Planning in a Changing Wealth Landscape

By Chris Zander

Securing and transferring even the most complicated assets has been relatively straightforward – and exceptionally rewarding – over the past 10 years. That was then. The landscape now looks very different, with lower return expectations, rising interest rates, and a changed tax regime among its most striking features.

Staying on track to meet retirement and other long-term wealth planning goals means revisiting wealth plans and adjusting course as needed. Here are some current highlights to consider; each merits in-depth and personal discussions between families and their advisors. The combination of these and other factors should drive the advice, and the best solutions will be based on individual circumstances and long-term goals.

LOWER RETURN EXPECTATIONS

For many Americans, the market's gains over the past 10 years obscured insufficient savings, even as guaranteed corporate pensions were relegated into the history books and real estate values in many areas declined. At the same time, gifted assets have considerably outperformed expectations across most asset classes.

As John Apruzzese writes in this issue, we expect a 10-year average annualized return of 6.3% for balanced portfolios, down from a realized annualized return of 7.8% since our firm's inception 10 years ago.[1] That's still a reasonable return rate, but it's going to come as something of a shock to those who don't adjust their plans accordingly. It's important to be mindful of these lower expected returns, which not only amplify the need to be more tactical in wealth transfer planning, but also to understand what it's going to take to meet retirement lifestyle goals. Planned transfers to family or to charity may need to be revisited.

RISING INTEREST RATES

After 10 years at near zero, interest rates are rising. While we do not expect rates to rise significantly in the near term, families who wish to transfer assets (without using their current gift tax exclusion) may wish to consider locking in current rates through several types of wealth transfer planning techniques commonly referred to as estate freeze strategies. Grantor retained annuity trusts, or GRATs, installment sales to intentionally defective grantor trusts, charitable lead annuity trusts, intra-family loans, and other freeze strategies that tend to perform well in periods of low rates and high (or even modest) investment returns, can still be attractive options in transferring wealth, especially if they contain rapidly appreciating assets. However, their hurdle rate – the rate of return required by the IRS – rises along with interest rates and presents an additional headwind.

In addition to selecting assets for transfer with high appreciation potential, such as a private company expected to be taken public or to be sold, families should revisit utilizing assets that have inherent valuation discounts to future fair market value. These valuation discounts may be augmented in cases where a family entity (such as a family limited partnership or LLC) owns one or a series of these assets for business management purposes. Transferring a non-voting interest in one of these entities may result in additional future wealth transfer value to heirs, due to the potential lack of marketability and minority interest discounts.

BIG TAX CHANGES – AND AN UNCERTAIN LEGISLATIVE FUTURE

Income taxes, already low by historical standards, are now lower still for many high net worth families. The Tax Cuts and Jobs Act of 2017 lowered many personal and corporate income taxes and provided enhanced deductions for pass-through income. However, the gains are at least partly offset by the elimination of many itemized deductions, notably the state and local tax, or SALT, deductions.

In this political climate, it is impossible to know what the next year will bring, let alone the next 10 years. In any case, planning should be based on each family's specific circumstances, goals, and tolerance for risk.

If income tax rates do move up, the value of tax deferral, as well as that of charitable deductions, increases proportionately. In lieu of an outright sale of a highly appreciated, low-cost stock position, families may consider certain hedging techniques (such as equity collars and prepaid variable forward), tax-efficient transition investing strategies, and charitable alternatives such as outright gifts and charitable remainder unitrusts to diversify the position and hedge risk in a tax-efficient manner.

Tax reform also introduced a considerable degree of uncertainty into longer-term wealth planning, as it effectively doubled the federal gift, estate tax and generation-skipping tax, or GST, exclusion amounts to $11.18 million per person (recently changed to $11.4 million for 2019). Without legislative action, the law will sunset after December 31, 2025 (although it's worth noting that newly proposed and temporary regulations have diminished risk of a clawback).

Families with large estates would normally try to maximize gifting up to the federal gift tax exclusions in effect at the time. The increased exclusion, coupled with lower expected investment returns projected, leaves the onus on families and their advisors to holistically determine how much they can reasonably afford to transfer from a retirement perspective. As discussed in past editions of *Independent Thinking*, spousal limited access trusts, or SLATs, can be an effective tool to manage transfers now while providing emergency access for grantors who err in their projections for retirement.

As families determine appropriate transfer amounts, another key interplay between estate tax efficiency and income tax planning should be considered. To the extent that a grantor transfers assets that appreciate over time, the recipient (either an individual beneficiary or a trust) will likely bear the income tax on those future gains. This made sense in the past as the estate and gift tax rates were higher than income tax rates and grantor trusts offered flexibility with substituting assets to mitigate the potential tax on heirs.

Now, however, an estate in the neighborhood of $22 million left by a married couple at death would receive a step-up in income tax basis. Transferring appreciated or soon-to-be appreciated assets that would never be taxed from a federal estate tax perspective (under the higher federal estate tax exclusion) would mean forfeiting the step-up and incurring a potential future income tax for the family that could have been avoided. The impact of different state estate and gift tax regimes is an additional variable to consider depending on one's domicile. And, of course, the estate tax legislation could be changed again.

Again, every situation is different and it's important to work with your trusted advisor to evaluate the range of options and scenarios and put a flexible plan in place.

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[1] EWM Balanced Composite 10-year return from 2.1.2009.

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