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Your **Active Wealth**
Podcast

Tax Changes to Look Out for in 2022

February 2022

Featuring:

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VO [00:00:01] Is your wealth strategy supporting your long-term goals? Welcome to *Your Active Wealth* with BNY Mellon Wealth Management, where we offer insights that can help you move closer to your goals. We'll tackle timely topics through the lens of the five pillars that comprise our Active Wealth framework, Invest, Spend, Manage, Borrow and Protect, and provide guidance on navigating the unpredictable, to help you build and sustain wealth.

Ben [00:00:34] Hi, welcome back to *Your Active Wealth*. I'm your host, Ben McGloin, head of advice, planning and fiduciary services at BNY Mellon Wealth Management, and today we'll discuss certain planning concepts and techniques that should be considered to offset the impact of higher taxes. I have the pleasure of welcoming to the show, Belinda Herzig, senior wealth strategist here at BNY Mellon Wealth Management. Belinda, welcome.

Belinda [00:00:55] Thank you, Ben. This is a fun topic for me. It's a conversation we have every day with our clients and taxes are always top of mind. So I'll just say, although everyone's situation is different, I hope this gives guidance, maybe provides some enlightenment and maybe it triggers some action.

Ben [00:01:18] Well, I'm certainly looking forward to the conversation, but perhaps before we get to the plethora of proposed changes to taxes on individuals, maybe could you share your thoughts on what individual taxpayers should keep in mind when selecting an advisor to help really develop and execute tax savings plans?

Belinda [00:01:35] You know, most of our clients have a team of advisors and we collaborate as needed, and it usually includes a banker, the investment manager, the portfolio manager, an accountant, an attorney, and oftentimes there's an insurance professional, so life insurance, casualty, making sure our clients are appropriately covered. Usually, that team has a quarterback or a lead advisor, and more often than not, that's the investment manager. We play that role. A lot of times the relationship manager, and I'll say that-that person is critical. So when you're selecting an advisor, you're putting together a plan. That's the initial selection, and I would say your lead advisor might initiate that process, right? They'll initiate the discussion planning options. We have a lot of conversations with clients where we'll talk through the menu of estate planning options because there are risks, there are benefits, there are complications. There are considerations and it's critical to have that conversation and clients love using us as a resource. And then from there, I'd say find a subject matter expert. So make sure that your legal counsel or your CPA understands what the tax implications are, especially when you're making transfers. A lot of our clients will transfer units of an S-corp or LLC units to fund a trust, or they're making changes to an existing structure, and there's an interplay between income tax and any gift tax. So in that way, you need an advisor who's dynamic. So another piece of that is, I would say, be sure your lead advisor understands your full financial statement, including asset titling. That's really critical when you're in a community property state such as California, Texas, Arizona, Wisconsin, Louisiana right, there are nine community property states. And they follow the rule that all assets acquired during the marriage are considered community property and there are special rules when making a transfer right, you might need a partition agreement. So again, subject matter expert because changes might require an expertise. So with our Active Wealth platform, we do look at the full financial picture and we look at defining core capital versus excess capital. And we talk about that a lot with our clients. It's core capital, meaning how much do I need to provide for my lifestyle, how much am I comfortable keeping as personal reserves? And usually that's based on life expectancy. But for some of our clients, they say I have longevity in my family. I'm planning to live to age 100, you know, make sure that I have enough, it's that oxygen mask rule, right? Make sure you're secure before you can provide for others. So but then there's the excess right? That excess capital and that becomes the planning for future generations. That is the amount

that clients look to giving to charity or using that excess for discretionary spend items. So again, that's the lead advisor. They understand the full financial picture, sources of income, we have run models making growth projections, things like that. But I'll say after that, putting together, if you will, there's the execution and the implementation of a wealth plan. In addition to looking to your advisor, make sure your advisor's nimble, right? Are they aware of tax policy changes that affect clients who are like you, who are similarly situated? Because having that person that's monitoring ongoing changes, tax policy is always changing, that can have a huge impact on your overall wealth. You know, just as an example, we know exemption amounts have increased. From 2021 to 2022, the inflation adjustment caused the federal estate tax exemption amount to increase by $360,000. So for clients who utilize their lifetime exemption, that $11.7 million per person in 2021 now has an additional $360 million available. The exemption is $12.06 million per person in 2022. So when you make use of your additional lifetime exemption and you do that early in years prior to death, that allows the gifted amount, once it's invested, to grow and compound exponentially over time. And it's all outside of the individual's taxable estate.

Ben [00:06:30] So Belinda, you mentioned potential tax policy changes. And unsurprisingly, I think individuals are quite concerned about the impact of emerging tax policies. And I know, while the contentious Build Back Better Bill is currently stalled in the Senate, really curious as to what you think some of the likely tax changes we could expect to see in the coming year?

Belinda [00:06:50] Well, I mean, there's the build back better framework. As you know, we have had a tax whiplash, if you will, a little bit of a roller coaster throughout 2021, from Spring into Summer and then into the Fall, there was a lot of negotiation, what was included, what was excluded and then nothing passed. So the Democrats have a lot of seats up for reelection this year. They would love to have a win, so build back better might resurrect itself. But it feels like we're getting a really quiet start to the year. Aside from Build Back Better, you know, I just reviewed the list of expiring federal tax provisions, which that was prepared by the staff of the Joint Committee on Taxation, and it highlights provisions that are expiring in each of the next 10 years. So absent changes, legislative changes by Congress, there are federal tax provisions that are just expiring. So, for example, in 2021, you know, a lot of our clients took advantage of that non-business energy property tax credit where you would receive a tax credit for energy efficient windows and doors and in energy efficient heating and cooling, it was at 25C. So that's part of what they're trying to bring back under Build Back Better, but that expired. So again, you know, there are provisions that just naturally are expiring in each year going forward. One thing that no one disagrees on Democrats or Republicans is that we're at an all-time low for rates. So when I think about changes in the coming year, I think about the higher applicable federal rates, higher 7520 rates that are used when clients are engaging in different estate planning structures like intra family loans and things like that, it's hard to believe that those rates will be going down. The Fed has said that they plan to increase rates in 2022, so that's one thing that we can anticipate changing, an increase in rates. Clients who have not already used their individual lifetime exemption by 2025, absent some changes, we know that the estate tax exemption amount, that current $12.06 million is due to sunset. So clients who have not utilized that lifetime exemption, it will sunset and we anticipate the exemption going down to $6.5 million per person. So if you haven't used your exemption, you are losing over $6 million of an estate tax exemption. I mean, just the simple math is 40% of a tax on $6 million is $2.4 million of tax. So that in many cases, that can be avoided with the right planning. So just executing on changes that we know are happening, that are due to expire, provisions that are due to expire is something that clients can be proactive now, absent the positive knowing of what's going to resurrect itself with build back better if we see that come forward.

Ben [00:10:22] So, so specifically, let's talk about some of those planning strategies that may help mitigate the financial repercussions of those potential higher tax rates.

Belinda [00:10:32] Just thinking about higher gift and estate taxes, right? Because we can have a whole conversation about higher income tax and how to plan for that. Higher gift and estate taxes make irrevocable gifts, right, to the extent that you're able to maximize the highest state tax exemption amount. Another tool is utilize annual gifting, right? If that's part of your strategy, continue with that. That amount, that annual gift tax exclusion amount also has increased. So in 2022 each person may gift $16,000 per person to any number of recipients in each year, and that's an annual exclusion. And what we found, we run these illustrations for our clients, is that over a 10-year period, that's a significant savings. You know, if husband and wife get gifted $32,000 per person, let's say there are three children. So $96,000 this year, $96,000 next year and methodically over a 10 year period are gifting that annual exclusion amount. The dollars transferred exceed $1.3 million if you assume a minimum 4% growth, that's over $500,000 of estate tax that saved just by doing that simple annual gifting. So that's one thing. Another thing clients can do is transfer assets that have a low valuation. Some of our clients will do a part gift, part sale of units or shares in a business, right? An S-Corp or an LLC, and they'll do that in advance of the sale. So presale business planning and what happens is when

those units, for example, we have a client who did just that. He gifted some shares of his S corp. He also sold some units to a trust in exchange for a note. And when clients do that, there are certain requirements, of course, that have to be met, right? The trustee in that case filed the ESBT election with the IRS, so they don't blow the companies subchapter S election, but something to explore with your advisors, right? Because if those assets are transferred, presale the appreciation passes outside of your estate, so all of that growth is captured in the trust. And that's an amazing tool to save the tax on the appreciation of that asset, compounded with the low valuation used for the gift.

Ben [00:13:11] So, so kind of combining you talked about the applicable federal rate, the AFR rates, and also trust, but maybe kind of just to expand upon that or kind of combine them, maybe kind of making the case for using trusts that benefit from low interest rates. Can you maybe give some examples along those lines, Belinda?

Belinda [00:13:26] Yes, yes. Many of our clients lend money to trusts. They'll do that in exchange for a note, and intra family loans are a great tool for that. They provide funds to family members and it takes advantage of that low rate. The current applicable federal rates are still low. They're up almost 1% from this time last year, but historically they're still very low. In January, the mid-term rate was 1.3%. In February, it's 1.4%. So that's the rate at which grantor, lender can lend money to a family member, a note is drafted with the stated rate based on the current AFR. If that rate is set at or above the AFR rate, there are no gift tax consequences. So the terms can be flexible, the note can require principal and interest, or it can require interest only where, that's what most of our clients do. They'll make it an interest only note where the borrower can make a balloon payment at the end. Sometimes the grantor forgives the interest, especially if it qualifies for the annual gift tax exclusion. If it's under $16,000, then no tax is due by forgiving the interest. Actually, an added advantage to that is when a grantor makes an intra family loan to an irrevocable trust for descendants. Same concept, but the growth on the assets lent to the trust accumulates in the trust, so the grantor receives his or her original principal back, they retain dominion and control over the asset, but they've transferred the appreciation. You know, our clients realize with a taxable estate, a transfer of the appreciation is at least saving 40%, 40 cents on every dollar of growth. Another tool, trusts can be created as grantor. So if that same intra family loan is made to an irrevocable trust and it's a grantor trust, then the grantor pays the tax that would otherwise be owed and payable from the trust. So by absorbing the tax liability of the trust, the grantor is further reducing his or her taxable estate, which is also inuring to the benefit of the trust beneficiaries.

Ben [00:15:43] I do want to go back to the intra family loans and the AFR rate. Maybe if you could provide a specific example, I mean, it sounds very compelling. I'd love to kind of hear a very kind of specific example of how that actually would work.

Belinda [00:15:56] Sure. So let's say client lends $500,000 this year in 2022. If the note was drafted in January, we would use January's AFR rate, 1.3%. That money can be lent either to an individual or it could be lent to a trust. If the terms of the loan are interest only, and let's just assume it's a nine-year term with the balloon payment at the end, the interest in each year is $6,500, so the grantor could possibly forgive the interest as part of the annual exclusion amount. The total interest over the nine years is $58,500. All of the growth above that 1.3% rate during the entire loan period passes to the borrower. That initial principle, that balloon payment comes back to the lender, comes back to the grantor, but the growth stays in the trust. It's owned by the individual, so if it's in the trust, it's growing, it's compounding all of that appreciation and growth above the 1.3% is outside of the grantor's estate. And that's the goal, it's to continue to chip away at the size of the taxable estate.

Ben [00:17:10] And I know when we start talking about trusts, a lot of acronyms can come up, SLATs and GRATs and IDGTs and CLATs, and it can become quite complicated, but kind of back to the question just around the benefits of trust, right? And the case for leveraging assets, but utilizing trust, maybe can you talk through kind of some of the strategies again in the context of what we potentially may see with tax rates this year and some of the potential to utilize, as you mentioned, kind of gift and estate tax exemptions? Maybe talk through some of the other opportunities that a high-net-worth individual may have this year.

Belinda [00:17:42] Sure. So in order to utilize your lifetime exemption, it has to be a completed gift. In order for it to be a completed gift, the gift has to be made to an irrevocable entity or outright, it has to be an irrevocable gift. Grantor has to give up dominion and control of that asset. You mentioned SLATs, that's the spousal lifetime access trust. That's a wealth transfer technique where one spouse makes an irrevocable gift using his or her available estate tax exemption to fund a trust for the other spouse, and they do that to an irrevocable entity, the trust, which makes it a completed gift. Other tools are dynasty trusts, right, set up for descendants. Same thing. One thing that we do is go through all of these choices. There is a menu of choices and clients, it's not one size fits all. A client may choose one strategy over another based on their goals, their family goals, who they intend to benefit. A lot of times they're driven

by the tax savings. A lot of times legacy is more important, or benefiting charity is the top priority. So being mindful of that, we like to walk through all of the different strategies and it's a process. So sometimes clients want a quick fix, but there's not really a quick fix and we invest in the time and it's more of an education.

Ben [00:19:15] So Belinda, in one of our other *Your Active Wealth* podcasts, we talked about strategic borrowing, and I'm curious as it relates to the conversation today and really thinking about loans. You mentioned kind of low interest rate environment, but really kind of think about, you know, what types of loans and borrowing strategies may help to offset taxes and maybe augment some of the planning techniques you're outlining? Could you maybe expand upon that?

Belinda [00:19:37] Most all of our clients have an investment credit line in place, an ICL, and they use that so that they can stay in the market and stay invested while paying a lower interest rate than the return on those invested assets, and that's in an effort to mitigate capital gains as well. You know, we say harvest losses when you can, or stay invested and manage the timing of your liquidity event. The use of borrowing when you need cash for liquidity, sometimes it's for a tax payment. Other times, it's just that lifestyle spend, but rather than selling in an environment when the market's performing very well, it's advantageous to borrow at a lower rate secured by the assets. And that's a great tool. Other investment strategies, you know, some of our clients have the ability to substitute or swap assets in a trust, especially in an IDGT, the intentionally defective grantor trust, another acronym. But grantors can manage tax liability at times by exchanging assets depending upon, you know, some clients if they're looking for a basis step up near death, they might substitute assets. If they're planning to sell a particular asset, they might swap it in or out of a trust. So that's something else that your advisor can run projections for and support you in making that decision.

Ben [00:21:10] Great. Thanks. Thanks for that, Belinda. And I do want to kind of circle back, somewhat related to potential tax changes this this year and certainly back to some of the provisions we saw, early iterations of the Build Back Better, and I think really tying it to maybe some recent publicity regarding some extremely large tax deferred accounts, particularly Roths, IRAs, owned by very wealthy taxpayers. We saw the inclusion of some provisions. Can you maybe talk about the potential likelihood of seeing some of those and the ramifications for, I think, what's known as mega IRAs?

Belinda [00:21:40] Yes, mega IRAs. So the new rules around IRAs. Secure Act changed the rules in that an IRA has to be distributed within 10 years once a beneficiary inherits the IRA, and there are some exclusions for that. If it's a spouse they can continue the IRA as his or her own, there are some other additional choices. But with the Roth, as you know, you're not required to take a distribution, you're not, and there's no income tax on that. But those, you know, those rules were changed under the Secure Act. And so, if you are a beneficiary of an IRA, the rules as an inherited beneficiary are complex and that requires, again, conversation with your lead adviser to explore the options and figure out what's best for you.

Ben [00:22:37] So maybe one other technique Belinda I wanted to raise, another acronym, an ILIT, irrevocable life insurance trust, but maybe get your thoughts on benefits of life insurance establishing some of these structures, particularly again in light of potential tax changes, in particular the lifetime exemption.

Belinda [00:22:53] The ILIT has been used for a long time in estate planning, an irrevocable life insurance trust, because the intent of the ILIT is for the death benefit to be excluded from the estate. So in other words, the irrevocable trust owns the life insurance policy during the life of the insured. The beneficiary, if a trust is set up, the heirs, the beneficiaries of the proceeds, the beneficiaries of the trust receive the proceeds free of estate tax. When the ILIT is set up right, grantor funds the ILIT, purchases the policy. In each year, typically, the grantor makes a gift to the trust, usually utilizing his or her annual gift tax exclusion amount. And there is, as long as each beneficiary has the right to withdraw that gift, it's called a Crummey power. They are given notice of their right to withdraw that gift. It's considered a completed gift. The trustee can use that gift to make the insurance policy premium payment. The trust owns the policy. The trust is the beneficiary of the insurance policy. And in that way, many of our clients will use their annual gift tax exclusion amount to gift to the trust which then can use that gift to make the insurance premium payment. The benefit is that large, let's say it's a $10 million policy. Once the grantor passes, that death benefit pays into the trust and funds the trust. And it's not part of the grantor's taxable estate. It's a great tool, it's commonly used to provide wealth.

Ben [00:25:04] Right, and I know again, in the face of some of these potential tax changes, it seems like they're becoming even more popular, maybe after a lull over the past number of years. You know, maybe the last question before we wrap up, I know again, tying it back to some of the contentious debate around the Build Back Better was

the SALT, state and local tax deduction, and I'd love to kind of ask the question, maybe in the context of some of the domicile changes that we've seen. But, you know, maybe some advice for clients and for high-net-worth individuals, you know, thinking about relocating, redomiciling? You know, the impact of potential tax changes and things that they should be considering?

Belinda [00:25:39] Yeah, so throughout 2021, right, there was a lot of negotiation around the SALT cap, especially from senators in states that were seeing an exodus, Chuck Schumer in New York, Pelosi in California. They were advocating for increasing the SALT cap to most recently as part of Build Back Better, if we see a resurrection of that, the conversation is they're trying to raise it at least to $80,000 through 2030, which would be an increase from what it is now. It's $10,000, that's the state and local deduction cap. A lot of states have provided their own incentives, if you will, a state tax credit to mitigate some of that in the absence of an increase to the federal SALT cap of $10,000. I see we get a tax report every morning and it seems like there is a lot of legislation being passed in the Northeast, particularly in New Jersey, New York, states where they can, they have the ability to expand and give credits to state residents where there is a state income tax and provide an offset.

Ben [00:26:53] And as it relates to clients that are migrating to maybe more tax friendlier states, anything for due consideration in 2022 based on potential tax changes?

Belinda [00:27:04] Many states have no state income tax, and that's the incentive, right? Texas, Florida, there are some states that have reduced their state income tax rate. I know North Carolina, for one, went from over 4% to I think it's 3.95% or something. That's unheard of. So I think states are looking because of the outflows and not just migration to these non-state income tax states. They're looking to provide incentives. So whether it's in the form of a credit for SALT or if it's in the form of a reduction of income tax, they're looking to stay attractive, if you will, to residents.

Ben [00:27:46] OK, well, thanks Belinda, for joining me to go through some of the strategies that may help protect wealth in an environment of high taxes.

Belinda [00:27:51] My pleasure. I just say gift to the extent you can, whether it's utilizing your lifetime exemption or annually gifts and take advantage of the low rates, this low-rate environment that we're in.

Ben [00:28:05] Well, terrific. And I think as you've highlighted very well, it's important to remember that these proposed changes to many areas in the US tax regime are far reaching and may significantly affect the wallets of upper income taxpayers. But there are a number of strategies, as you've outlined, that can help mitigate negative impacts to your wealth. Now is the time to plan, but not panic. While some strategies may be worth considering, you should consult your wealth manager and tax professional to ensure those strategies are consistent with your long-term goals. To learn more about our Active Wealth approach and our protect practice, you can visit our website bnymellonwealth.com. Thanks for joining and see you on the next episode of *Your Active Wealth*.

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