2021

Financial Planning Update

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WEALTH MANAGEMENT

Inside the Issue

And just like that we are already in the second half of 2021. In so many ways, our lives are starting to go back to "normal"...which we are thankful for!

In this Edition of our Financial Planning newsletter, we will share our perspective on the Biden Tax Plan and take a closer look into a few planning strategies. If your financial situation has recently changed, creating the need to review where you are today, don't hesitate to reach out so we can discuss the strategies that might be appropriate for you and your family.

As always, please remember to consult with your tax and financial advisors before taking action and discuss the options that might be appropriate for you sooner rather than later.

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TAX PLANNING

BIDEN'S TAX REFORM

Now that Congress has approved a budget resolution, they are in the process of hashing out specifics through the reconciliation process. The goal is to complete this by the end of September. There will be negotiations on the details, but the starting point is President Biden's budget proposal. While it is still unclear what adjustments Congress will make, it is worth considering the suggested budget changes and how they might impact you. Outlined below are proposed changes to high-income taxpayers and an assessment of who might be impacted.

Raise the top marginal income tax rate: The proposed budget resurrects the 39.6% income tax rate earlier than scheduled. The Tax Cuts and Jobs Act of 2017 reduced the top marginal tax rate from 39.6% to 37%. This change is scheduled to last through 2025, reverting to the former rates in 2026. President Biden's proposal renews the 39.6% tax rate as of January 1, 2022. If the proposal is passed, joint taxpayers with taxable income over $509,300 and individual taxpayers with income over $452,700 next year would pay a marginal tax rate of 39.6% on ordinary income in excess of those amounts.

Tax capital income for high-income earners at ordinary income tax rates: Currently, long-term capital gains and qualified dividends get preferential tax treatment. They are taxed at lower, long-term capital gains tax rates than the ordinary income tax rates applied to earned income, such as wages. Long-term capital gains tax rates are 0%, 15% and 20%. Biden's tax proposal would add another long-term capital gains tax rate for high-income taxpayers. Once taxable income exceeds $1 million, long-term capital gains and qualified dividends would be taxed at the ordinary income tax rate of 39.6%. In addition, this income would still be subject to the 3.8% net investment income tax (NIIT), effectively imposing a 43.4% tax on portfolio income over $1 million. (Taxpayers in the 15% or 20% long-term capital gains tax rate are also subject to the NIIT tax if their taxable income is over $250,000 for a married couple filing jointly or $200,000 for a taxpayer filing single.)

This particular change is scheduled to go into effect "after the date of announcement". Unlike the other proposed tax changes, the impact would not be postponed to the 2022 tax year. There is no clarification as to what the date of announcement refers to. It could be when Biden released his American Families Plan in April or when he announced his budget in May. Alternatively, it could be as of the date the budget is approved.

Eliminate the step-up in basis and treat transfer of property by gift or death as realization events: Currently, assets transferred upon the death of the owner receive a step-up in basis from the original value to the fair market value on the date of death. This means that the person inheriting the asset doesn't owe any tax on the asset and their "new" basis moving forward is the fair market value at the time of death. Biden's tax plan eliminates the step-up in basis. Furthermore, death is to be treated as a realization event, meaning the estate would have to pay taxes on the difference between the fair market value and the basis of the asset. Gifting of assets would also be treated as a realization event, making it difficult to avoid gains by gifting prior to death.

There are exceptions to this proposal. The capital gains tax from realization events would not have to be paid on family owned and operated businesses until they are sold or are no longer family operated. Also, a 15-year period would be granted for payment of taxes on illiquid assets. Finally, each taxpayer would be allowed a $1 million exclusion from recognition of gains plus another $250,000 exclusion for their primary residence. For married couples, there is no tax on assets transferred to a spouse and the exclusion is portable. The exclusion amount would be indexed to inflation.

The impact of proposed changes will depend upon your specific circumstances. However, we provide a few thoughts about the potential new taxes:

- Most people won't be impacted by the new taxes: President Biden is determined to not raise taxes on those with income under $400,000 and the new income tax rate applies only to incomes higher than that amount. Similarly, the new capital gains tax rate would only apply to those with income over $1 million. The end of the step-up in basis would impact only estates with taxable accounts holding unrealized gains in excess of the exclusion amount. Retirement accounts would not be impacted by the elimination of step-up in basis
- There are no proposed changes to the estate tax: One item not included in Biden's budget proposal is changes to the estate tax exemption. TCJA raised the estate exemption amount from $5.49M to $11.18M in 2018 (the amount is indexed, so it is now $11.7M). The increase is set to sunset in 2026, dropping back to $5M, adjusted to inflation. The 2022 budget proposal maintains the schedule set by the TCJA. However, this may be an alternative way to raise taxes if the other tax proposals are cut back.

- The elimination of step-up in basis is key: Limiting the step-up in basis would remove a major planning strategy. Given the uncertainty regarding the effective date, realizing gains before the tax law is put into place may not be possible. Instead, new strategies could be adopted such as annual filling in of lower brackets, rethinking asset location or filing taxes separately.

Take the time now to consider whether you might be impacted by the proposed changes. If so, review the above considerations with your financial and tax advisors and develop an appropriate plan of action.

REQUIRED MINIMUM DISTRIBUTIONS (RMDS) ARE BACK!

The pandemic changed our lives in many ways over the past 15 months. We have all had to make adjustments personally and professionally. From a financial standpoint, federal and state governments intervened in many ways in an effort to counteract the devastating impact of COVID-19. The IRS moved tax deadlines, Congress passed new legislation to provide support for small businesses and taxpayers and the Fed flooded the system with liquidity while slashing rates. One notable change from 2019 was the passage of the Coronavirus Aid, Relief and Economic Stimulus (CARES) Act of 2020. While the CARES Act contained a myriad of economic aid and tax changes, this article will focus on one particular area: required minimum distributions (RMDs) from retirement accounts. An RMD is a calculated amount that retirement account owners are required to distribute annually and pay income taxes on. RMDs were paused for calendar year 2020 as a method of providing relief to taxpayers. At least for 2020, retirement account owners were off the hook for RMDs. It is 2021 and RMDs are back again, but there's a catch.

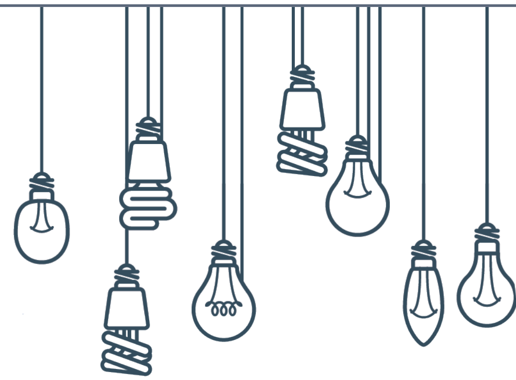
Before we move forward, we must look back to another recently passed piece of legislation that altered the RMD landscape. In December 2019 Congress passed the SECURE Act that made changes to the age at which RMDs must begin. Under the Act, qualified retirement account owners must begin RMDs at age 72 rather than age 70.5. Since Congress changed the guidelines in 2019, they had to decide who would be subject to the new rule. Thus, anyone who turned 70.5 (or older) in 2019 would continue to take RMDs in 2021 while those born after June 30, 1949 have until age 72 to begin mandatory distributions.

Of course, there is more to the story. The more we write about this development the more it starts to sound like an iteration of "Who's on First?". Last November, the IRS updated life expectancy tables to reflect how Americans are living longer. This is the first increase in life expectancy tables since 2002. Rather than having the new life expectancy tables coincide with the rekindling of RMDs in 2021, and considering the disruption caused by the pandemic, the IRS delayed their use until 2022. Ultimately, anyone subject to an RMD in 2021 will continue to use the old life expectancy tables to calculate their taxable distribution.

The new life expectancy tables, which are used to calculate the dollar value of the RMD, will translate into slightly smaller distributions. For example, under the current Uniform Lifetime Table, the divisor used to calculate the RMD for a retirement account owner aged 72 is 25.6. Thus, an IRA worth $1,000,000 would be subject to an RMD in the amount of $39,062.50. Under the new tables, the same IRA would have a divisor of 27.4 and an RMD equal to $36,496.35 (a decrease of approximately 6.5%).

One final twist and something to keep in mind. A few weeks ago, the House Ways and Means Committee drafted the "Securing a Stronger Retirement Act" to further build on the SECURE Act of 2019. One of the provisions in this proposed legislation includes further moving the RMD age to 73 in 2022, to 74 in 2029 and finally to 75 in 2032. This SECURE ACT 2.0, as it has been dubbed, is said to have fairly solid bipartisan support. We will keep our ears to the ground, and should new legislation be signed into law you will be hearing from us.

There are many other factors involved with required minimum distributions including which life expectancy table to use, to the timing of when to take an RMD, to tax withholding and penalties for missing a distribution. We are here to answer your questions and make sure the proper process is followed. As always, please feel free to reach out to your wealth advisor to discuss further.



FOR PARENTS SAVING FOR THEIR CHILDREN'S COLLEGE EDUCATION, A SECTION 529 PLAN MAY OFFER SEVERAL ADVANTAGES. SECTION 529 PLANS, OPERATED BY INDIVIDUAL STATES, LET FAMILIES SET ASIDE MONEY TO COVER FUTURE EDUCATION EXPENSES OF ACCOUNT BENEFICIARIES.

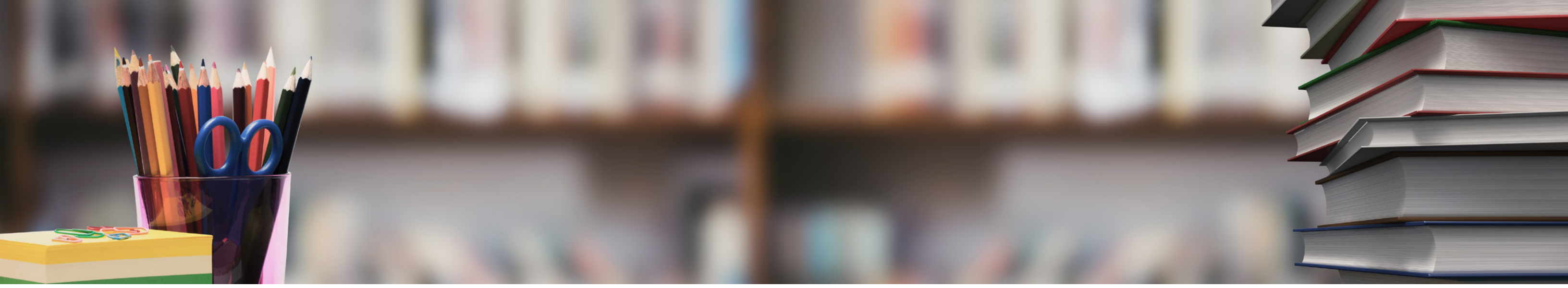
These plans are flexible, tax-advantaged accounts that accumulate funds for higher education. They allow you to invest after-tax dollars in a selection of investment funds. The investments in the account grow tax-free and the withdrawals are tax-free for qualified expenses.

"Qualified" expenses include tuition, fees, books, supplies, equipment, and room and board. In addition to using 529 plans for higher education, up to $10,000 can be withdrawn per year for kindergarten through 12th-grade tuition at private schools. Any unused funds can also be used for graduate, trade or vocational education or reassigned to another beneficiary (sibling, niece/nephew, yourself, etc.). If funds are withdrawn for non-qualified expenses, then taxes will have to be paid on the growth as well as a 10% penalty.

You're not obligated to use a Section 529 college savings plan for a college in your state, and you're free to use another state's plan if you like its features and they allow non-residents to enroll in the plan. Some states offer tax deductions for contributions to the in-state plan. This often makes your in-state 529 plan the most advantageous. If there is no state tax benefit or your state plan has high fees, then consider investing in another state's plan. New Jersey does not offer tax deductions to its' residents so you might be better off using a plan from another state.

THERE ARE THREE THINGS WE LOOK FOR IN A 529 PLAN:

one LOW FEES	High fees reduce the return on your investment. There are plenty of good 529 plans that you should find a plan where the underlying investments charge 0.20% or less.
two INVESTMENT ALLOCATION OPTIONS	Age-based investment options are ideal for 529 accounts since they are invested for growth when the child is young but shift toward more conservative investments as the child approaches college age. Consider a state with multiple age-based options with different risk levels (aggressive, moderate and conservative).
three INVESTMENT FUND OPTIONS	If you have a preference for a certain investment family, such as Vanguard, then look for a state that uses those funds.



HERE ARE SOME PLANS THAT WE LIKE GIVEN THEIR FEE STRUCTURES AND INVESTMENT OPTIONS.

NEW YORK

https://www.nysaves.org

Total asset - based expense (administrative + fund expense fees): 0.13%

Age - Based Options with different risk levels, multi-fund and single fund investment options

Vanguard mutual funds

ILLINOIS

https://www.brightstart.com/

Total asset - based expense (administrative + fund expense fees): 0.11% - 0.14% for index funds; managed funds are higher

Age - based options with different risk levels, using either index funds or a managed strategy; multi-fund target strategies and single fund investment options

Vanguard, DFA, T. Rowe Price and Dodge & Cox funds

MICHIGAN

https://www.misaves.com

Total asset - based expense (administrative + fund expense fees): 0.075% - 0.135%

Age - Based Options with different risk levels, multi-fund and single fund investment options

TIAA-CREF, Vanguard, Schwab and iShares funds

OHIO

https://www.collegeadvantage.com/

Total asset - based expense (administrative + fund expense fees): 0.17% - 0.50%

Age - Based Options with different risk levels, multi-fund and single fund investment options

Vanguard and DFA mutual funds

UTAH

https://my529.org/

Total asset - based expense (administrative + fund expense fees): 0.12% - 0.167% excluding customized options which are higher

Age - Based Options with different risk levels, multi-fund and single fund investment options. Also the plan offers age-based strategies either with or without global investments.

Vanguard, Dimensional and PIMCO mutual funds

Millennials (a.k.a Generation Y) are defined as those who were born between 1981-1996. Even though many individuals in their mid-30's don't associate themselves as a millennial...I'm sorry to say but you are! This generation is known for and accustomed to instant gratification. Basically, when they want it; they want it NOW! If Siri doesn't know the answer, they give up. Instant gratification is the opposite of what many of us have been taught and difficult to break. Where am I going with this? As a millennial who works in the financial industry, I witness firsthand my generation's spending and saving habits. "What stock should I buy to double my money?" "I put all my money in Bitcoin!" "Stocks only go up!" These are just some of the things I hear. SMH! (that's "shaking my head" for you older folks). It may be difficult for many millennials to comprehend, but what if I told you that the best thing you can do is pay tax today, then wait to reap some solid benefits. What I'm talking about is saving using a Roth IRA.

The Roth IRA was introduced as part of the Taxpayer Relief Act of 1997, named after Senator William Roth. A Roth IRA is an account that you fund with after-tax dollars and then all future withdrawals are tax-free. Generally speaking, there is more flexibility regarding withdrawals from a Roth IRA than those for the 401k or Traditional IRA (the tax man already collected some of your earnings) and you may be able to access the original contributions without penalty before age 59.5. However, earnings in the account will follow specific distribution rules based on your age and length of ownership of the account. So how can this benefit millennials? In the early stage of your career, you will likely be in a the lower tax bracket than you'll be in the future. Therefore, taking advantage of paying taxes at a lower tax rate today will benefit your future-self.

Did I mention the Roth account also grows tax-free?! This means that once you invest, the earnings are not taxable AND you get to take out the funds tax-free when you retire. That being said, there are some constraints, such as income limits and contribution limits. For the tax year 2021, the contribution limitation is $6,000.

LET'S TRY AN EXAMPLE TO SHOW THE COLLECTIVE POWER OF A ROTH IRA AND COMPOUND INTEREST.

EXAMPLE: Billy is 25 years old and just started his first job. He contributes $6,000 to a Roth IRA for 15 years at an average long-term growth rate of 8%. When he turns 40, he meets the income limitation and can no longer make any further contributions. At retirement he is now 65, and with the magic of compounding interest the account is worth, $1,204,960. He would have contributed $90,000 over 15 years which resulted in a total account value over $1.2 million at retirement. Billy can then take the funds out TAX FREE!

All in all, a Roth IRA can be a great investment vehicle, especially if started early on. Just as you would diversify your investments, it is just as important to diversify the "type" of investment accounts and the timing of your tax bill. A Roth IRA is a great vehicle to diversify your accounts and is a stellar hedge for future (unknown) tax rates.

2020 HINDSIGHT — AN ESTATE PLANNING HOME RUN

Last fall, we wrote about an interesting estate and gift planning technique called Grantor Retained Annuity Trusts (GRAT). A more in-depth explanation can be found here: CLICK TO READ.
In brief, GRATs can be a very effective way for families to gift assets without giving up principal. Essentially, GRATs allow an investor to retain the principal and give away the growth.

The last twelve to fourteen months have been historic on many levels. During this time, a couple of key factors impacting the use of GRATs happened to create quite the attractive opportunity. The Federal Reserve intervened at the start of the COVID-19 pandemic to slash interest rates and provide monetary support. GRATs require the use of a particular interest rate (7520-rate) published by the IRS monthly. By April 2020, the 7520-rate dropped to 1.2%. Simultaneously, the stock market fell by more than 25% in response to the global shut down.

GRATs can thrive with low interest rates and low stock valuations. To generate a gift to a beneficiary the investment performance on assets in a GRAT must exceed the 7520-rate. The lower the rate, the easier it is to outperform over the term of the trust. Looking back, if someone had funded a $1,000,000 GRAT in April 2020 and invested in an index that tracked the Nasdaq it would have returned approximately 87% through May 2021. This represents an investment gain of $870,000.

With a typical 2-year GRAT term this would represent a home run. Special language in the trust would allow the grantor to lock in the gains and swap in less volatile assets for the remaining term. In this overly simplistic example, the grantor would receive two annual annuity payments of approximately $509,000 (principal plus interest) while generating a gift of over $800,000 to the beneficiary.

We recommend working with an estate planning attorney to execute a gifting technique such as a GRAT. The combination of investment strategy, gifting objectives and the retention of principal can make Grantor Retained Annuity Trusts an effective tool for estate planning.

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Need More Information? Please do not hesitate to contact a member of the Withum Wealth Management Team with any questions or concerns:

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