Key Family Wealth — Business Advisory Services (BAS)

# When the Levy Breaks: Three Tax Planning Arenas of Opportunity

> **I'm proud to be paying taxes to the United States of America. The only thing is — I could be just as proud for half the money.**
>
> — Arthur Godfrey, radio broadcaster and entertainer

## Introduction: The income tax in american history

It can be hard to believe that the United States only has consistently levied an individual income tax for a little over a century.[1] For the vast majority of the 1700s and 1800s, America was able to run budget surpluses sustained by tax receipts from customs duties (i.e., tariffs) alone; only in the early 1900s did the concept of a progressive income tax begin to take root in the burgeoning New World. Today, as the 250th anniversary of the American republic begins to loom less than two years away, citizens ask themselves again: What can I do this year to be "just as proud for half the money"? This article may not enable you to cut your tax bill in half, but it should provide you with key insights to discuss with your tax advisory team to help you keep more of what you make — in three different arenas.

## Arena #1: Retirement planning

It's striking how few people have saved enough for retirement. Data from the Federal Reserve[2] reveal that the median value of retirement assets held by U.S. households was $86,900 in late 2023 — 108% of the median annual family wage in the same year.[3] This suggests that the median American household has just 13 months' income in retirement funds. Is it surprising that Congress incentivizes retirement savings with credits[4] and deductions? Having seen these data, what's to be done? It's simple: If you have a retirement plan, at the very least contribute to the match; and insofar as it's possible, contribute to the max. The compounding effect becomes increasingly impactful, as demonstrated by the following brief sensitivity analyses.

This table shows the horizon-end values of various annual contribution amounts (columns) over various numbers of years (rows) — all at a 3% annual investment return.

| Annual contribution (columns); Investment horizon in years (rows) | 5,000 | 10,000 | 15,000 | 20,000 | 25,000 |
|---|---|---|---|---|---|
| 5 | 26,546 | 53,091 | 79,637 | 106,183 | 132,728 |
| 10 | 57,319 | 114,639 | 171,958 | 229,278 | 286,597 |
| 15 | 92,995 | 185,989 | 278,984 | 371,978 | 464,973 |
| 20 | 134,352 | 268,704 | 403,056 | 537,407 | 671,759 |
| 25 | 182,296 | 364,593 | 546,889 | 729,185 | 911,482 |

The figures from this table lend themselves well to a slogan: "5 x 5," for example — contributing $5,000 per year for five years, compounding at 3% — results in $26,546 of savings. This means that $1,546/$25,000, or 6.2%, of the wealth is from compounding. In the middle of the table is the result of a "15 x 15," which results in $278,984.

Since 15 years x 15,000/year = $225,000 of contributions, this means that $53,984/$278,984 = 19.4% of this wealth comes from compounding.

Finally, the "25 x 25" strategy results in ending wealth of $911,482. Since 25 x $25,000 = $625,000, this means that $286,482/$911,482, or 31.4%, of the wealth is from compounding.

| Annual contribution (columns); Investment horizon in years (rows) | 7,500 | 15,000 | 22,500 | 30,000 | 37,500 |
|---|---|---|---|---|---|
| 5 | 39,819 | 79,637 | 119,456 | 159,274 | 199,093 |
| 10 | 85,979 | 171,958 | 257,937 | 159,274 | 429,895 |
| 15 | 139,492 | 278,984 | 418,476 | 557,967 | 697,459 |
| 20 | 139,492 | 278,984 | 418,476 | 557,967 | 697,459 |
| 25 | 273,444 | 546,889 | 820,333 | 1,093,778 | 1,367,222 |

Now let's take the same table, but assume we have a 50% match on the contribution amount.

Since the 20% qualified business income deduction is sunsetting at the end of 2025, the 21% C corporation tax rate introduced in 2017 is permanent, and the operating activities of many of these passthroughs might qualify as QSBS activity, many passthroughs probably should be evaluating what their corporate lives would be like as C corps.

Of course, most people investing in assets with risk, such as equities, typically aim for a higher long-term return than 3%.[5] This table shows an annual contribution at the $30,500 catch-up limit, at various investment returns (column) and investment horizons in years (rows).

| Annual investment return (columns); Investment horizon in years (rows) | 3.00% | 4.00% | 5.00% | 6.00% | 7.00% |
|---|---|---|---|---|---|
| 5 | 161,929 | 165,198 | 168,532 | 171,931 | 175,398 |
| 10 | 349,648 | 366,186 | 383,626 | 402,014 | 421,402 |
| 15 | 567,267 | 610,719 | 658,146 | 709,917 | 766,435 |
| 20 | 819,546 | 908,231 | 1,008,512 | 1,121,961 | 1,250,363 |
| 25 | 1,112,008 | 1,270,200 | 1,455,677 | 1,673,368 | 1,929,096 |

For those who want to defer more than the $30,500 available to a 50-something with a retirement plan, consider defined benefit (DB) plans. There is no statutory limit on the amount that can be contributed, but the maximum benefit to a participant is the lesser of $275,000 or the three highest consecutive years' compensation for the employee. This can create some very high-base-rate potential contributions; many older DB participants can defer upward of $200,000/year into their plans. These contributions reduce taxable income, and generally allow the plan beneficiary to defer taxes until distributions begin.

## Arena #2: Split-interest philanthropic planning

A river of goodwill runs through American history, and our tax code incentivizes and reflects it.[6] Charitable giving tends to run at approximately 2% of GDP,[7] and rises and falls with financial market cycles. Some of the most common pieces of advice on charitable giving for individuals touch on matters like bunching donor-advised fund (DAF) contributions for maximum benefit in a high-income year; ensuring the substantiation requirements are met; evaluating 30% versus 50% organizations, and so on. What sometimes gets overlooked is the potential for some donors to have their proverbial cake and eat it too: to consider splitting a charitable gift so part of it passes to charitable groups, and part to their family. One example of this is charitable lead trust planning for those with significant means.

Let's look at a brief example:

Assume a donor has a liquidity event in early 2024, selling zero-basis shares in a privately held business for $25 million. Her effective tax rate is 30% on these shares. This donor is highly charitably inclined, and has already given low seven-figure gifts to various charities in her community. Her first thought is to make a $5 million cash donation to a donor advised fund, which will allow her several things. First, she receives a dollar-for-dollar tax deduction in the year of the gift, up to the adjusted gross income (AGI) limitation of 60% (for cash).

Next, she has the benefit of knowing she doesn't have to pay out the $5 million in the DAF all at once; she can stagger her gifts over time and be thoughtful with them.

Last, she reduces the size of her estate by the entire $5 million gift. She thus receives: a) a $5 million income tax deduction that should be fully deductible in 2024 (60% of $25 million is $15 million, well above the $5 million gift); b) the knowledge that her DAF is holding the $5 million to administer under her advisement, with no capital gains or transfer taxes payable on those funds; and c) the removal of those assets from her estate, and thus from gift or estate taxes. Trifecta!

Now let's add a twist. One of the core things this donor realizes is what $5 million grows to over a generation — namely, $10 million, at 3% over 25 years or so — and is wondering whether she can keep any of those future proceeds for her heirs. With a charitable lead trust, she well might be able to.

How? By contributing the $5 million to a grantor charitable lead annuity trust, this donor receives:

- The same $5 million deduction, assuming the trust is structured properly[8];
- The responsibility of paying the income taxes on the dividends, interest, and capital gains of the trust throughout its 25-year life[9];
- The knowledge that the trust is paying a charity a sizeable sum of money each year (about $333,000);
- The knowledge that the asset is removed from the grantor's estate, as long as she lives throughout the trust's horizon; and
- The ability to pass any remaining trust amount to her heirs gift- and estate-tax free at the end of the trust's 25-year life.

As of October 2024, with a $5 million gift, a 7.50% investment return, and a 25-year trust, the expected payout to heirs at the trust's end is $7.81 million. This is a significant lift over the amount of money expected to pass to the heirs 25 years after the DAF gift, which is zero.[10]

**Arena #3: Qualified Small Business Stock (§1202) planning**

One of the greatest benefits in the entire U.S. tax code is found in IRC Section 1202. This section affords entrepreneurs founding "qualifying small businesses" the ability to exempt a significant portion of the capital gains on the sale of their stock from federal (and sometimes state) taxation.

This capital gain exclusion is the greater of a) $10 million or b) ten times the adjusted basis in the stock at the time of issuance, up to a maximum gross asset value of $50 million (and thus an adjusted basis of $500 million). Since the 20% qualified business income deduction is sunsetting at the end of 2025, the 21% C corporation tax rate introduced in 2017 is permanent. The operating activities of many of these passthroughs might qualify as Qualified Small Business Stock (QSBS) activity,[11] and many passthroughs probably should be evaluating what their corporate lives would be like as C corps.[12]

Those considering §1202 planning have several factors to consider, and the matter is complex. A few bullet-pointed considerations are:

- The earlier the planning starts, the better. Two big no-nos are a) share repurchases by the C corporation from any individual shareholder in the four-year window starting two years before share issuance; and b) share repurchases by the C corporation of more than 5% of the outstanding shares in the two-year period starting one year before issuance. Making sure owners don't tender their shares back to the corporation is mission-critical during these windows.
- Get an opinion letter to certify that you're holding on to QSBS. There are some operating businesses that have one activity that falls under the QSBS-permissible activities, and another that doesn't. Talking to tax advisors and legal counsel early on can help you plan the entity structure of operating divisions in advance so you're situated to take advantage of QSBS treatment on as much of your enterprise as can qualify for it.
- Depending on the size of your exit, you may need to consider exemption stacking. In its simplest form, let's assume A owns QSBS with $25 million of qualifying gain. If he sells, he will be exempt on $10 million of gain, and pay tax on the remaining $15 million. But if he gifts stock with $10 million of embedded gain to his spouse, outright or in trust,[13] husband and wife each now have $10 million of exempt gain, and only have to pay taxes on $5 million. And yes, you guessed it: If they contribute the stock with the remaining $5 million of embedded gain to a trust for baby's benefit, they now have a $25 million liquidity event without any federal income tax. Can this be real? It can be — if you plan for it!

## Corporate Transparency Act reminder

One item for many entity owners to consider as the year winds down are the impending reporting requirements of the Corporate Transparency Act. The details of this legislation are too lengthy to recount here, but you can go to this link to find out more.

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## Conclusion

Election years always afford spectators a look into the minds of the "choice and master spirits of this age"[14] from a tax standpoint. Jousting proposals this past election have included the corporate tax being lowered to 20% or even 15%, or alternatively being raised to 28%; and capital gains taxes being kept at their current 20% for high-income taxpayers, or raised to 28% for those with over $1 million in annual income ... the drums beat on. The most important point to remember in most tax planning is knowing where to incorporate flexibility in a tax position, and knowing where to make a firm stand.

The three arenas above not only represent outstanding opportunities for employees, charitable-minded folks, and entrepreneurs to increase their wealth — they represent three arenas where congressional intent clearly points toward a favored activity: saving for retirement, giving to worthy causes, setting up U.S. supply chain businesses that produce tangibles or intangibles that benefit U.S. customers, suppliers, employees, and stakeholders. Such things are much less ephemeral than today's political promises to be forgotten tomorrow — and will help save you money.

For more information, please call your relationship manager.

The Key Family Wealth BAS team is dedicated to providing guidance and support to owners of privately held businesses like you. Specifically, the BAS team helps owners prepare for an eventual business transition with strategies and advice on how to maximize the after-tax value of a business transition.

[1] The Federal government did enact a personal income tax in 1861 that helped finance the Civil War, but this tax was repealed after the war, and the First Form 1040 wasn't due until 3.1.1914, after the ratification of the Sixteenth Amendment and the Revenue Act of 1913.

[2] *Changes in U.S. Family Finances from 2019 to 2022*, October 2023, Federal Reserve Board, p.16.

[3] Statista.

[4] The retirement saver's tax credit is unavailable to married filers with more than $76,500 of AGI in 2024, but offers up to $1,000 of credit for taxpayers with incomes below this. Check out this link for more.

[5] According to Dimson, Marsh, & Staunton, 1.1.1900-12.31.2015 annual risk-adjusted stock returns in the U.S. have averaged 9.40%.

[6] Those who doubt this should consult Karl Zinsmeister's Almanac of American Philanthropy, a masterful chronicle of U.S. largesse from 1636 all the way up to 2017. You can find it here.

[7] The Philanthropy Roundtable.

[8] The IRS publishes rates for these trusts each month, known as the Section 7520 rate. In a falling interest rate environment, these trusts become more attractive, because they can pass more wealth to their heirs gift- and estate-tax free. As of the time of writing (October 2024), the §7520 rate is 4.40%. To illustrate further, a $5 million constant-payment 25-year CLAT structured to make no taxable gift, with an asset growing at 7.50%, would have passed $5.89 million at the end of the 25 years using the August §7520 rate of 5.20%; $6.86 million at the September §7520 rate of 4.80%; and $7.81 million at the October §7520 rate of 4.40%. All of these sums would have passed gift- and estate-tax free to heirs at the CLAT's terminus.

[9] This is known as a grantor CLAT — its income tax characteristics pass through to its grantor.

[10] Different investment returns will pass different sums to heirs under this scenario. For example, if the return is 5.50%, only $2 million will pass to the heirs; if it is 8.50%, $12.2 million will pass to the heirs. This is why investment policy inside a CLAT is paramount. CLATs can also be "back-loaded," so that the charitable payments increase by a constant amount each year. This tends to pass even more wealth to heirs. For example, the same $5 million, 25-year trust with an investment return of 7.50% will pass $7.81 million with a constant annual charitable payment of $333,000; but it will pass $12.8 million with a payment starting at $25,000 and growing 20% each year until the trust ends. Such nuances make it imperative to talk to an experienced tax and legal advisor when considering a strategy like this.

[11] A qualified trade or business is defined in the negative. In general, service business are excluded, as are banking, insurance, financing, farming, and hospitality businesses. For more, see *Qualified Small Business Stock – The Next Big Bang*, by Paul Lee, L. Joseph Comeau, Julie Miraglia Kwon, and Syida C. Long, 2019.

[12] QSBS status applies to the shares of C corporations only.

[13] Assuming MFJ filers.

[14] Julius Caesar, Act III, Scene 1.

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