The Good, the Bad and the Ugly: A Lawyer's Thoughts on the Market

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For those of you who think this is another analysis of the history of the stock market, you are wrong. I actually know very little about the stock market, having spent the large majority of my career in private law practice. My goal and the purpose of this article are to use my legal knowledge and experience to put the ups and downs of the market in perspective and present opportunities for tax and estate planning.

The Good - 2013. At the end of 2013, the S&P 500 was up over 29% and investors enjoyed some of the best returns since the 1990s. Growing balance sheets helped companies and investors obtain credit and just about anyone who needed to raise funds were able to do so at a time when the market was up rather than down. Investors paid more in taxes in 2013 than in prior years and revenues to the federal government and states flowed in. Unfortunately, the next few years would not be so good.

The Bad - 2014. Well, 2014 really wasn't that bad. The S&P ended the year up over 11%, but compared to 2013, it didn't seem so good. The market made double digit gains even though investors were worried about the world stage. Some notable events which might have hampered the market achieving gains similar to 2013 were Russia's aggression towards the Ukraine, the economy in China, terrorism and falling oil prices. Perhaps investor sentiment towards those events waited until 2015 to manifest itself.

The Ugly - 2015. The year ended with the S&P down approximately .07% with somewhere around 70% of investors losing money. It certainly wasn't as ugly as what investors endured in 2007, 2008 and 2009. During the year, the market fluctuated monthly between positive and negative returns. Investors lived with the uncertainty of what would happen next and how the market would close the year.

Now we are in the second quarter of 2016 and are again facing uncertainty. So far this year, the S&P has suffered negative returns for two months and one month with positive returns. I haven't yet mentioned the fixed income market and with good reason. It hasn't had a good year in a long time.

Believe it or not, the fluctuating stock market and low interest rate environment provide opportunities in both the estate planning and tax planning areas. This is a time when your estate planning attorney, accountant and other professionals can help you turn a seemingly negative situation into a positive one.

Estate planning and taxation are often intermingled and it is difficult to discuss one without the other; however, there are matters which are purely of a tax nature. Many investors have large holdings of a particular stock that have been amassed through employment, purchased over time or inherited. An investor may wish to diversify the holding but doesn't want to incur large capital gains and the associated tax. And who can blame them? Taxpayers in the upper tax brackets may lose as much as one-third to federal, state and local income taxes. In addition to the capital gains tax, many investors find themselves subject to the additional 3.8% tax on net investment income or the Medicare tax.

While no one wants to sell an asset for less than its purchase price, incurring capital losses can be a good thing. Capital losses are first used to offset capital gains and then to offset up to $3,000 of ordinary income per year. Realizing tax losses to offset capital gains helps reduce or eliminate the bite of the capital gains tax. In a down market, harvesting tax losses may be a useful tool to offset future gains. Capital losses may be carried forward to future tax years until fully used. A careful portfolio review will expose those holdings which are not performing or underperforming or which have simply lost their allure.

From an estate planning perspective, a down market presents numerous opportunities for the transfer of wealth through outright gifts or with the use of other estate planning vehicles. An individual is permitted to transfer a total of $5,450,000 during his lifetime or at his death without paying estate or gift tax. This amount is referred to as the estate and gift tax exemption and increases annually to keep pace with inflation. Additionally, each individual is permitted to give $14,000 per year to as many donees as desired without reporting the gift and using part of his exemption amount (called "annual exclusion gifts").

Making gifts of marketable securities is fairly simple and does not require an appraisal of the asset to determine its value for gift taxes purposes. When the market is down, a stock gift may be appropriate to transfer wealth or shift income. The value of the gift is only important on the day it is made so if the market rebounds and the stock increases in value the next day, the donor has used less of his gift tax exemption amount or has made an annual exclusion gift effectively worth more than the value on the date of the gift. In addition to leveraging the use of the gift tax exemption amount or annual gift tax exclusion, the gift will shift the burden of capital gains tax to the donee if the asset has appreciated (even in the down market) and shift the burden of tax on the income produced by the asset to the donee.

A donor may not want to make outright gifts of stock or other assets for a number of reasons. Some of those reasons include the age of the donee, the spending habits of the done, or concern about creditors and spouses of the donee. Additionally, a donor may want to benefit more than one generation of donees such as children, grandchildren and more remote descendants. Depressed stock prices and overall lower asset values present an excellent opportunity to make gifts in trust. A dynasty trust is an irrevocable trust meant to be in existence for as long as the law permits to benefit generations of family members. A donor funding a dynasty trust typically makes a large initial contribution or gift and uses a portion or all of his available federal estate tax exemption as well as his available generation-skipping transfer tax exemption to the gift. When distributions are made from the trust to children and more remote descendants, the distributions are free from estate, gift and generation-skipping transfer tax. As long as the assets remain in trust, they will not be subject to transfer tax as the trust benefits multiple generations of beneficiaries. A dynasty trust is suitable for high net worth individuals who do not need the assets or the income produced by the assets.

Not every donor has the luxury of giving away $5,000,000 worth of assets. Fortunately there are other ways to benefit family members without giving up income from gifted assets, initially at least. The IRS has established a specific interest rate (the "7520 rate") to value present and remainder interests in property, value an income or annuity stream and certain other gifts which are not made outright. The 7520 rate varies monthly and corresponds with the interest rates paid to investors and charged to borrowers. The on-going low interest rate environment makes gifts valued with the 7520 rate attractive.

A grantor retained annuity trust ("GRAT") is a type of gift made in trust where the grantor or donor retains an income stream from the gifted property. A GRAT is an irrevocable trust established by a donor for a term of years. Upon establishing the trust, the donor transfers or gifts property to the trust. During the term of the trust, the donor has the right to receive an annual annuity amount from the trust. The value of the amount gifted (what is predicted to be left at the end of the trust term) is determined using the 7520 rate and factors such as the value of the initial gift, the length of the trust term, and the annuity amount. To the extent that the assets outperform the 7520 rate, the value of the remainder interest increases. With a GRAT, it is possible for a donor to make a gift with a value of zero for gift tax purposes. This requires the donor to be paid a large annuity amount which typically means that both income and assets will be distributed back to the donor as part of the annuity payment. A donor who wishes to make a gift which does not reduce his available federal gift tax exclusion amount is best served by making a gift of property likely to appreciate substantially in value such as pre-IPO stock. If the property does not outperform the 7520 rate, there will be nothing left to distribute to the remainder beneficiaries at the end of the trust term.

Donors who have charitable intentions can also take advantage of the currently low 7520 rate by establishing a charitable remainder trust ("CRT") or a charitable lead trust ("CLT"). A CRT benefits a charitable entity or entities at the end of the trust term while a CLT benefits a charity during the trust term. In the case of a CRT, the 7520 rate is used to value the annuity stream paid to the donor for a term of years or the lifetime of the donor. For a CLT, the 7520 rate is used to value the projected amount left to non-charitable beneficiaries after the annuity or income stream is paid to a charity.

Donors who have appreciated property and charitable intentions may wish to consider a CRT. A CRT is not subject to federal or state income tax and provides an excellent vehicle to sell appreciated property. The donor is taxed on income which occurs within the trust, but only as such income is distributed to the donor as part of an annuity or unitrust payment. In addition, the donor is afforded an upfront charitable deduction in the year the CRT is established. A CRT is an irrevocable trust established for a term of years or the lifetime of the grantor. Each year, the donor receives an annuity payment (a fixed percentage of the trust established at the time the trust is created) or a unitrust payment (a percentage of the trust established annually). At the end of the trust term, the balance remaining in the trust is distributed to charity. The donor usually retains the right to change the charitable beneficiaries, if he so desires. The value of the charitable gift (the charitable deduction to the donor) is calculated by valuing the annuity or unitrust payment which will be made to the donor. A lower 7520 rate means that the value of the retained interest (the amount the donor will receive during the trust term) will be correspondingly lower.

Unlike a CRT, a CLT pays the charitable beneficiary during the term of the trust. The purpose of the CLT is to provide an annuity or unitrust payment to the charitable entity for a term of years or during the lifetime of the donor. At the end of the term, the balance remaining in the trust is paid to the donor's beneficiaries. Because the value of the amount going to charity and the value of the projected amount left at the end of the term are calculated using the 7520 rate, a low interest rate makes this type of gift appealing. If the donor pays income tax on the income produced by the trust, the donor is entitled to an upfront charitable deduction. If the trust pays the income tax on any income not distributed to the charity as part of the annuity or unitrust payment, the donor is not entitled to a charitable deduction.

Finally, a low interest rate environment makes borrowing money extremely attractive. Interest rates for mortgage loans, home equity lines of credit and automobile loans are at historical lows. This presents the opportunity for individuals to purchase a larger home, enter the housing market for the first time or refinance an existing loan. Homeowners with available equity in their properties may want to take advantage of the low interest rates to make needed repairs and updates. Although secured by a property, a home equity line of credit does not have to be used in connection with the residence. The line of credit can be used to purchase an automobile, pay college tuition or purchase a second or vacation home.

Additionally, the low Applicable Federal Rate ("AFR") provides an opportunity for intra-family lending. The AFR is published monthly by the Internal Revenue Service and is used for a variety of purposes including lending. The AFR is broken down into short-term (3 years or less), mid-term (more than 3 years but less than 9 years) and long-term (more than 9 years) rates. The AFR is further broken down into periods for compounding which are monthly, quarterly, semi-annual and annual. As an example, the long-term AFR for a loan compounded annual interest is 2.24% for the month May, 2016. A child who needs funds for a down payment on a home or to make needed improvements to a home can borrow from parents at an affordable interest rate. The interest on some loans which are properly documented can be deducted as qualified mortgage interest on the borrower's income tax returns.

In closing, there are many more opportunities than those discussed in the preceding paragraphs. Clients who wish to explore establishing a dynasty trust or making an intra-family loan should contact us. Our goal is to provide you with basic information, analyze whether a particular vehicle is appropriate for you, and direct you to a professional who will help you implement your plan.

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