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WEALTH MANAGEMENT

Orange Bank & Trust Company
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Use it or lose it?

DEAR TRUST OFFICER:

My parents are very financially secure, as my father saved several million dollars during his successful career. They are in "senior living" now. I've heard that federal estate taxes might be going up. Should my parents be taking estate planning steps right now? Should I? What might those steps be?

—CONCERNED POTENTIAL HEIR

DEAR CONCERNED: I would need much more information before answering this general question for your circumstances.

Let me begin by noting that the amount exempt from the federal estate tax has never gone down in American history. Reductions that have been enacted in the past were subsequently reversed by a later Congress before taking effect. Also, although President Biden has proposed significant tax increases for the wealthiest, he has not called for any change in the federal estate or gift taxes.

But having said that, I must also point out that under current law the amount exempt from federal estate tax will drop roughly in half in 2026. That law does not presently look likely to be amended. Senator Sanders of Vermont has proposed dropping the estate tax exemption from the current $11.7 million per person to $3.5 million, starting next year. Those possibilities have many affluent families considering steps to "lock in" today's higher exemptions.

Locking it in

Under current law, in 2021 everyone has one $11.7 million transfer tax exemption which can be used to protect gift and estate transfers from the federal tax, which is generally imposed at a 40% rate on amounts over the exemption. Making a large taxable gift "locks in" the exemption without incurring any immediate tax liability, although it uses up the exemption available at death for the estate tax.

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Example one. Joe's total estate is $12 million. If he dies this year, only $300,000 will be exposed to estate tax. Should he die in a future year when the exemption is only $3.5 million, the tax will apply to $8.5 million.

If Joe makes a gift of $11.7 million this year, he will use up that portion of his exemption. Then if he dies after the exemption is lowered to $3.5 million, only $300,000 will be subjected to federal estate tax.

However, to achieve the lock-in effect, one must go "whole hog" on the lifetime transfer.

Example two. Joe is not willing to part with his entire estate, so he makes a taxable gift this year of only $3 million. His 2021 exemption is large enough that no gift tax is payable. What happens if Joe then dies in a future year when the exemption is reduced?

The estate tax impact largely will be the same as if Joe did nothing at all. If the exemption is worth $3.5 million, Joe will have only $500,000 left to shelter his remaining $9 million estate. None of today's larger exemption is locked in by the smaller gift.

To complicate matters further, no one is suggesting a change to the marital deduction, or to the rule that a surviving spouse may inherit any estate tax exemption not used up by the estate of a decedent spouse (the "Deceased Spouse's Unused Exemption," or DSUE).

Example three. Joe's estate comes to $16 million, which he will leave entirely to his wife, Martha, in a marital deduction trust. Assume that Joe dies in 2021, when the exemption is $11.7 million. None of that exemption will be used, thanks to the unlimited federal marital deduction. Martha thus will have an $11.7 million DSUE, and that figure is locked in by Joe's death.

Assume next that Martha dies in a year when the exemption has been reduced to $3.5 million. She will have the benefit of that smaller exemption plus the DSUE, a total of $15.2 million. Only $800,000 of Martha's estate would be exposed to the federal estate tax.

Nonterminal solutions

Is there a way for Joe to lock in that DSUE amount for Martha short of dying? Yes, estate planners have developed a wide range of trust-based strategies that may achieve this goal. You will need to consult an experienced estate planning lawyer to learn more about these approaches.

The lawyer will need to understand much more about the scope of your parents' assets, their health, and their hopes for their wealth. Nonprobate property, such as retirement plans and insurance policies, will need to be taken into account. This is an area where there are no "cookie cutter" plans, only guidelines.

We don't do estate planning, but we can be a valuable resource in preparing you for an efficient meeting with your estate planning advisors.

Estate planning for capital gains

Under current law, there is generally no income or capital gains tax on inherited assets, as their tax basis becomes fair market value on the date of the owner's death. (Note that this rule does not apply to inherited tax-favored retirement accounts.) Accordingly, estate planners may recommend holding substantially appreciated assets until death, so as to secure that tax-free basis step-up.

President Biden called for a dramatic increase in federal spending in the "American Families Plan," to be "paid for" with a restoration of the 39.6% tax rate at taxable income of $400,000 or more, and capital gains would be taxed as ordinary income for those with taxable income more than $1 million. What's more, the President suggested that basis step-up at death should be ended. In a clarifying statement, the Biden administration reported that $1 million in basis step-up would be granted to each estate, so smaller estates would be excused from application of this new rule.

Would the end of basis step-up mean a "carryover basis" for heirs, as already happens with the federal gift tax? Or could death become a realization event, with a "deemed sale" of all appreciated assets, requiring the estate to immediately pay tax on unrealized gains? Such a dramatic change in tax law would have a tremendous effect on estate planning.

Therefore, this is an issue that estate planners are watching closely. With the Congress closely divided, it is far from certain that any tax increases will be enacted this year. On the other hand, the growing federal deficit needs attention, and tax increases on "the rich" may be inevitable.

No taking chances

Recently overheard:

"You should invest in the S&P 500."

"I should have invested in the S&P 500 a year ago."

With the benefit of hindsight, we can say that the stock market collapse in the spring of 2020 was an overreaction, and in fact it was a great time for bargain hunters. But given all the uncertainties we faced about vaccine development and the economic consequences of the lockdowns, that was exactly the time when putting down a big bet on stocks may have seemed reckless and much too risky.

What's an investor to do about financial market volatility? For many investors, the answer is, not much. Ideally, one wants to be in the market on the up days and out on the down days. In reality, no one can call those days accurately in advance. Academic studies have shown that most of the gains in the stock market occur on just a few trading days. The risk of being out of the market on good days outweighs the reward of avoiding the losers and the transaction costs of managing the process.

The historical record

In one major study of market returns, business professor Javier Estrada of the IESE Business School in Barcelona, Spain, quantified the effect that exceptional days can have on investment returns. He studied the Dow Jones Industrial Average for the period from 1900 through 2006. Looking at the best 100 trading days, the lowest return was 3.9 standard deviations above the mean. Statisticians will tell you that data suggest such a return should be seen once in 83 years—yet that return or better occurred 100 times in the course of the study.

To translate Estrada's findings into dollars, $100 invested in the DJIA at the beginning of 1900 would have grown to $25,746 by the end of 2006. However, if the investor had missed just the ten best days of those 107 years, the investment would have grown to only $9,008, a reduction of 65%. Miss the 20 best days, and the portfolio would have grown to only $4,313. Finally, missing the 100 best days of the 29,190 in the period under study, one-third of one percent of the trading days, would have resulted in a loss of capital, as the terminal wealth would have been just $83.

Of course, there are exceptional days on the downside as well, as Estrada documented. If you had kept all the best days and avoided just the ten worst days, terminal wealth would have jumped to $78,781. If you had accurately predicted the 100 worst days and avoided them, your $100 would have grown to an astonishing $11,198,734!

And it's not just the U.S. stock market that exhibits such behavior. Estrada went on to document similar results in foreign markets as well. He concluded: "A negligible proportion of days determines a massive creation or destruction of wealth. The odds against successful market timing are just staggering."

Lessons for investors

What can investors take away from studies such as these?

- The costs and risks of trying to time the market probably are larger than the potential benefits. Academic studies of returns are inherently artificial and tend to overstate returns because they do not factor in transaction costs or taxes. Thus, the case against market timing is likely even stronger than suggested by Professor Estrada.

- Over the long term, the stock market has balanced the negative and positive abnormal days. Past performance does not guarantee future results, but, overall, stocks have outperformed all other investment classes.

- Diversification may help moderate the impact of exceptional days. On a day when the stock market overall is down, some stocks are, nevertheless, up. Stock selection matters. The bond market doesn't always move in lockstep with the stock market, so an allocation to this asset class also may reduce the impact of daily swings. Keeping some cash on hand may help the investor weather a rough patch, or even take advantage of opportunities that arise.

Michael Jackson's final tax bill

Imposing an estate or inheritance tax at death is not very difficult when the assets consist of cash and marketable securities. Those values are readily obtained. But when an estate includes intangible assets, the process can become very complex indeed. One of the best illustrations of this phenomenon may be the estate of Michael Jackson. The Tax Court has rendered its decision, nearly 12 years after Jackson's death in 2009.

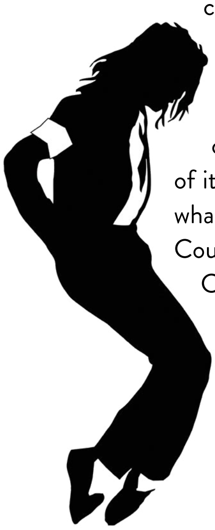
There were three key assets for which the estate and the IRS could not find an agreement as to value, requiring the services of the Tax Court. First there is the commercial value of Jackson's image and likeness. The estate valued it at only $2,105 on the estate tax return. The IRS' expert pegged the value at some $161 million! At trial, the estate conceded that the right to use Jackson's image was closer to $3.1 million in value.

Given the hundreds of millions of dollars earned by the estate since Jackson's death, even that figure might seem laughably low. However, the estate tax is imposed on the value of the asset at the moment of death, and events after death are not taken into account. Jackson's reputation was at a low point before he died.

The Tax Court judge criticized the IRS' approach to valuing this asset. "Any projection that finds a torrent of revenue, and not just a trickle, from such a man's image and likeness—especially one who in the last two years of his life was so unpopular he did not even have a Q score—is simply not reasonable," he wrote. The judge decided Jackson's image was worth $4.2 million at death.

Jackson owned a 50% interest in a joint music venture with Sony. The estate reported that asset as worthless, because the venture's liabilities exceeded its assets. The IRS asserted it was worth more than $206 million. But the IRS was wrong, the judge ruled, because its expert treated the venture as a music catalog when it was in fact an operating business. The estate was correct, this asset had no value.

Finally, a trust that owned the copyrights to Jackson's music had to be valued. The estate had valued the trust at $2.3 million, while the IRS put it at $114.3 million. The Tax Court judge concluded it was worth $107.3 million.



The IRS had initially asked for a penalty tax on the substantial valuation shortfalls on the estate tax return, which could have run to hundreds of millions of dollars. Even though the Jackson estate won most of its arguments, there remained a huge gulf between what the estate tax return reported and what the Tax Court finally ruled as correct values. Nevertheless, the Court held that no penalty was appropriate. In this incredibly complicated case, the estate had relied upon competent experts, was not negligent, and had acted in good faith.