Making the Most of Market Shifts

Five planning strategies for uncertain times

The current challenges we are facing in the markets understandably raise concerns about one's financial future. Although we may be facing an economic downturn, we would be remiss not to explore the positive ways that your wealth plan can take advantage of depressed asset values. There are several wealth planning strategies that are particularly attractive in this environment.

Key takeaways

- Although we are facing many challenges on the economic and market fronts, there are positive ways that your wealth plan can benefit from the current depressed asset values
- This article explores five wealth planning strategies that may be particularly attractive in today's environment
- As with any planning strategy, it's important to consult with your advisors to be sure you are incorporating strategies that are right for your particular situation

1. Gifting assets with depreciated value

If the value of your assets has declined due to challenging market conditions, this may be a perfect time to gift those assets. The federal lifetime gift tax exemption amount, which is the amount you can transfer free of gift tax, is at an all-time high of $13.99 million for individuals and $27.98 million for married couples. While asset values are low, you may gift more of your assets to maximize the use of your federal lifetime gift tax exemption. This is because the use of the exemption is based on the fair market value of the asset transferred at the time of gift. Furthermore, any future gains from these assets could be held in trust outside of your estate.

Making the most of today's high federal exemption before it expires

The current heightened federal estate, gift, and generation-skipping transfer (GST) tax exemptions amount (collectively, the federal exemption) is only temporary. As part of the many tax provisions of the 2017 Tax Cuts and Jobs Act (TCJA), it is scheduled to expired or sunset at the end of the year. While there has been discussion to extend some of the tax cuts, it is unclear at the time of this writing whether the federal exemption will indeed be extended. Without further Congressional action, the federal exemption will automatically be reduced to approximately half the amount on January 1, 2026, thereby making this an opportunistic time to take advantage of the current law and make gifts while the valuation is low.

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Considering cost basis

It is important to think about the cost basis of an asset when determining a gift. Unlike a bequest at death, which is typically assessed at the fair market value at the date of death, the cost basis of a lifetime gift is the same for the person receiving the gift as it is for the person giving the gift.

By gifting high basis assets and allowing low basis assets to receive the step-up at death, beneficiaries may have zero or minimal gain, resulting in less capital gains tax.

Understand that there are exceptions. For example, if you gift property and the fair market value is currently below basis, the cost basis of the recipient depends on whether the asset will be sold for a gain or a loss. For purposes of determining loss, the recipient's basis will be the fair market value of the property at the time of gift. However, the recipient's basis is the adjusted basis in the hands of the donor when it comes to determining a gain.

Consider a share of stock purchased for $150 that has since declined in value to $100. If you gift the stock to your child and he or she sells the stock for $90, it would result in a $10 loss because the fair market value of the time of the gift was $100. However, if the child were to sell the stock for $200 later on, it would mean a gain of $50 because the child's basis is the adjusted basis ($150) at the time of the gift. A sale price that falls between your basis and fair market value at the time of the gift would mean no gain or loss is realized.

Benefits of gifting into a trust

When considering gifts of significant size, you may wish to utilize a trust structure rather than an outright gift for maximum flexibility, tax efficiency, and creditor protection. A trust may be structured as a so-called "grantor trust." A grantor trust is disregarded for income tax purposes and the grantor continues to be responsible for the income tax associated with the trust assets. Therefore, the basis of the property remains unchanged in the hands of the trust. If the grantor trust were to subsequently sell the assets, then the donor would recognize a gain or a loss as if the donor had held the assets in his or her individual name.

If you're looking for multigenerational gifting, you might also consider gifting depressed assets to a dynasty trust. This type of trust is an irrevocable trust with the ability to stay in effect for multiple generations. Because future growth of the trust's assets is not subject to estate, gift, or GST taxes, the trust can in effect become a "family legacy fund" for future generations.

2. Grantor retained annuity trust (GRAT)

In times of market downturn and volatility, a GRAT can be an opportunistic planning strategy. A GRAT is a type of trust that could provide a method of transferring the growth on assets to future generations at a reduced gift and estate tax cost. The donor (grantor) transfers assets expected to appreciate to an irrevocable trust, retaining an annuity stream for a fixed term. At the end of the fixed term period, the remaining assets pass to family members outright or in further trust.

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Although the transfer of assets to the trust is considered to be a gift, the amount of the gift is reduced by the actuarial value of the annuity retained by the grantor, so the amount of the taxable gift may be small or even zero compared to the value of the assets transferred. If the asset growth outperforms the IRS statutory rate used to value the remainder interest (Section 7520 rate or the so-called "hurdle rate"), the additional growth is transferred free of gift and estate taxes to the trust's beneficiaries. The benefit of a GRAT during a market downturn is that you can transfer assets at the lower valuation into the GRAT and capture all the future market upswing and appreciation inside the structure. This is especially relevant for those who are inclined to hold on to the asset and weather the downturn because you believe in the asset's long-term growth potential.

In addition, a GRAT is most effective when the hurdle rate is low, as appreciation of the asset above that rate passes to the beneficiaries free of wealth transfer tax. Although interest rates have been rising in recent years, the hurdle rate, relatively speaking, is still sufficiently low such that if you combine this with a depressed asset, the possibility of the depressed asset increasing in value above the hurdle rate could still make this a compelling strategy.

Setting the length of the GRAT term is critical—as the grantor of the trust, you must survive the term in order for the tax benefits to be realized; otherwise, if you die before the end of the GRAT term, most to all of the assets in the trust will be taxed to your estate. You may consider mitigating that risk by purchasing life insurance to cover the estimated amount of federal estate tax that would be due if you did not survive the term of the GRAT.

3. Sale to an intentionally defective grantor trust (IDGT)

Similar to the GRAT, this strategy leverages both the low valuation and relatively low interest rate environment. As a first step, you as the grantor make a completed gift to an irrevocable trust to provide the so-called "seed money." This initial funding of the IDGT will remove future appreciation of the gifted asset from your estate and also sets up the IDGT in anticipation of an eventual sale of assets to the trust. Typically, you will also allocate an equivalent amount of GST exemption so that the trust can grow for future generations without being subject to both estate and GST taxes. By retaining certain trust powers (e.g., the power to substitute assets of equivalent value) you will continue to be the owner of the IDGT assets for income tax purposes. You can then sell additional assets to the IDGT in exchange for a note. The note will bear the minimum Applicable Federal Rate (AFR), which again, is currently at relatively lower rates. This way, any growth of the assets that exceeds the AFR will inure to the benefit of the IDGT and may be available for multiple generations to come.

This strategy is particularly worth considering if your goal is to transfer wealth from a multigenerational perspective. For those who have already created irrevocable or dynasty trusts, this could be an additional strategy to leverage those existing structures.

4. Roth IRAs: Tax strategies to consider

The threat of higher tax rates in the future emphasizes the importance of a tax-free source of income. It is not yet determined at the time of this writing whether the lowered individual income tax rates of the TCJA will be extended beyond the end of this year. Therefore, planning with an anticipation of a higher income tax rate may be prudent. A Roth IRA can be an effective legacy planning tool. By preserving the Roth IRA for as long as possible, you are providing the opportunity for maximum growth to an account that can be 100% income-tax-free.

Given the long-term benefits that Roth IRAs can provide in planning, conversions from traditional IRAs to Roth IRAs should be evaluated in the scope of your overall income tax and estate planning. Although there is an upfront tax paid when the conversion takes place, under the current market environment, it could be cheaper than in the past.

The benefit of a Roth IRA is that it is essentially an income-tax-free vehicle. While assets in a traditional IRA benefit from tax-deferred growth, future distributions are taxed at ordinary income tax rates. Alternatively, Roth IRAs not only grow on a tax-free basis, but distributions are also income-tax-free in the future. Furthermore, there are no required minimum distributions from Roth accounts unless they are inherited accounts.

Converting to a Roth is a taxable event where the tax is based on the fair market value of the traditional IRA at the time of conversion. However, if the traditional IRA is currently undervalued, then the resulting conversion tax would be lower as well. Additionally, once converted, any rebound of value inside the Roth IRA would be income-tax-free.

As with all tax strategies, there are many variables that factor into the decision to make the conversion, such as the expected future tax rate and investment growth, the age of the account holder, and aggregation rules. A detailed analysis of the various factor is highly recommended.

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5. Asset swap with an irrevocable trust

For those with an existing trust holding low basis assets, now could be a great time to consider an asset swap. In this strategy, you, as the grantor of the trust, would substitute assets in the trust by swapping cash from your individual account with the assets held by your trust which have since dropped in value. In doing so, you will receive the low basis assets back in your individual name, which will get the benefit of the basis step-up at death. The trust, in turn, will have the cash to hold steady in any future market downturn and be positioned to be deployed on any future investments. Because the valuation of assets has dropped, the cost of this strategy has now decreased because you need less cash to do the asset substitution. For those who may not have cash readily available for this strategy, a short-term bridge loan may also be a possible solution. It is important to note that this strategy only applies if your trust is structured as a grantor trust that has the relevant substitution power language in the trust agreement. A review of the trust terms with your advisor and attorney is recommended.

Before implementing any of the above strategies, it is important to have a sound financial plan in place that has accounted for market downturns and any future assumptions so that any projections are realistic under the current environment. This is exactly the type of moment when having a long-term plan and projecting multiple economic scenarios will help you make informed decisions on these long-term strategies.

Although we are facing many challenges on the economic and market fronts, we would be remiss not to explore the positive ways that your wealth plan can benefit from the current depressed asset values. Times of uncertainty can offer opportunities, and using all or some of these strategies can help your wealth plan in the long term during an otherwise stressful and unpredictable time. As with any planning strategy, it's important to consult with your advisors to be sure you are incorporating strategies that are right for your particular situation.

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