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Financial Planning Opportunities in a COVID-19 World

Think about how much the world has changed since the end of 2019: An extreme market downturn stemming from a health crisis, a price war between two foreign oil superpowers, plummeting interest rates, plus the passage of two major pieces of legislation in the SECURE Act and the CARES Act. Given all this economic upheaval, it's understandable if any financial goals you might have set for yourself at year's end already seem out of reach. Yet despite the current environment of broad market instability and low interest rates, there are several long-term planning opportunities you can take advantage of now. Let's take a look at some of them.

TAX PLANNING

Tax-Loss Harvesting

While no one likes broad market declines like what we've experienced early in 2020, you may be able to put those declines to use through tax-loss harvesting. Tax-loss harvesting is the selling of securities at a loss but then using these losses to offset current or future capital gains. When preparing your tax return, you can use any capital losses to offset capital gains, and if an overall net capital loss exists, you can deduct up to $3,000 of it against your ordinary income. What's more, any unused capital losses after that can be carried forward to use in future years.

If you're considering tax-loss harvesting strategies, though, remember the wash sale rule's 61-day window: If a security, or any substantially identical security, is purchased 30 days prior or 30 days after the date it is sold, the loss generated from the sale can't be utilized for tax purposes.

Mutual Fund Repositioning

This might also be a good time to consider repositioning your investment portfolio. Many high-net-worth individuals currently own legacy mutual funds, which likely are not the most tax-efficient vehicle for them. The challenge has always been the tax consequences of shifting these positions in a flourishing market and incurring a large capital gain. The market decline may provide you with an opportunity to reposition your portfolios without the extreme tax consequences.

Roth IRA Conversions

Converting from a traditional IRA to a Roth IRA has become increasingly popular of late, for several reasons:

- When a traditional IRA is converted to a Roth IRA, income tax is assessed on the asset's value on the date of the transfer. If the securities in your traditional IRA have experienced a drop in value and you convert to a Roth IRA, any potential recovery in value won't be subject to future income tax.
- The Tax Cuts and Jobs Act, passed in December 2017, has reduced personal income tax rates and decreased the number of tax brackets. Many taxpayers are seeing a drop in tax on their ordinary taxable income, making today an even better time to convert to a Roth IRA.
- The Setting Every Community Up for Retirement Enhancement (SECURE) Act has extended the age at which required minimum distributions are required from 70½ to 72, and the Coronavirus Aid, Relief and Economic Security (CARES) Act has eliminated the need to take RMDs for 2020 altogether. These changes allow more time for those who would have otherwise been forced to take RMDs, giving them an opportunity to convert to a Roth IRA and create tax diversity during their retirement years.

Health Savings Accounts (HSAs)

A beneficial – and often underutilized – savings tool for healthcare expenses is a health savings account. An HSA allows you to apply pre-tax dollars to qualified medical expenses for yourself and your family. Any funds not used by the end of the year are then rolled over to the following year and continue to grow tax-free.

In response to the recent COVID-19 pandemic, the IRS has issued Notice 2020-15, which states that a high-deductible health plan – which is required for an HSA – can cover pre-deductible medical care services and supplies to diagnose and treat the coronavirus without losing its HDHP status. This notice gives HDHPs the flexibility to provide health benefits for COVID-19 testing and treatment without requiring a deductible or cost sharing.

Individuals also have an option to convert a portion of their traditional IRA to their HSA, changing the funds from tax-deferred to tax-free, assuming the HSA funds are used for qualified medical expenses. This one-time rollover can be very beneficial if you have a medical emergency and don't have enough funds in your HSA. The rollover amount is subject to HSA contribution limits and must be reduced by any contributions already made for the year.

Stock Options

The recent stock market fluctuations have emphasized the importance of having a financial plan in place with specified price targets, especially if a component of your overall compensation includes stock options. To illustrate this fact, consider two employees of the same company:

- Employee A is granted $100,000 worth of stock, either RSUs or RSAs
- Employee B is granted $100,000 worth of at-the-money stock options (i.e., stock options whose exercise price is equal to the price of the stock at the time of the grant)

Should the stock price fall by 50%, Employee A would lose $50,000, leaving $50,000 in stock. For Employee B, though, if the stock price fell below the grant price, the stock option is considered "underwater" and would hold no intrinsic value whatsoever. In other words, their value would be reduced to zero.

Your Baird Financial Advisor can work with you to strategically mitigate downside price fluctuations by planning to exercise stock options at various planned price targets.

ESTATE PLANNING

Much like financial plans, estate plans should be reviewed regularly, especially given the many provisions in recent tax legislation that can impact the assets remaining after death.

Gift Tax Exemptions

The Tax Cuts and Jobs Act's increased estate tax exemption has created an opportunity for those wishing to minimize the effect of federal estate and gift taxes. As of January 1, 2020, we each have an exemption against gift, estate and generation-skipping taxes of $11,580,000, with a 40% tax levied on any excess. However, the use of this exemption is not restricted to your estate and can be used throughout your lifetime via gifts. Currently, the annual gift tax exemption is $15,000 per year, which means you can give up to $15,000 to each recipient per year and not tap into your lifetime exemption amount.

Some of the advantages to using gifts include:

- A gift-splitting election allows married couples to split the value of a gift between them: If you gifted your son $30,000, you and your spouse can make the gift-splitting election and treat the gift as $15,000 by you and $15,000 by your spouse. This would keep the gift amount per recipient at the annual exemption amount.
- Any assets given away during your lifetime, and any growth on those assets, will no longer be included in your estate. For gift tax purposes, assets are valued at the

date of gift – and therefore the growth of these assets is no longer held in the estate.

- Appreciating assets provide a carryover basis to the gift recipient, so any gain recognized by the gift recipient when the asset is sold will receive long-term capital gains treatment of 15% or 20% – a significantly better rate than the 40% assessed at the estate level.

Note that the increased exemption is scheduled to sunset as of January 1, 2026, at which point it will revert to $5 million per person (adjusted for inflation). The IRS and Treasury Department have confirmed that individuals who take advantage of the increased gift tax exclusion before 2026 will not see those exclusion benefits "clawed back" retroactively after January 1, 2026.

Grantor-Retained Annuity Trusts (GRATs)

One vehicle that allows people with estate tax issues to take advantage of low interest rates is a grantor-retained annuity trust.

When creating a GRAT, an irrevocable trust is established and funded, with a fixed expiration date and annual payment to its creator, expressed as a percentage of the initial value of the trust. For example, a $50,000 GRAT with a 10% payout over 10 years would typically pay its creator $5,000 every year, plus the IRS's applied interest rate, regardless of the value of the assets in the trust. Once the period has expired, the trust terminates, and anything remaining in the trust will go to the beneficiaries without gift or estate tax consequences.

Given the historically low interest rates, individuals who have used up their lifetime gift exemption might find the GRAT a valuable tool to transfer wealth without incurring additional gift or estate tax consequences.

Intrafamily Notes

People deciding whether and how to shift assets out of their taxable estates have other options beyond lifetime gifts. Intrafamily loans can be especially beneficial in today's low interest rate environment.

The concept is simple enough: One family member makes a loan to another. In order to keep the transfer from being treated as a gift, there must be an obligation of repayment (ideally with a written agreement) and there must be reasonable interest charged. Through an intrafamily loan, the lender (such as a parent) gets to keep the cash flow equal to the value of the asset, plus interest, in the form of repayments made by the borrower (the child). If the cash is not needed, the parent can use their annual exemption ($15,000 per year per recipient in 2020) and lifetime exemption to forgive repayments by the child. (This "forgiveness" should not be the intent when issuing the loan, as the IRS could argue that the full amount of the loan at inception was truly a gift.) Assets in the hands of the child can then appreciate without inflating the parent's taxable estate, and the parent can keep their gift and estate tax exclusion to use toward other transfers during their lifetime and/or upon death.

Note that if the loan is used to purchase property, you might want to consider securing the loan by having the borrower pledge the property as collateral.

While the COVID-19 pandemic has thrown much of the market – not to mention our daily routines – into disarray, there are financial and estate planning opportunities that could benefit you in the long run. Your Baird Financial Advisor can help make sure your properly positioned for what comes next.