Panorama

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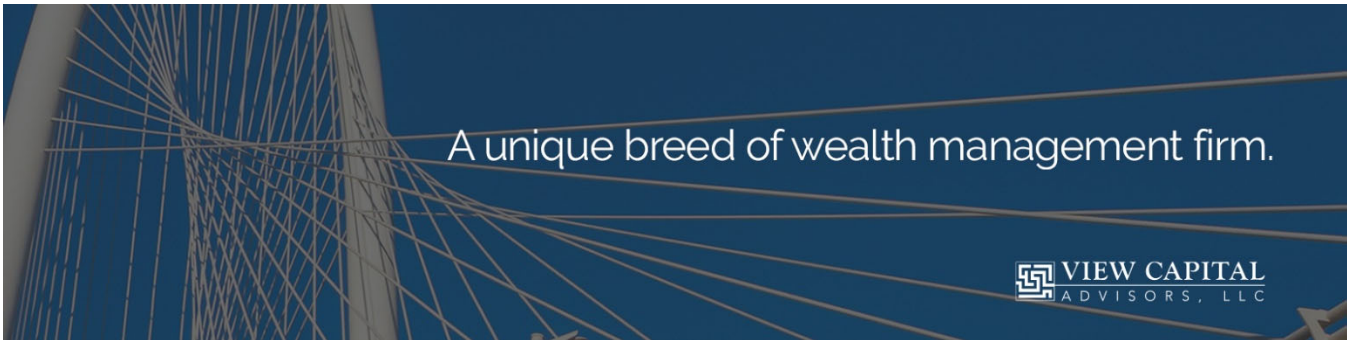
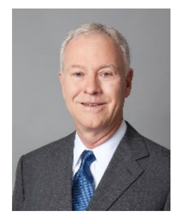


Contributing to this issue:

R. Craig Brubaker

2727 N Harwood, Suite 225

Dallas, TX 75201



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IRS PROPOSED ESTATE TAX CLAWBACK REGULATION

On April 26, 2022, the Treasury Department released proposed regulations prescribing certain limits to the anti-clawback rule previously published on November 26, 2019. The new proposed regulations address some situations in which an estate could be taxed on gifts made by a donor after 2017 and before the scheduled 2026 reduction in the basic exclusion amount, where the gifts are sheltered from gift tax by the then applicable exclusion.

The exclusion before the 2017 Tax Cuts and Jobs Act (TCJA) was $5 million per person as adjusted for inflation. The TCJA temporarily increased the exclusion to $10 million as adjusted for inflation for decedents dying and individuals making gifts after December 31, 2017, and before January 1, 2026. The exclusion is scheduled to revert to $5 million as adjusted for inflation, beginning January 1, 2026.

The temporary nature of the increased exclusion caused concern that estates of donors who die after the temporary increase expires would be taxed on completed gifts made between 2018 and 2025 that were free of gift tax when made. That is, such nontaxable gifts might be "clawed back" into the taxable estate of a donor. The Treasury Department released final regulations in 2019 creating a special rule that ensured that such a clawback would not occur.

The 2019 anti-clawback regulations however did not distinguish between completed gifts and gifts with certain "strings attached". Gifts with strings occur when the donor retains beneficial use and control of the transferred property, generally found in a retained life estate or an estate tax inclusion period. These are technical tax terms that mean the gift donor or his estate could possibly get the transferred property back under certain circumstances.

The new proposed regulations provide an exception to the anti-clawback rule, clarifying that included gifts are clawed back into the donor's estate for estate tax purposes and are subject to any remaining exclusion in effect at the time of death. For example, the gift of a remainder interest in a grantor retained annuity trust (GRAT) will be clawed back into the donor's gross estate if the donor dies during the GRAT's term.

The proposed regulations also address gift tax situations involving charitable and marital deductions. The anti-clawback rule is not applicable to those gifts because no exclusion is applied against them. The proposed regulations also create an 18-month lookback rule where included gifts will continue to be clawed back into a decedent's estate even after the decedent relinquishes his or her retained interest in the gift unless the retained interest was relinquished more than 18 months prior to the donor's death.

However, the proposed regulations will not apply to the termination of a retained interest within the 18-month period prior to the donor's death if the termination is pursuant to the original transfer instrument and occurs due to the passage of time or the death of any person. This presumably would prevent the clawback of a GRAT if the donor failed to survive for 18 months past the GRAT's term. Further, the proposed regulations provide a de minimis rule to prevent the clawback of includible gifts if the value of the taxable portion of the transfer determined as of the date of the transfer was 5% or less of the total value of the transfer. Finally, the proposed regulations provide seven examples to illustrate application of the proposed regulations. These examples demonstrate the implications of a gift of an enforceable promise that remains unsatisfied at the donor's death, transfers to a GRAT in which the donor does and does not survive the GRAT term and use of a predeceased spouse's deceased spousal unused exclusion.

REMAINING CALM IN THE STORM

For those of you old enough, you've seen this financial markets horror movie before in 2020, 2008, 2000, and 1987. All seems right in the investment world and your retirement security seems intact or achievable. Then suddenly events occur that totally erase that premise and the hand wringing begins.

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Finding the words to alleviate any investor's concerns seems impossible. Nevertheless, history gives us a preview of how the movie might conclude. Reflect on the following observations recounted by J.P. Morgan Asset Management[1] of how earlier versions of this movie turned out.

1. *Volatility is normal and should be expected*

   On October 19, 1987, later referred to as Black Monday, the S&P 500 experienced a fall of 20.5%. This is still the worst day for the stock market on record. While days like Black Monday have occurred throughout history, they are rare and unpredictable. In fact, because Black Monday was a result of trading behavior and not market or economic fundamentals, the S&P 500 still finished the year with a slight gain. Volatility is unavoidable in investing. There are many measures of market volatility including the standard deviation of returns, the VIX index, implied options volatility and many more. For long-term investors, the most meaningful measure may be the largest intra-year decline (or maximum drawdown) since it represents the largest loss an investor experiences during a given year.

2. *Moderate pullbacks happen frequently even in normal times*

   Market corrections of 20% or more have historically occurred at the end of market cycles. But how volatile can markets be in the short run? Historically, the market has pulled back 5% an average of 6 times a year. Drawdowns between 2% and 3% occur far more often, at least monthly on average, and have historically fully recovered within weeks.

3. *The investment time horizon is a powerful tool for managing volatility*

   Although volatility is unavoidable, it is a reason for investors to maintain a long-term perspective rather than a reason for pessimism. After all, an investor's sensitivity to market volatility is largely determined by their investment time horizon, and US equity markets have rewarded those who have stayed invested over longer periods of time. Over any one-year period, the S&P 500 has experienced gains as high as 51% (in 1954) and losses as low as -37% (in 2008). Clearly, an undiversified equity portfolio is inappropriate for short-term goals. Simply expanding to a five-year holding period improves the risk-return profile of stocks dramatically, with the worst five-year period since 1950 experiencing only a 2% decline. Most importantly, there has never been a twenty-year period in the post-war era that has experienced losses. While this is no guarantee of future returns, it demonstrates the importance of specifying the right time horizon to minimize portfolio risk.

4. *Portfolio diversification and rebalancing can provide greater stability in volatile markets*

   Stock market volatility can be managed through diversification and rebalancing. Over the last 15 years, the asset allocation portfolio has generated an annualized return of 5.7%, comparing quite nicely to other major asset classes. More importantly, by diversifying and rebalancing, an asset allocation

[1] J.P. Morgan Asset Management Insights, "Investing with Composure", June 27, 2022.

portfolio achieved these returns with lower volatility than other equity asset classes. Over this 15-year period, the asset allocation portfolio's volatility was two-thirds that of the overall stock market and almost half that of emerging market equities.

TURNING LEMONS INTO LEMONADE

The current drawdown in the equity markets is significant, and it rivals some of history's biggest declines. But the current situation may also present some planning opportunities. We have discussed the concept in prior Panorama newsletters of tax loss harvesting. Harvesting tax losses is a good way to make lemonade out of lemons and be positioned for the eventual recovery. The concept is simple – sell loss positions in your taxable accounts to accumulate those losses to potentially offset current or future taxable gains. You can replace the sold security with another security as long as you follow the "wash-sale" rules discussed below. The end result of a successful harvest is you get the deduction on the losses and you can still participate in the market recovery.

The tax laws provide certain rules that apply to tax loss harvesting. First, tax-loss harvesting only works in taxable accounts. Second, losses are fully offset against gains and any excess losses can be deducted against ordinary income at the rate of $3,000 a year. Third, harvesting a loss has a long-term benefit, since you can carry forward any unused capital losses for future use indefinitely, or at least until your death.

There is a special tax rule known as the wash sale rule. The concept is that the tax law will allow the taxpayer to claim the tax deductible benefit of the sale of a capital asset at a loss so long as the taxpayer experiences a true economic loss on sale. Selling a loss position and immediately buying it back won't get you a deduction because you have not suffered an economic loss yet. The rule defines a wash sale as one that occurs when an individual sells or trades a security at a loss and, within 30 days before or after this sale, buys a "substantially identical" stock or security.

The 30-day rule can be managed. If you own a stock you want to keep that has an unrealized loss, buy more of the stock, wait 31 days then sell the losing shares. Or, you can wait 31 days to replace the stock. The term "substantially identical" is important. Mutual funds and ETFs are easy to replace within the wash sale rule.

"TRUST" YOUR KIDS WITH THEIR INHERITANCE

Parents love their children but many fear leaving them too much money as an inheritance. Parents hear stories about a friend's child, who ended up doing little with their lives being dependent on inheritance and abusing drugs and alcohol. Or they may conjure up images of "trust fund babies" who sleep all day and party all night. The good news is that the vast majority of children with inherited wealth do lead productive lives and would not fall into any of the above descriptions.

Parents have legitimate concerns about leaving their children a significant part of their wealth because it could ruin their drive to live a productive life, fearing they simply might not feel the need to work. The children might feel that any financial success they could achieve on their own will not be meaningful compared to their inheritance. So, parents sometimes choose to leave a relatively small inheritance, enough to help but not eliminate the need to work. But parents often underestimate the amount their children may need simply as a safety net, let alone to enhance their lives. Further, parents may not be aware there are certain controls they can put on the money they leave to their children that can relieve fears about misuse of the inheritance.

Entities called trusts can be a good solution to provide future controls that parents feel comfortable with. Trusts can provide the "adult supervision" parents desire, and provide constraints on appropriate uses of the principal and income from the inheritance left in trust. A child can become his/her own trustee, or not, depending on the structure and terms of the trust. Additionally, the trust can be designed to last several family generations if the size of the inheritance warrants.

As parents grow older and learn about these controls, and start to realize future economic conditions will be very different than those they experienced, many end up changing their minds about how much money they want to leave their grown children. Coming to this conclusion earlier rather than later can have its benefits. Consider these what-ifs:

- What if the adult child has a health crisis or they have a baby with a disability, Incurring significant costs to the adult child and/or preventing them from being able to work?
- What if the market sinks and the inheritance is significantly reduced?
- What if despite working hard, they or their employer are put out of business by a competitor, regulations or shifts in consumer taste?

While an inheritance of $500,000 may seem like a lot, if you take into consideration all the possibilities, it can be dissipated quickly on non-frivolous expenses. The difficulty is determining the point at which the line is crossed from "enough" to "too much". Parents want to help their kids, but they don't want to leave them beyond what they could possibly need.

These goals may change as the child ages and grandchildren are born. Once their adult child starts working, parents may want to help with rent so they can have a nicer place to live or groceries so they eat a healthier diet. When grandchildren enter the picture, the parents may want to help their adult children buy a big enough house in a safe neighborhood with good schools. Grandparents may want to help pay for the grandkids' higher education or even private school for K-12 or want to ensure they will be able to afford good health care. So before you commit to a path of "tough love", consider the "trusting" tools that are available to address common parental concerns about inheritance.

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View Capital Advisors, LLC was founded in 2004 by its principals with the mission of providing sophisticated investment asset management and financial and estate planning to our U.S. and Non-U.S. clients.

We seek to bring wealth planning best practices and a wide range of non-proprietary solutions to our clients. We also conduct our own research and diligence on world markets and investment alternatives.

For further information, please contact your investment representative or one of our wealth planning specialists:

R. Craig Brubaker 214-855-2556 cbrubaker@view-cap.com
