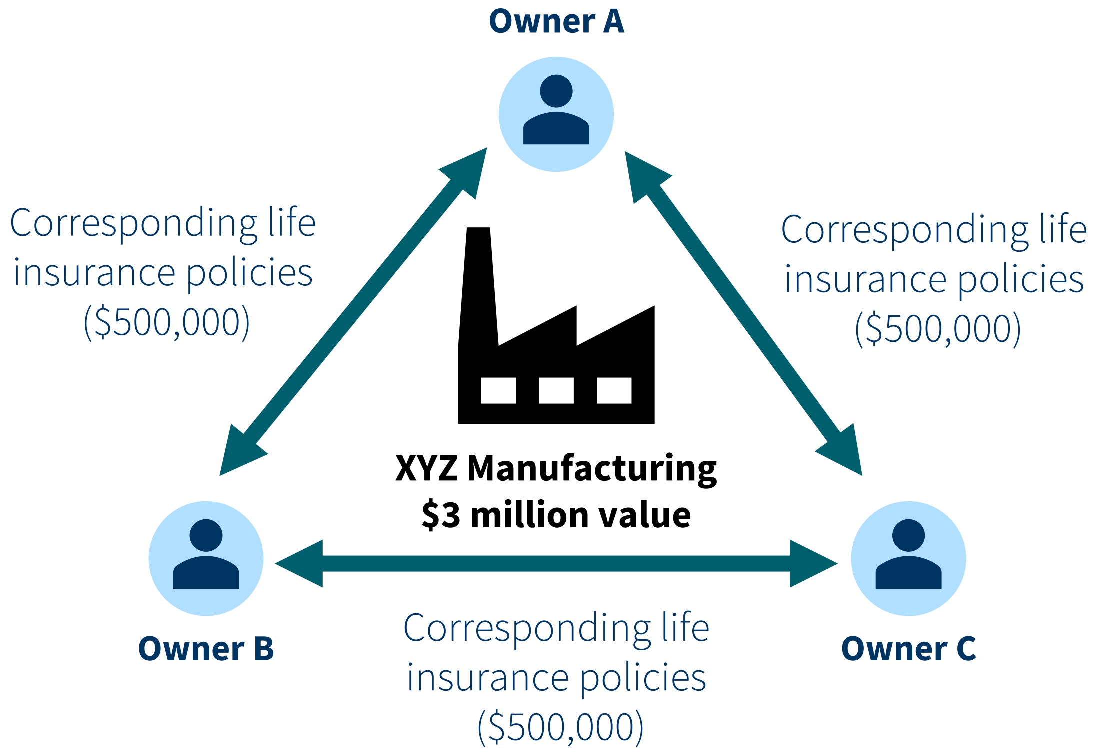
# Business succession planning post election

- Need for a plan-only 30% have a plan; failure rate from 1st to 2nd generation is 30%, then 12% to 3rd and 3% to 4th
- Do a valuation of the business
- Consider type of buy-sell agreement
- Estate planning techniques such as GRAT or IDGT
- Income tax planning such as QBI deduction
- On sale use of section 1202



320930 7/20

# A cross-purchase agreement provides liquidity for transition to other owners






320930 7/20

# Consider wealth client regardless of who is elected

- Categorize client wealth-are clients way over current $11.58m X two, are they under $12m but asset values growing (remember in 2026 the exemption drops to $5 million indexed for inflation
- Under current law the $11.7 exemption (for 2021) drops down in 2026 to $5 million indexed inflation
- Or Biden proposes either $5 million exemption or $3.5 estate tax exemption and 45% rate based on 2009
- Is $5 million indexed for inflation under Biden plan?
- Under $12 million ($6 million doubled assumes Trump 2026) and asset values growing-use of an ILIT; maybe a SLAT and don't forget 529 plans
- Way over current $11.58m doubled-consider different advanced strategies which follow



320930 7/20

- If say under $7 million ($3.5 doubled) consider portability and

# Step up thoughts (or no step up!)

- Eliminate step-up in basis on inherited assets (on all non-IRD assets) under Biden
- Would this be carry over basis? Or a tax for bene on built in gain at death?
- Likely outcome look something like 2010 when if taxpayer chose the no estate tax option the step-up was limited to $1.3 million to non spouses and an added $3.0 million to spouses
- So sell appreciated assets or gift them away prior to death (ex: you have cost basis of $1m in Amazon now worth $2m, sell in Dec. 2020 pay 250K gains tax, reduces your estate by 250K paying at Trump rates; otherwise at death $2m times estate tax plus Cap gains tax on $1 m


320930 7/20

# Biden's Taxes on Wealthy Estates

*(All dollar figures in millions)*

| | |
|---|---|
| **Value of original asset** | **$100.00** |
| Capital gains taxed at ordinary rates 39.6% + 3.8% NIIT = 43.4% | 43.4% |
| **Capital gains tax owed** | **$43.40** |
| | |
| **Value of remaining assets in the estate** | **$56.60** |
| Biden's estate tax exemption ($3.5 million) | $3.50 |
| Taxable estate | $53.10 |
| Biden's estate tax rate (45%) | 45% |
| **Taxes owed on the estate** | **$23.90** |
| | |
| **Total taxes paid on $100 million asset =** | **$67.30** |
| **Effective tax rate** | **67.3%** |

# Planning techniques for estate tax changes

- Think about cost basis issue – maybe strategic selling during lifetime of client to “smooth out” capital gains and avoid spike to 43.4% (39.6 plus 3.8)
- If forced sale of assets at death then avoid dying (while owning assets!): lot of ways to gift while alive
- Lot of strategies-GRAT, IDGT, ILIT, SLAT, and CLAT and some of these could be on the table for regulations along with gift tax discounting of value (under Biden)
- Under Trump think about calendar year 2026 when exemption drops
- And under Biden when midterm elections happen in 2022


320930 7/20

# Existing credit shelter trusts (CSTs) may not be needed consider portability

Couple's total estate

Death of 1st spouse

### Marital trust ("A")

- Funded with the amount in excess of the BEA
- No transfer taxes due, step-up in cost basis

### Bypass trust ("B")

- Typically funded with the BEA per a formula clause
- No transfer taxes due, step-up in cost basis

Death of 2nd spouse

### Beneficiaries

- Transfer taxes due, step-up in cost basis

### Beneficiaries

- No transfer taxes due, no additional step-up in cost basis

No step-up in cost basis



320930 7/20

# Other strategies to maximize or preserve step-up in cost basis at death

- Gift low basis assets to older family members (be aware of § 1014(e) inclusion)

Example-Dad is older and ill, Daughter Sally has stock with basis of $10,000 and FMV of $100,000. She gifts stock to Dad who dies two years later. Stock gets a step up to $100,000.

- Utilize swap powers within a trust

- Spend down retirement assets to preserve low-basis assets for wealth transfer



320930 7/20

# Use up $11.58 by end of year or maybe do so if Biden elected and Dems have the Senate

- Use of a Spousal Lifetime Access Trust (SLAT)
- Wait and See QTIP
- Gifting of primary home or vacation home fractional interests to separate trusts for the kids
- The Biden Two Step ( a bit late now)


320930 7/20

# Spousal Lifetime Access Trust (SLAT)

- Trust by donating grantor's spouse for his/her health, education or maintenance and that of descendants
- So husband gifts $10m into SLAT for wife
- Wife can be given power withdraw greater of $5,000 or 5% trust principal and testamentary limited power of appointment
- Upon death wife first husband loses indirect access so wife could have ILIT
- Watch out for reciprocal trust issue and "floating spouse"


320930 7/20

# Wait and see QTIP

- Fund a QTIP trust now for spouse that will pay all income to spouse and you have until Oct. 15, 2021 to file gift tax return
- Can be pure 100% marital deduction no use of $11.58m for gift
- Or entire trust treated as gift so trust value not part estate bene spouse and you use up $11.58m or a portion thereof
- Or make a partial election so part of trust is credit shelter and rest is marital deduction
- See article in Leimberg services: Alan Gassman & Wesley Dickson - When to Unplug Great Grandpa and Other Tax Strategies to Consider, Oct. 20, 2020

# Estate planning no mater who wins

- **Grantor trust:** donor obligated pay the income tax, $10m in grantor trust produces income for ten years at 7% annual rate and 50% that income is ordinary rate and 50% capital gains rate, more than $3 million of value removed from the estate

- **Fractional gift**: Donor who owns $6 million in real estate gives a 1/3 tenants in common to trusts for each kids, So gift value with 25% discount is not $2m but $1.5m

- **Private annuity:** A 60 year old sells $1m of assets to a grantor trust  in exchange for annuity of $48,974, death occurs next several years significant wealth is removed

# Other strategies under estate planning

- The Family Loan
- GRATS-Grantor Retained Annuity Trust
- Intentionally Defective Grantor Trust
- Charitable Lead Trust and Remainder Trusts
- Hybrid Domestic Asset Protection Trust
- Optimal Basis Increase Trust



320930 7/20

# Different ways to utilize a family loan

## Example 1: Loan and invest

**Parents loan $1 million over 5 years**

Current mid term AFR: 0.39% (as of 11/20)

**$1 million principal grows to $1,469,328**

Assumes 8% annual growth over 5 years

**Interest paid back to parents over 5 years = $19,500**

If funds from loan can be invested and generate returns in excess of AFR, this can be a tax-free gift!

**Difference in growth minus interest paid = $449,828**

**Wealth transferred from one generation to the next without making a gift**

## Example 2: Below market rate mortgage

**Parents loan $1 million over 15-year term to child to purchase house**

Current long term AFR: 1.17% (as of 11/20)

**Interest paid over the term = $175,500**

**No gift made**

**Kids secure a mortgage at less than current market rate of 2.33%** (FreddieMac, 10/20)



320930 7/20

# Opportunity with grantor retained annuity trusts (GRATs)

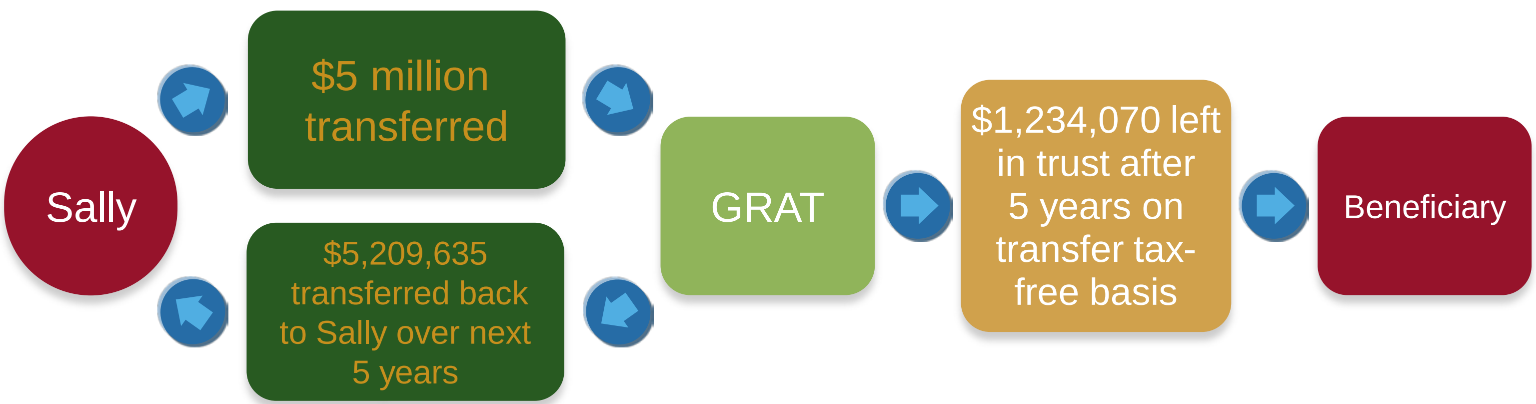
- Type of irrevocable trust where the grantor retains a right to annuity payments from the trust over a number of years
- Can be an effective method for transferring wealth free of gift and estate taxes if designed properly
- Especially attractive right now considering historically low IRS interest rates; should GRAT be short or long term?
- HNW clients may want to consider acting now because of potential legislative threat



320930 7/20

# Using a GRAT to transfer wealth free of gift taxes

- Sally transfers $5 million in property to an irrevocable trust
- The trust transfers property back to Sally over the five-year term based on an annuity calculation
  - Annuity factor is based on IRS 7520 rate of 0.4%, as of November 2020
- If trust assets grow 8% annually, then over $1 million remains in the trust free of gift and estate taxes for the benefit of Sally's beneficiaries
  - Assumes Sally outlives the five-year term for the GRAT to be an effective strategy




For illustrative purposes only.

# What is an Intentionally defective grantor trust (IDGT)?

- Irrevocable trust valid for gift and estate tax purposes, but considered a grantor trust (i.e., defective) for income tax purposes
- Often funded with limited partnership (LP) interests as part of a business succession plan
  - Funding with LP interests allows valuation discount
- Appreciated asset is sold to the trust in exchange for a promissory note
- Grantor payment of taxes allows maximum potential growth for assets held within the trust

# Charitable lead trust

- Grantor and non-grantor trust
- Low interest rate so large deduction if grantor trust
- Example: $1,000,000 gift with term of 20 years and payout of 5% the tax deduction is $959,205 at a 0.4% 7520 rate for grantor lead trust
- Of course grantor is currently taxed on income and capital gains of trust
- Remainder of term what is left in trust goes to beneficiary
- Possible use to offset a large capital gain or windfall

# Charitable remainder trust

- Gift to charity and income back to beneficiary for life or a period not to exceed 20 years
- CRUT is more favored increase with inflation
- Example: $1,000,000 to charity, 5% payment to donor, deduction with 0,4 7520 rate is $445,330
- The remainder value to charity must be at least 10% of the funding amount
- Uses-offset gain but get income stream or as alternative to conduit trust as bene of your IRA


320930 7/20

All funds involve risk, and you can lose money.

This information is not meant as tax or legal advice. Please consult your legal or tax advisor before making any decisions.

For informational purposes. Not an investment recommendation.

*Investors should carefully consider the investment objectives, risks, charges, and expenses of a fund before investing. For a prospectus, or a summary prospectus if available, containing this and other information for any Putnam fund or product, call your financial representative or call Putnam at 1-800-225-1581. Please read the prospectus carefully before investing.*

Putnam Retail Management
putnam.com



320930 7/20

Putnam
INVESTMENTS