Year-End Estate and Tax Planning 2022: Fundamentals to the Forefront

The year 2022 has provided us with some interesting dynamics when we consider the larger economy: the stock market has experienced some volatility, interest rates have increased, and we are experiencing the highest level of inflation in recent history. By most accounts, 2022 has been a tumultuous year from a financial perspective. Yet, reflecting on those dynamics is a good reminder as to why it is important to have a plan in the first place. In times of uncertainty, a sound foundation will help keep you on track to meet your long-term goals.

Key points:

- It is important not to overlook routine year-end planning, even when there may be no imminent changes to tax laws as a motivating factor
- Moreover, periods of market volatility, as has been the case in 2022, can present unique planning strategies to consider implementing
- Implementing a plan that combines both routine strategies with opportunities specific to the market environment in 2022 may help optimize your tax and financial situation

Despite challenging market dynamics, one thing that has remained relatively constant is the applicable tax legislation. Despite the twists and turns in the various tax law proposals that have been discussed over the past couple of years, no substantial changes to the applicable tax laws have occurred. While recognizing that legislation could change at any time and that plans need to be flexible to adapt to such changes, with no new tax legislation to respond to at this time, we now have an opportunity to re-focus on the fundamentals when evaluating year-end planning opportunities. As the end of 2022 approaches, now is the time to assess whether your wealth plan is still on the path to help you achieve your long-term goals.

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Review your income tax picture

Tax-loss harvesting

The final months of every year should give you the ability to fine-tune your income tax situation for that year. For instance, if you find that you have had a year of higher-than-expected income, there could be the opportunity to reduce some of that taxable income before the year is out. Taking advantage of investment losses is one way to assist with this.

Your portfolio may have some underperforming assets that you can purposely sell at a loss to offset some, or all, of the capital gains you have realized during the year. This strategy is often referred to as tax-loss harvesting and may be one of the planning options that you routinely consider at the end of each year. In a year of market volatility, such as 2022, some tax-loss harvesting may have occurred earlier than usual as a part of responding to market conditions. If that is the case in your situation, it is important to coordinate year-end tax-loss harvesting with your earlier realized losses. If you find yourself with an excess of capital losses, any such unused capital losses this year could be used against ordinary income up to $3,000, with the excess carried forward to use in future tax years. When taking advantage of capital losses, be aware of the IRS' wash sale rule. This rule states that a loss may be disallowed for tax purposes if the security you are selling was purchased 30 days before or repurchased 30 days after the sale. To avoid this restriction, you are allowed to purchase a similar but not "substantially identical" security to the one sold.

Charitable contributions

Changes to the applicable income tax laws in recent years have made it more beneficial for many individuals to use the standard deduction, thus making charitable contributions less appealing from an income tax planning standpoint. Similarly, some charitable giving strategies, such as gifts of appreciated securities—typically affording the added benefit of avoiding recognition of capital gains—may be less appealing in light of recent decreases in asset values. However, even given those market dynamics and the increased use of the standard deduction, there remain some charitable income tax strategies to consider.

First, individuals older than age 70 ½ may wish to consider making a qualified charitable distribution (QCD). Through a QCD, the Internal Revenue Service (IRS) allows such individuals to transfer up to $100,000 directly from an individual retirement account (IRA) to a qualified charitable organization. The amount transferred as part of a QCD can be counted toward your required minimum distribution without adding to your annual taxable income. It could have the additional benefit of allowing you potentially to avoid the Medicare surtax on net investment income. Next, you may implement a strategy of "bunching" charitable contributions that you would have made over several years into one year. This "bunching" method could allow you to take advantage of a substantial income tax deduction to reduce your current year's taxable income.

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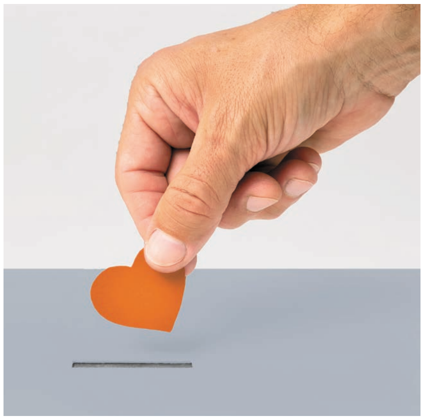

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Additional income deduction and deferral strategies

In addition to the above, several states offer an income tax deduction for contributions that you make into a 529 college savings plan. These plans allow for tax-free growth of contributions and tax-free withdrawals if used for qualified education expenses for the beneficiary of the plan. Check with your tax advisor to see if your state offers an income tax deduction for these types of contributions.

Finally, another fundamental planning opportunity to review at the end of each year is your available retirement plan and Health Savings Account (HSA) contributions. Contributions to these types of plans may not only help your income tax situation for the year but can also enhance the state of your overall financial plan. If eligible, you can contribute to your employer retirement plan (i.e., 401(k), 403(b), etc.) or an IRA as a way of not only saving toward retirement but also reducing your taxable income for the year. The IRS sets a maximum limit on how much you can contribute to these plans. For example, in 2022, the maximum amount you can contribute to a 401(k) is $20,500 (plus an additional $6,500 if over age 50) and $6,000 to an IRA (plus an additional $1,000 if over age 50). Also, the HSA is another way to save for future expenses while reducing your current taxable income. To be eligible to contribute to this type of account, you must be enrolled in a high-deductible health plan. An HSA allows for tax-free growth on contributions as well as tax-free withdrawals if used for qualified medical expenses. As this is not a "use-it-or-lose-it account," it can be a great savings tool as a way to pay for health care costs in your later retirement years on a tax-free basis. Like retirement plans, the IRS imposes a limit on annual contributions to these accounts, and it is set at $7,300 for family coverage (or $3,650 for individual coverage) in 2022, with an additional $1,000 allowed if over age 55.

Taking advantage of a lower income year

What if you had a year when your taxable income is lower than usual? You may find it prudent to accelerate income into the current year. Instead of seeking investments that have underperformed for losses, it may be wise to lock in some capital gains on investments that have performed well. You may find that you can pay the tax on those gains at a lower capital gains rate than you typically would. Another tactic could be to proactively take distributions from your retirement plan (if eligible and not subject to penalty) and possibly pay a lower ordinary tax rate on those than you could when your required minimum distributions begin. Reducing the value of your retirement plan could be beneficial when you ultimately do need to start your RMDs, as this would equate to a lower required distribution when the time comes.

Another opportunity to consider in a year with lower than anticipated income could be a Roth IRA conversion, which could be implemented to enhance the planning that you have already done. For example, if—in light of the market performance so far in 2022—

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your IRA or retirement plan has decreased in value, perhaps you can afford from an income tax perspective to strategically accelerate more income into 2022. In such a situation, your lower income year and lower IRA value could signal an opportunity to convert that IRA to a Roth IRA and pay less tax than if you had done it a year earlier and position you to benefit from income tax-free growth in the future.

Typically, retirement plans (IRA, 401(k), 403(b), etc.) are comprised of pre-tax funds. When you take a distribution of those funds, you pay ordinary income tax on those distributions. However, you can strategically convert those pre-tax retirement funds to a Roth account. The benefit of doing this is to allow the funds to grow tax-free and to have distributions taken from the Roth be tax-free as well (so long as the distributions are qualified). The big caveat to converting pre-tax retirement funds is that you will owe income tax on any converted funds in the year of the conversion. In 2022, however, we have seen retirement plans decline in value, making the conversion of those assets "cheaper" than it was a year ago. Additionally, taking advantage of depressed retirement plan values for this strategy would allow the rebound of those assets to occur in a tax-free Roth account. Also, with the market volatility we have experienced this year, you may benefit from tax-loss harvesting to offset some of the ordinary income that a Roth conversion would create.

Assess your estate and gift tax exposure

Before the end of each year, making use of annual exclusion gifting remains a straightforward way to begin to reduce potential estate and gift tax exposure. Annual exclusion gifting allows each individual (or married couple) to make gifts on a tax-free basis up to $16,000 ($32,000 for a married couple) to as many other individuals as desired without counting against your lifetime federal estate and gift tax exemption. Notably, 2022 marked an increase in the annual exclusion amount (up from $15,000 per individual or $30,000 per married couple in 2021) for the first time since 2018, and another increase will occur in 2023 when the annual exclusion amount will increase to $17,000 per individual or $34,000 per married couple. For those not ready to implement a full estate and gift tax mitigation strategy, but who still may have estate tax exposure after the anticipated decrease in the lifetime federal estate and gift tax exemption in 2026, annual exclusion gifting can be a proactive strategy to begin reducing such exposure in a more modest way.

For those with more significant assets and currently taxable estates, implementing a more robust gifting plan remains important to consider as 2026 approaches. Specifically, the federal unified estate and gift tax exemption rose to $12.06 million (or $24.12 million per married couple) in 2022, up from $11.7 million (or $23.4 million per married couple) in 2021, and will rise again in 2023 to $12.92 million (or $25.84 million per married couple). Unlike the flurry of proposed tax law changes that have surfaced over the past couple of years, no imminent new changes to the federal estate and gift tax exemption appear to be contemplated.

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It also is important to be mindful of the impact rising interest rates can have on various gifting strategies that you are considering implementing or that you have already implemented.

Despite that, under current law, the exemption level is set to decrease on January 1, 2026, down to $5 million (indexed for inflation). If you have a taxable estate under the current federal estate and gift tax exemption, you may wish to design and implement a strategy to capture the benefits of this period of higher exemption before it ends. Those who have already begun implementing such a strategy also should consider taking advantage of the increase in the 2022 exemption level from 2021 as part of the continuing optimization of your estate tax mitigation efforts.

Depending upon your situation and broader cash flow and estate planning goals, there are a number of gifting strategies to consider, including outright gifts, gifts to trusts, and contributions to 529 plans. Even though a few years remain to take advantage of the higher estate tax exemption, 2022 marks an opportune time to gift for a few reasons. Specifically, gifting assets that have decreased in value but are expected to increase as the market rebounds effectively allows you to move assets out of your estate at a lower impact to your lifetime estate and gift tax exemption, while also allowing you to shield the growth from any eventual increase in asset values outside your taxable estate.

Similarly, assets previously transferred to grantor trusts with retained substitution powers also should be assessed for opportunities to move low-basis assets out of such trusts at a lower current value in exchange for higher-basis assets. These types of asset swaps could allow you to minimize capital gains on lower-basis assets by returning them to your taxable estate, thus allowing them to benefit from the step up in basis at death, with no impact on your remaining available lifetime estate and gift tax exemption and no increase in the size of your taxable estate.

It also is important to be mindful of the impact rising interest rates can have on various gifting strategies that you are considering implementing or that you have already implemented. The effectiveness of strategies such as grantor retained annuity trusts (GRATs) and intrafamily loans are linked to the applicable federal rates. For example, with respect to a GRAT, the IRS allows a gift tax deduction for the actuarial value of the income interest retained during the term of the GRAT, which is calculated using the interest rate specified in IRC Section 7520 (also known as the hurdle rate) at the time the GRAT is established. Thus, in times of rising interest rates, the assets transferred to a GRAT will need to perform better to clear the hurdle rate and have the effect of transferring appreciation over the retained income interest to the GRAT's beneficiaries free of gift and estate tax. Similarly, intrafamily loans will need to charge a higher interest rate to avoid being treated as gift loans. While these strategies still may serve your planning goals, evaluating their performance is especially important in the 2022 interest rate scenario, and you may wish to implement these strategies sooner rather than later to avoid further increases in the applicable interest rates.

In contrast, other strategies may become more appealing in light of rising interest rates. One such strategy may include the creation of a qualified personal residence trust (QPRT). A QPRT is an IRS-approved type of trust that may be used to transfer a primary residence, as well as one additional residential property, out of your taxable

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estate for an impact to your lifetime estate and gift tax exemption that is lower than the property's total fair market value. Instead, the transfer of property to a QPRT is a taxable gift only to the extent of the remainder interest in the property that will be left to the trust's beneficiary after the expiration of the QPRT term. Because the remainder value is calculated by reference to the value of the grantor's right to use the property during the term of the QPRT, as interest rates rise, the grantor's right to use the residence during his or her lifetime increases, while the value of the taxable gift (i.e., the remainder interest) decreases, making the use of a QPRT more advantageous from an estate and gift tax perspective. Charitable remainder trusts (CRTs) similarly become more appealing as interest rates increase because the higher the applicable interest rate, the increased likelihood that the CRT will meet IRS minimum remainder thresholds.

For any year-end gifting strategy, it is important to be mindful of the timing requirements. While gifts to qualified charitable organizations generally are treated as deductible in the year the donor makes such gifts to the charity, gifts to individuals need to be fully completed before the end of December 31. For practical purposes, this means that gifts made by check should be both delivered by the donor to the beneficiary and deposited into the beneficiary's own account no later than December 31. With respect to gifts of securities, the transfer of such securities likewise should be fully completed and registered in the beneficiary's name no later than December 31.

Stress test your financial plan

Financial planning should be viewed as an ongoing process: It doesn't stop, and you want to be able to adjust, update, and confirm your plan every few years or more frequently as circumstances require. Periods of disruptions to the economy or markets provide a good opportunity for you to evaluate what type of impact those disruptions could have on your long-term financial goals.

As has been discussed, 2022 has had its share of disruptions. Now is the time to review your financial plan to determine what type of changes you might need to make, if any, to stay on track. Talk to your financial advisor to see if they can stress test some of the assumptions in your plan to illustrate the impact of an unexpected occurrence. In light of 2022's historically high inflation rates, consider assessing what would happen to your plan if the long-term expectation of inflation remains at such levels or becomes even higher. How would that impact your ability to meet your lifestyle goals in retirement?

Your advisor can assist you in this exercise by assuming higher-than-normal inflation assumptions going forward and stress testing the assumptions underlying your financial plan, which may reveal that you could benefit by saving more while you are still working. Perhaps delaying retirement, liquidating your business, or taking a more aggressive investment posture might benefit you. Or these types of exercises might help you just by confirming that what you are doing is still suitable for your long-term goals. Often, this may also lead to broader planning considerations such as rebalancing your portfolio or adjusting your retirement horizon and other goals.

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Review your estate plan, including beneficiary designations

As another year comes to a close, it is useful to assess whether your current estate plan still works to fulfill your goals in light of all the factors discussed above. Reviewing your overall distribution scheme and fiduciary appointments on an annual basis provides opportunities to make adjustments for new circumstances. This may be especially true in a year such as 2022. For example, if your asset levels have decreased as a result of market conditions, it may be beneficial to be sure that any bequests you have incorporated into your estate plan can still be fulfilled as you intended. Or if you planned to leave a retirement account to a charitable beneficiary, is the value of that account still sufficient to fulfill your philanthropic goals?

Your estate plan also should be reviewed to consider any changes you may have made as a part of your other year-end planning efforts. If you have begun making sizable gifts to trusts to make use of your lifetime estate and gift tax exemption, you may wish to consider updating your broader estate planning to coordinate other dispositions with any newly implemented trusts and gifting strategies. As part of that effort, it also is important to review beneficiary designations on retirement accounts and life insurance policies to make sure that the beneficiaries of those assets are coordinated with the rest of your estate plan.

As you complete the foregoing exercises as part of evaluating your overall wealth plan at year end, you may find opportunities to position yourself for even more financial success in the future and also increase your confidence that your plan can carry you through challenging market conditions such as those that we have experienced in 2022.

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As part of the Wilmington Trust Emerald Family Office & Advisory® team, Dolly is responsible for providing strategic and holistic wealth planning advice to high-net-worth individuals, as well as successful entrepreneurs, executives, and their families, by reviewing and illustrating their current plans, highlighting potential deficiencies, and modeling effective tax and estate planning strategies.

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