



By Kristi Mathisen, JD, CPA, PFS



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The times they are a-changin', proclaimed Bob Dylan. And that could well be true for U.S. taxes. In the coming years, we could see higher tax rates, especially on upper-income households, regardless of the outcome of the 2020 elections.

For one, the U.S. federal budget deficit has risen dramatically in the past several years (to around \$1 trillion annually), and higher taxes are a key way to limit the red ink. Just as important, many of the tax breaks in the 2017 Tax Act are temporary; they will expire at the end of 2025 unless renewed by Congress.

Calls to Raise Taxes

Tax increases being discussed by the Democratic presidential candidates and/or members of Congress:

- **Wealth tax.** Taxing net worth over a certain amount (starting at around \$16 million) in addition to annual income. Would probably require the equivalent of filing an estate tax return each year.
- **Higher estate taxes.** Currently, estates valued up to \$11.58 million are excluded from federal estate taxes; this exclusion could drop by 50% or more, down to \$3.5 million.
- **No more "stepped-up tax basis" at death.** Heirs would inherit property at the amount originally paid for it — not the current market price — resulting in high capital gains taxes upon sale. Or it's possible the estate would pay a capital gains tax, as in Canada.
- **Taxing unrealized capital gains annually.** The increase in value of investments and real estate would be taxed annually, not only when sold.
- **Surtax on high income.** On incomes of \$1 million or more, for example, there would be an extra tax, basically adding a new higher tax bracket.
- **Higher Social Security taxes.** Increase the current rate of 12.4% paid jointly by employer and employee, and/or subject annual earnings above \$137,700 to Social Security taxes.

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While higher tax rates are by no means a given, it's wise to have a plan in place just in case. Below are some key ways to take advantage of current low rates, as well as to prepare for change. Keep in mind that each situation is different and that there are many moving parts — income and capital gain taxes, as well as gift and estate taxes. Tax planning that takes into account all your assets and finances is a must, and something we can help you do.

Estate Tax Exclusion – Use It or Lose It

Worth exploring: Are you making the most of lifetime gifts and asset transfers – outright or to a trust – to lock in the expanded gift and estate tax exclusion?

The biggest potential tax savings now are in estate taxes. That’s because the 2017 tax law doubled the amount you can leave to your heirs free of federal estate tax; currently the exclusion is \$11.58 million per person, over \$23 million for a married couple (see box).

In November 2019, the IRS made a very important clarification: This higher exclusion is permanent for those who take advantage it before the tax law changes. Basically, this has created a use it or lose it situation. The “use” means giving away – directly or to a trust – up to the full exclusion (\$11.58 million) by the end of 2025.

Strategic Use of Trusts

Creating a legacy. There are many reasons to establish a trust, not just to lower estate taxes. It is beneficial to consider doing so at this time because the trust can be funded with a higher level of assets, enough to make large gifts that benefit both children and grandchildren over their lifetimes.

For example, say you have a sizable estate consisting mostly of real estate that is likely to grow in value, and you want to provide for future generations of your family, not just your children. A Generation-Skipping Trust (sometimes called a Dynasty Trust) could be funded with up to \$11.58 million in assets, over \$23 million for a couple. In Washington State, trusts can last for up to 150 years, so this would allow many generations to benefit from the trust.

Transferring assets, not taxes. When you give assets away during your lifetime, you also transfer the tax obligation that goes with them. On a \$5 million parcel of land purchased for \$500,000, for example, your beneficiaries will be taxed on \$4.5 million when they sell. Use of what is commonly known as a “defective” trust is just one of the strategies that can be used to minimize beneficiaries' capital gains taxes. In this example, you could transfer the land to the trust, and later have it substituted (tax-free) with an equivalent-valued asset that has not gained much in value. What if you wanted to

Doubled in Size: The Federal Estate Tax Exclusion

	2017	2018 - 2025
Estate & Gift Tax Exclusion: How much you can give away during your lifetime OR upon death	\$5.5 million per person	\$11.58 million per person (inflation-adjusted annually)
Estate Tax Rate	40.0%	40.0%

Washington State Has Its Own Estate Tax

If you live in Washington State and have a net worth higher than \$2.19 million, there is also the WA State estate tax to consider (see below). The good news is that any gifts you make, either outright or through a trust, reduce your WA estate tax. Many other states do not allow this. They – including Illinois and Massachusetts – add back all gifts in calculating your taxable estate at the state level.

WA Estate Value Above \$2.19 Million	Estate Tax Marginal Rate
\$0 to \$1 million	10%
\$1 million to \$2 million	14%
\$2 million to \$3 million	15%
\$3 million to \$4 mil	16%
\$4 million to \$6 million	18%
\$6 million to \$7 million	19%
\$7 million to \$9 million	19.5%
Over \$9 million	20%

continue receiving rents from the land? Instead of gifting the property, you could sell it to the defective trust in exchange for a note, whose payout approximates the rents.

Capital Gains – Hold 'Em or Fold 'Em?

Worth exploring: Your total amount of unrealized long-term capital gains by source and potential selling strategies.

Gains on investments you hold more than one year are taxed at lower rates than regular income (see box below), and taxes are due only after you sell. The lower rate also applies to qualified dividends. What this means: How and when you sell to generate capital gains should be considered carefully as part of your tax strategy. This is especially true now, since the current favorable treatment of gains could change in one of two ways, or both:

- (1) Higher rates on capital gains;
- (2) Tax capital gains annually on any increase in value, even if the investment is not sold.
This is a US Senate bill now, although it does not currently have strong support.

It's important to have an idea of your total unrealized capital gains. It could be stock that you've owned for a long time, equity acquired through work, or a real estate investment. We advise clients against selling solely for tax reasons. But if your current income qualifies you for the 0% or 15% capital gains rate on an investment you think has peaked in value, a sale may be worth considering.

With political uncertainty and the possibility of changes to capital gain tax rates, you may want to work with your LNWM advisor to determine the optimal time to sell appreciated assets based on expected returns, your desired holding period, and potential increases in tax rates. Another strategy is to look for "tax-loss harvesting" opportunities within your investment portfolio, which we routinely do for clients. Basically, it means selling at a loss and using that loss to offset gains.

Tax Rates on 2020 Income Vs. Long-Term Capital Gains

The capital gains rate you pay – 0%, 15% or 20% – is based on your total taxable income, including the gains.

Regular Income (Marginal Tax Rates)			Long-Term Capital Gains (Marginal Tax Rates)		
Rate	Taxable Income Single	Taxable Income Married, Filing Jointly	Rate	Total Taxable Income Single	Total Taxable Income Married, Filing Jointly
37%	> \$518,400	> \$622,050	20%	> \$441,450	> \$496,600
35%	\$207,351 – \$518,400	\$414,701 – \$622,050			
32%	\$163,301 – \$207,350	\$326,601 – \$414,700	15%	\$40,001 – \$441,450	\$80,001 – \$496,600
24%	\$85,526 – \$163,300	\$171,051 – \$326,600			
22%	\$40,126 – \$85,525	\$80,251 – \$171,050			
12%	\$9,876 – \$40,125	\$19,751 – \$80,250	0%	Up to \$40,000	Up to \$80,000

Personal income: Get Thee Tax-Advantaged

Worth Exploring: Are you making optimal use of tax-free investments (such as municipal bonds), tax-advantaged accounts and charitable giving strategies?

The 2017 Tax Act broadened the tax brackets and lowered the rates, especially on the higher end. Today, a married couple filing jointly with \$326,000 in taxable income pays a top rate of 24%. A few years ago, that rate was 33%. If you have the flexibility to increase your income sooner rather than later, without bumping up to a higher tax bracket, this year might be a good time to do that. Also, revisit the use of Roth IRAs as part of your toolset.

Roth IRAs. You fund Roth IRAs with after-tax money, but after five years withdrawals are tax-free (after age 59 ½), and you have no Required Minimum Distributions during your lifetime. The catch: You cannot make annual contributions to a Roth IRA if your income is higher than \$139,000 in 2020 (\$206,000 for couples filing jointly).

If you have a traditional IRA(s), you can convert some of that into a Roth IRA. The amount converted will be taxed as regular income, so it's worth strategizing about how much to convert annually without a higher tax bracket. Conversions from an IRA to a Roth IRA are not limited based on your income, giving everyone the opportunity to do this. Note that if you have no existing IRAs, at any income level you can start contributing to a newly created IRA and later convert that to a Roth IRA. You should also find out if your employer offers a Roth 401(k).

Business owners: Use or lose the 20% deduction

Worth exploring: Are your businesses and other investments benefiting from the 20% Section 199A deduction?

If you personally pay the tax on your business' income — you are a sole proprietor, own an interest in a partnership, limited liability company (LLC) or an S corporation — find out if you qualify for a deduction that is up to 20% of the business income. This is one of the most complicated aspects of the 2017 tax law, so quite a few people are not aware they qualify. It can apply to income generated not just by certain businesses but also income from some real estate investments, including REITs. Trusts qualify for this deduction as well. This provision expires at end of 2025 and could be done away with sooner.

The Year Ahead

As 2020 unfolds, we are keeping a close watch on tax policy and the proposals of the presidential candidates and will be providing updates on new developments that could affect tax planning. ■

The SECURE Act

While focused on retirement, the SECURE Act, signed into law in late December 2019, includes some key tax provisions that affect younger people.

Section 529 Plans for education. Tax-free withdrawals are now permitted to pay for two new things: (1) qualified apprenticeships; and (2) up to \$10,000 in student loans per lifetime for beneficiaries *and* their siblings. This is in addition to college and graduate school tuition, and up to \$10,000 annually for K-12. Home schooling still does not qualify for tax-free Section 529 benefits.

Kiddie Tax reversal. Starting in 2020, the unearned income of children is once again taxable at the parents' highest marginal tax rate (instead of the compressed estate and trust income tax rates). This is a good thing that will make life easier for families that benefit from school grants and other types of awards.



About the Author

Kristi Mathisen, JD, CPA, PFS is Managing Director of Tax and Financial Planning at Laird Norton Wealth Management. In addition, she provides guidance and advice on philanthropic strategies and estate planning to the firm's client services team and to clients directly. An attorney, CPA and Personal Financial Specialist with more than 20 years of finance-related experience, Kristi has a bachelor's degree in business administration from the University of Washington and a Juris Doctor from the University of Washington School of Law. She is a member of the Washington State and King County Bar Associations, the Washington State Society CPA and the American Institute of CPAs.

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