lairdnorton
WEALTH MANAGEMENT

Tax Strategies for Making the Most of Your Wealth

Maximizing your options in each phase of life

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Building & Accessing

The most basic economics

In the simplest terms, financial life can be divided into two phases: building wealth and accessing it. In modern society, you often hear about these in terms of working to accumulate wealth, fully accessing it in retirement, and eventually transferring it to the next generation. But often these phases happen simultaneously. And when you're talking about a high-net-worth portfolio, the building and stewarding of assets can be complicated even more by a sea of regulations and tax laws, as well as many different transfer strategies.

This e-book lays out what Laird Norton Wealth Management (LNWM) uses to help our clients manage taxes when building, accessing and transferring wealth. In it, we'll introduce you to our unique framework and how it applies before and after retirement. And finally, if you own a business, we'll offer you specific insights and ideas on optimizing your after-tax returns.

Tax-aware wealth planning provides a lifetime advantage. It creates a framework to maximize returns across your entire asset base now and for generations to come.

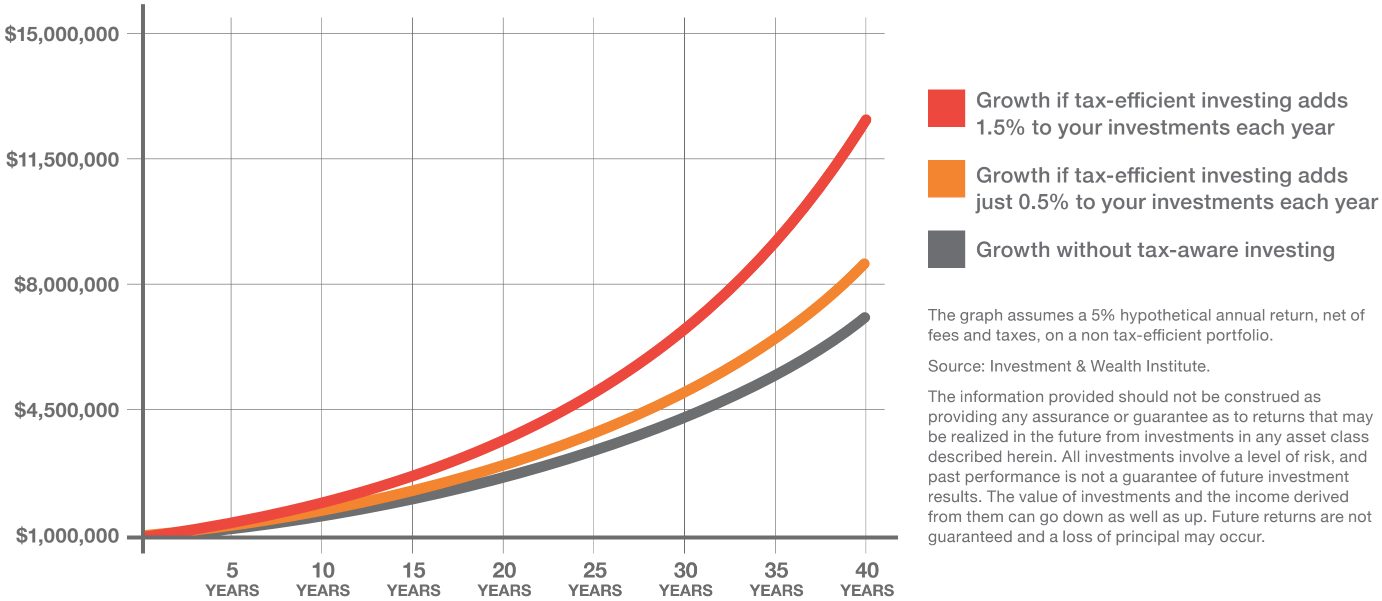
PART I: Tax strategies for building wealth

Do you have a tax-aware mindset?

A tax-aware mindset isn't about avoiding taxes; it's about having the largest possible return in your pocket after paying them. Consider reduced taxes as a form of return. For example, an investment with lower risk (and a commensurate lower return) could more than make up for that lower return with a tax advantage. That's why it's important to realize that WHAT you invest in, HOW and WHEN can all have a significant impact on your after-tax return. We call this a tax-optimized perspective and it should apply not just to investments but to your entire asset base and finances. That's what we'll be talking about.

Small tax advantage—big investment gain

Research has shown that tax-aware investing can significantly increase the overall value of a portfolio. This chart shows the dramatic long-term benefit of only slightly higher annual returns through tax management.



The graph assumes a 5% hypothetical annual return, net of fees and taxes, on a non tax-efficient portfolio.

Source: Investment & Wealth Institute.

The information provided should not be construed as providing any assurance or guarantee as to returns that may be realized in the future from investments in any asset class described herein. All investments involve a level of risk, and past performance is not a guarantee of future investment results. The value of investments and the income derived from them can go down as well as up. Future returns are not guaranteed and a loss of principal may occur.

You don't own what you don't keep

While making your tax contribution is very important to society, your portfolio should be focused on the after-tax results. At Laird Norton Wealth Management, we analyze your entire asset base for opportunities to maximize after-tax return, including placing tax-inefficient assets in tax-free and tax deferred accounts and strategically managing gains, losses and income within your portfolio(s).

Let's talk about how we do that.

Four variables for striking the right balance

When establishing the right combination of accounts and investments, don't forget to consider:

1. Your personal situation

It's all about you and what you want. Your age and investment horizon can affect your choices, and how aggressive you may want to be. The size of your estate is naturally a factor. Even the charities you intend to support. Don't forget that your health is also a consideration. If you or family members have medical expenses or conditions, these ramifications and costs impact your choices.

2. What your portfolio looks like now

Knowing where you are is critical to getting where you want to be. Where is your money currently? Is the mix of taxable, tax-deferred and tax-free still appropriate?

3. Your tax situation

For our purposes, this is critical. What are your current and projected effective and marginal tax rates? Can you convert your IRA accounts to Roth IRAs? And is that the right move? LNWM can also help your tax situation though the timing of purchases, sales, and disbursements.

4. Your cash flow

This may be the most important consideration of all. What are your current and future cash flow needs, and what impact will withdrawals have on your accounts? Also, which of your retirement accounts will require you to take minimum distributions starting at age 70 ½? It's not just a question of current cash flow, but how the predictable future looks.

TYPES OF ACCOUNTS AT-A-GLANCE

■ TAXABLE ACCOUNTS

INCLUDES: Brokerage accounts, money market accounts, savings, and others—most accounts that aren't retirement plans.

ADVANTAGES: They're easy to access, and you may be able to write off any losses you may incur.

DISADVANTAGES: You must pay taxes annually on income (interest, dividends) as well as a capital gains tax when you sell.

■ TAX-DEFERRED ACCOUNTS

INCLUDES: IRAs, 401(k)s and other retirement accounts that let you put off taxes until later.

ADVANTAGES: Tax break on the contributions you make, and money in the account grows tax-free.

DISADVANTAGES: All withdrawals are treated as ordinary income and taxed at your highest marginal rate. Plus, withdrawals before age 59 ½ are hit with a 10% penalty. Starting at age 70 ½, you must take required minimum distributions (RMDs).

■ TAX-FREE ACCOUNTS (ROTH IRA)

INCLUDES: Roth IRA accounts and 529 Plans.

ADVANTAGES: Your assets grow tax-free, and certain kinds of distributions are tax-free as well. No RMDs at any age.

DISADVANTAGES: No tax break for contributions, and when you open a Roth IRA, you have restricted access to your funds for the first five years and until age 59 1/2.

Three strategies to minimize investment taxes

When determining your basic strategy for tax-optimized investing, it's important to realize that there's no one solution for every portfolio. The extent to which any given tax-aware investment strategy will work depends on your unique circumstances. But no matter what your circumstances, in the end the goal is the highest return possible on your investments after paying taxes. LNWM can help you implement these three strategies to achieve that end.

Smart asset location

The first is a variation on the old real estate adage: Location, location, location. An asset location strategy should allow you to match high-taxable income producing assets (bonds, dividend-paying stocks) and high-turnover assets (stock funds that trade often) with tax-advantaged accounts; investments that generate little taxable income and/or few trading gains (such as municipal bonds and growth stocks) would then go into taxable accounts. Researchers, experts, and analysts agree there are substantial tax advantages to the right asset location mix. For instance, a March 2014 report by Vanguard Research estimates that the benefit of asset location for certain investors can be as high as 0.70% annually. Other studies echo this, with estimated benefits ranging from 0.25% to 0.50%. While 0.50% may not seem like much, over time it really does add up, especially given our historically low bond yields and a rather tepid 5.6% annualized return on the S&P 500 since January 2000.[1]

Tax-aware manager selection

One thing to realize about Laird Norton Wealth Management: we don't invest directly in stocks, bonds or other assets ourselves. That's because we think no one manager can optimally invest in all the different asset classes. Instead, we research and find those asset managers we think are best in

[1] "Asset Location Strategies: Part II" May 15, 2014, https://lairdnortonwm.com/2014/05/asset-location-strategies-part-ii/

their class for each asset category in your portfolio. And in doing that, we look for managers who prize tax-awareness. That means they tend to limit short-term trading and take advantage of losses to offset gains (more on that below). If asset managers are not tax-aware, then they will be constantly challenged to generate market-beating returns to compensate for the higher tax bill.

Tax-loss harvesting

Taxable accounts allow you to write off investment losses against gains. When prices fall, Laird Norton typically reviews all portfolios for opportunities to sell certain investments at a loss, so that loss can be used offset current and future gains. Typically, we replace the investments sold with similar ones to maintain the targeted asset allocation and risk/return attributes of each portfolio. Our goal is to use risk management and tax-awareness to keep you invested comfortably for the long term.

Other strategies LNWM can show you

We can also help you make the most of the new tax law—The Tax Cuts and Jobs Act of 2017—which affects virtually all US taxpayers and especially high-net-worth families, individuals and business owners. Some of the changes are beneficial. But if you're losing deductions under the new law, one strategy is to take advantage of the deductions still available and bunch them into certain years, especially during years of higher income. If you own a business or are thinking about starting one, you should definitely try to take advantage, if possible, of the new 20% deduction on business income (more on this later). Finally, what you give, when and how can also help reduce a variety of taxes (see box).

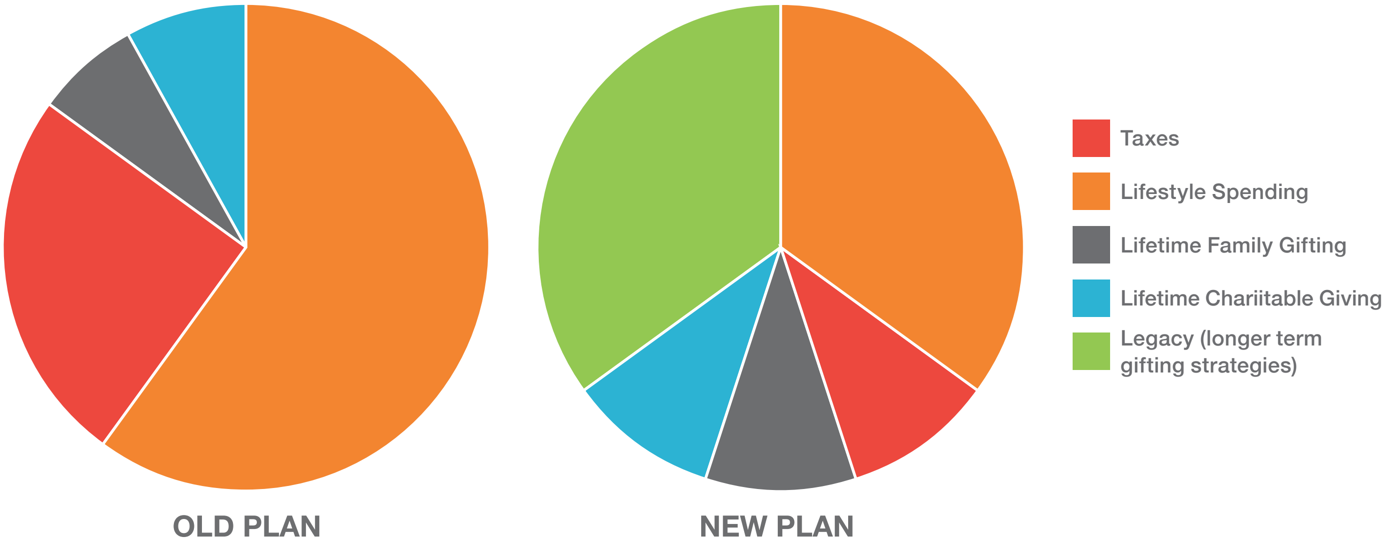
FOUR KEYS TO TAX-SMART GIFTS

Being generous can also have tax advantages. Here are four ways to give annually without having to file a gift tax return (IRS Form 709):

- **BE GENEROUS—GIVE UP TO $15,000 ANNUALLY** to anyone including of course each of your kids and grandkids. Your spouse can give another $15,000 for a total of $30,000 annually per recipient. This annual exclusion is indexed to inflation, so it will rise over time. What you give does not have to be cash. Giving away appreciated stock or shares in a private business can reduce your capital gains taxes, estate taxes and perhaps even income taxes.
- **PAY FOR EDUCATION—IT'S A GOOD INVESTMENT** as long as you make payments directly to a school, college or other educational institution, and you pay only for the tuition (not room, board, or supplies), none of your payments are counted in terms of gift taxes. Another smart way to pay for education is through a 529 plan. LNWM can help you establish a plan, so a couple could put up to $15,000 toward an education gift—and change beneficiaries at any time. Note: 529 Plans can now be used to pay for private K-12, as well as college.
- **TAKE CARE OF THOSE AROUND YOU** by paying medical expenses. You can pay any amount in medical expenses for others. The only caveats: Payments must be made directly to the provider — hospital, doctor, pharmacy or insurance company; the service or good must be something the IRS would allow as a medical expense.
- **NOT SURE WHERE YOU WANT YOUR CHARITABLE GIFTS TO GO?** Consider a Donor Advised Fund (or DAF). A DAF allows you to set aside money now for later charitable giving. You report a charitable contribution for the total amount you transfer to the DAF in the year you do so. You can deduct cash donations of up to 50% of your adjusted gross income (AGI). LNWM can help you identify a DAF that fits your plans and needs.

PART II: Tax strategies for accessing your wealth

Time for a new tax-optimized plan



When you move from a wealth-building mindset to a stewarding and accessing mindset, your financial picture changes. Your goals may change as well. And those changes should reflect who you are, and what you want to do in life. We can help you crystalize and realize your plan.

Start slowly—and a little early

While many tax and financial advisors may suggest you keep money in tax-advantaged retirement accounts as long as possible, it may be wise to start taking occasional withdrawals from IRAs and 401(k)s before retiring. The early withdrawal penalty on IRAs ends at age 59 1/2, and even earlier on 401(k)s – at age 55 if you leave your job or retire. This strategy can help you take advantage of any low-income years to streamline and restructure your savings. Say for instance, you choose to work less. That could be a good time to make IRA withdrawals, pay the income taxes on those and use that money to fund a Roth IRA, which is tax-free from then on (assuming you keep the money in for five or more years).

Convert assets into resources intelligently to put off capital gains

It's great to have assets—family property, farmland real estate, or even art. But they can be a tax burden when trying to get liquidity from them. Even though the value of many non-cash assets may have increased dramatically in recent years, they can be difficult and costly to maintain. But selling can also have tax implications many prefer not to face. The question to ask is not "what's the tax or other cost?" but what do I want? Then work back to achieve your goals. With help, you'll find there are many options available to you. Here are a few.

Installment sales

Installment sales can be an effective tactic to get the liquidity you want from assets but reduce the all-at-once tax expense. By taking payments from a buyer over more than one year, you can sell real estate, business interests or collectibles like art with tax benefits. The strategy here is to spread out the capital gains to take advantage of the lower tax bracket over multiple years, so you end up paying less tax over time. There are risks of course, the buyer may default, or taxes could rise during the term of the agreement.

More about trusts

To better control your wealth during your lifetime and beyond, you might want to consider a trust. There are two main categories that let you do that: irrevocable and revocable trusts.

- **IRREVOCABLE TRUSTS**
  As its name implies, an irrevocable trust generally cannot be changed or cancelled. It is designed to be a permanent way for you to determine the fate of your assets. LNWM can help you decide whether an irrevocable trust is right for you, and which type of trust, depending on what you want to accomplish—provide

The question to ask is not "what's the tax or other cost?" but what do I want? Then work back to achieve your goals.

for loved ones, privacy, minimize taxes, philanthropy or all the above. We'll talk a little more about irrevocable trusts below.

- **REVOCABLE TRUSTS**
  If you prefer to maintain some control over your assets, one of the most common trusts we work with is a "revocable" trust, which you can change or cancel at any time. In addition, upon your death, a revocable trust stays private and becomes irrevocable. You can use a revocable trust to care for a loved one during their lifetime and then transfer the remaining assets to a charity when that person passes away. LNWM can also help you with special needs trusts for relatives with disabilities, and many other specialized trusts.

Principal residence conversion

To get more cash from the sale of a residential property, it's sometimes beneficial to convert it to a principal residence and then sell it. To get the benefits of this, you must have resided in the property for two of the last five years before the sale. When you sell, you can exclude up to $500,000 in profit ($250,000 if single). Gains over that amount are taxed at 15% or 20%, depending on your income. Also, the cost of major improvements can be added to the purchase price, reducing the profit—and potentially, the tax.

Borrowing and renting

With interest rates still low, a mortgage or refinance can result in a substantial cash-out. One drawback to this is if the money borrowed is not used for an investment or home improvements, the interest payments you make may not be tax-deductible. You can also sometimes rent the property for a profit after paying the mortgage (if any), taxes, insurance and maintenance.

PART III: Wealth transfer

More than inheritance: wealth regeneration

You have a lot of tools at your disposal to control the transfer of wealth (titling of property, a will, various types of trusts, gifting, power of attorney, etc.). Using them well can save money and time while helping to preserve family harmony. For example, if you plan to leave major gifts to charity upon your death, consider naming the charity as the beneficiary of your IRA. Your other, taxable assets can then pass on to your heirs at current market valuations (resulting in potentially lower taxes when they sell), and your heirs can avoid having to take required taxable mandatory distributions from an inherited IRA.

Maximize gifting now, either outright or in trusts.

Under the Tax Cuts and Jobs Act of 2017, the total amount you can give away during your lifetime or pass on to your heirs tax-free at death has increased by over $5.6 million to $11.2 million per person—at least until 2026. This amount will increase each year with built-in inflation adjustments. Because the law may change in 2026, we advise taking advantage of the opportunity to make gifts now, including gifts to a trust.

As we said, there are many different kinds of trusts you can set up. Here are some of the trusts LNWM can help you with:

- **CONSIDER A GENERATION-SKIPPING TRUST.**
  With current large gift exclusions, establishing this type of trust during life allows you to fund it with a high-level of assets, enough to make large gifts for both children and grandchildren. For example, say you have a sizable estate consisting mostly of real estate that is likely to increase in value, and you want to provide for future generations of your family, not just your children. This type of trust (sometimes called a Dynasty Trust) can now be funded with more assets before estate taxes become an issue. In Washington State trusts can be in place for up to 150 years, so this would allow many generations to benefit.

- **CHARITABLE LEAD TRUST (CLT)**
  If you want both your heirs and a charity to benefit, think about a CLT. In this type of irrevocable trust, the charity you choose benefits first, then your heirs. Once you establish it, the CLT makes annual distributions to your favorite charities for a specified period or for your lifetime. The upfront income tax deduction you get depends on how much control you retain over the CLT and your willingness to pay tax on the CLT's income.

■ CHARITABLE REMAINDER TRUST (CRT)

In a way, a CRT is the reverse of a CLT. When you transfer assets to a CRT, the trustee makes annual tax-free payments to you (and your spouse or even another person), usually for life. The payments are based on the value of the assets in the trust tax-free (real estate, investments, etc.) When the transfer to the trust happens, you could get a partial income tax deduction, and then pay taxes on the income you receive annually from the trust. After the annual payments end, the charity or charities you specify get whatever remains in the trust.

■ NON-TRUST OPTION

Another idea is "upstream" estate planning to save on capital gains taxes. At death, the value of most assets that pass on to heirs gets stepped-up to the current market value. So, if you bought a house for $200,000 and it's currently worth $2 million, your heirs will inherit at a value of $2 million and can then sell without paying capital gains taxes. If you have appreciated property or high-value assets, you might consider gifting to less wealthy elderly parents, so the tax basis can be increased when the parents pass on. With the higher estate tax exclusion in the 2017 tax law, gifts that bring the parents' estates up to less than $11.2 million could save significant capital gains taxes in the future. This strategy may require some revision to the parents' estate plan as well and carries risks. For example, parents' creditors make claims against the assets or the parents could pass away before the safe harbor survivorship period ends.

Because the Tax Cuts and Jobs Act may change in 2026, we advise taking advantage of the opportunity to make gifts now, including gifts to a trust.

PART IV: Special business owners' section

Sell or Transfer?

Whatever you choose to do, sell the business or transfer it to the next generation, the devil's in the details. And no matter your plan, you still need to make sure your income needs are met. The experts here at Laird Norton Wealth Management can help you understand the minutiae for a realistic prediction of how much you will receive in net cash under each exit scenario. In the broadest terms, we've found a clear understanding of three elements provide the basis for a successful transition:

- Your family's ability to accept change and level of passion for it
- Your plan and expectations for leadership, succession, and ongoing income
- Your vision of what the business will look like in the future

Maintaining income with a trust for business assets

For assets likely to appreciate—not just a business, but also stock portfolios, or investment properties—a good solution can be a Grantor Retained Annuity Trust (GRAT).

A GRAT allows you to zero out the current value of the asset for gift purposes. That's because after you transfer the business to the GRAT, you get back a series of annual payments that over time add up to the value of the business when transferred. Let's say you have a business now valued at $5 million and choose a 10-year term. For 10 years, you would then get annual payments of $500,000 plus a specified rate of interest. At the end of those 10 years, all or part of the business will be owned by your heirs and not be counted as part of your estate for tax purposes. And if the business has increased in value more than 3.6%* annually (the current IRS specified rate), that gain will have passed on to your heirs without gift taxes. Two risks with GRATS: If you pass way before the annuity term ends, the assets in the trust come back into your estate. And, if the asset you give to the trust loses value, the strategy of passing on the appreciation to your heirs does not work.

*As of November 2018.

Do you qualify for the 20% business deduction?

The 2017 tax law provides for a new 20% deduction for certain kinds of business owners. If you report your business income on your personal tax return—for instance, as a sole proprietorship, partnership, LLC, or S Corporation—your business may now qualify for a 20% tax deduction on that income. That would be a $100,000 deduction on business income of $500,000, but only certain types of businesses qualify, and only if your taxable income is under $315,000 (married filing jointly) or $157,000 (unmarried).

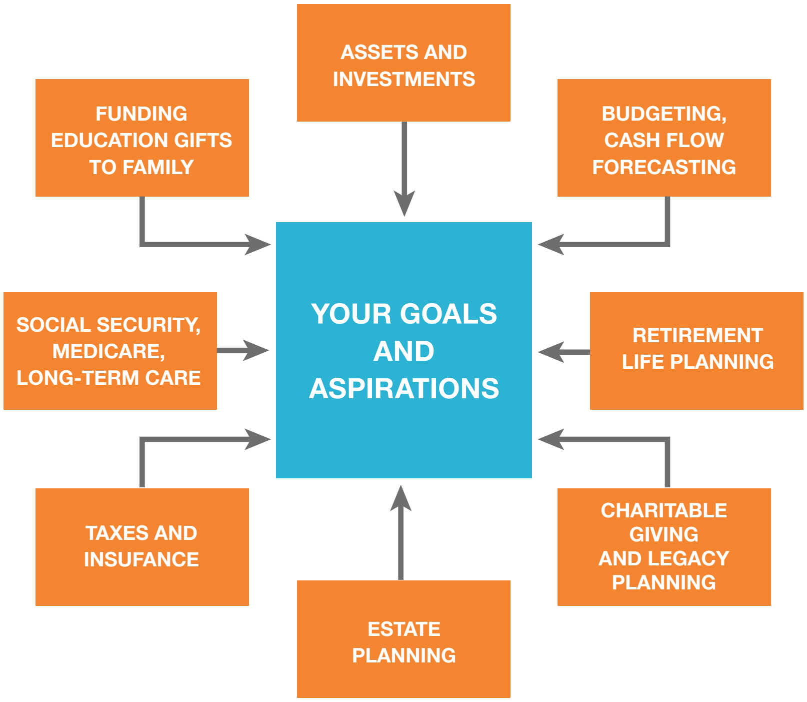
There is also a wage limitation that may apply to the deduction. It cannot exceed 50% of the business's W-2 wage expense, or 25% of the wage expense plus 2.5% of the cost of tangible property.

Finally, if you have any net capital gains income, your deduction may be limited. That's because capital gains income is already taxed at preferential rates (0%, 15% and 20%).

We can help you determine your status.

Laird Norton Wealth Management

The right help for changing needs.



The kinds of tax-aware investment decisions we've described here are examples of the effective stewardship of you and your family's wealth that LNWM can provide. At Laird Norton Wealth Management, our goal is a higher return after all taxes are paid, which is what really matters. In fact, tax planning is integrated into everything we do—STRATEGIC investment management, IN-DEPTH financial planning and EXPERT trust and estate planning. All our services working together can help you make the most of your assets, so you can lead the life you want.

We specialize in serving families, individuals, foundations and endowments with investable assets from $1 million to hundreds of millions achieve their goals and aspirations. As a fiduciary and fee-only investment firm, we put your interests first.

FIND OUT WHAT LAIRD NORTON WEALTH MANAGEMENT CAN DO FOR YOU.

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