ST. LOUIS TRUST
& Family Office

Five Planning Ideas to Make a Bear Market More Bearable

As we've watched the stock market crash in the past few months, I'm reminded of one of legendary investor Bob Farrell's 10 market rules: Bull markets are more fun than bear markets. How true.

But for those in need of a silver lining, you'll be happy to know that what's not fun for investments is great for estate and tax planning. As former Chief of Staff Rahm Emanuel said at a Wall Street Journal conference of CEOs in the thick of the 2008 financial crisis, "You never want a serious crisis to go to waste. It's an opportunity to do things that you think you could not do before."

So, in the spirit of turning a crisis into an opportunity, I offer some strategies that can improve your financial position even while it still feels like the sky is falling. We put many of these planning techniques into motion for clients during the Financial Crisis and have the benefit of time to see how they turned out. (Spoiler alert: Great.)

Estate Planning Techniques

During a bear market, there are two key ingredients that make it an optimal time for estate and tax planning: lower asset values and low interest rates. Here are some ways to take advantage of both.

1. Reduce wealth transfer taxes by making gifts to trusts or individuals

The estate tax, gift tax, and generation-skipping transfer tax (GST) are all levied on the fair market value of the assets at the time you transfer them. When values are lower, you can move assets out of your estate at lower values. And once you've moved assets out of your estate, all future appreciation of those assets is also out of your estate. This results in paying less estate tax or using less of your estate, gift, or GST exemption amounts over time.

For example, if you gift $1 million to an irrevocable trust outside of your estate, you will use $1 million of your lifetime gift and estate tax exemption, which is currently $11.58 million. If the value of the gifted assets doubles every ten years (a 7.2% return), it will be worth $8 million in 30 years. But that $8 million will be exempt from estate tax even though it was transferred out of your estate for $1 million.

2. Minimize the taxes you pay on asset appreciation by using estate freeze techniques

When asset values are low, it's a good time to engage in estate freeze transactions, such as an installment sale to an intentionally defective trust (IDIT sale). In an IDIT sale, you transfer the assets to a special type of irrevocable trust outside of your estate in return for a promissory note. The sale of assets to the trust is not considered a gift because the value of the note equals the value of the assets you transferred. The promissory note bears interest at an IRS prescribed minimum rate, which it announces each month. As the value of the assets you've moved to the trust grow beyond the interest charged on the note, that appreciation accrues outside of your estate.

The ability to transfer assets at depressed prices combined with low interest rates makes this planning strategy particularly compelling right now. For May, the IRS minimum rate on a 3- to 9-year term promissory note is 0.58%—the lowest it's ever been. That's compared to an average of around 1.5-2.5% over the past five years.

In the summer of 2009, the stock market had hit its lowest point, and the economic news was horrible. During this scary time, we helped client families set up IDITs sales, which turned out to be home runs. Over the next 10 years, the assets transferred to those trusts grew more than 300%, resulting in massive reductions of the clients' estate tax liability.

Other estate freeze transactions include establishing Grantor Retained Annuity Trusts (GRATs), which are similar to IDIT sales, and Charitable Lead Annuity Trusts (CLATs), which provide a stream of payments to a charity and then to the trust creator's family. Like an IDIT sale, both techniques work best when interest rates are low, and the assets you are transferring to the trusts have a good chance of appreciating.

Another planning tip: if you've engaged in an IDIT Sale in the past, now may be an excellent time to refinance it. The lower the interest rate, the higher the net growth of the value of the trust assets.

3. Now is a good time to use entities like LLCs to reduce your estate

Another good technique in the current market environment is using a limited partnership or LLC to discount the fair market value of your assets. Because the ownership units in a limited partnership or LLC aren't marketable and lack voting rights, those units are valued at less than the underlying assets. In the near-term, market volatility and economic uncertainty should make valuation discounts more generous. So, using discount planning in conjunction with gifting or estate freeze strategies can significantly reduce your tax liability.

Income Tax Planning Techniques

4. Use this as an opportunity to diversify your stock holdings or mutual funds

When you sell stocks or mutual funds, you realize a gain or loss equal to the difference between the amount of proceeds and the cost basis of the asset. The tax cost of realizing capital gains often causes investors to retain concentrated stock positions or investments in mutual funds that they would prefer to sell. Bear markets are an excellent opportunity to diversify out of these sorts of investments with reduced or zero tax costs. You can do this by selling investment assets at a loss and then using those losses to offset the gains you've realized by diversifying.

For example, let's say you have a stock portfolio worth $2 million, $500,000 of which is Netflix stock that has $400,000 of embedded gains. You'd like to reduce your concentration in Netflix to 10% of your portfolio by selling $300,000 of the stock. Such a sale will generate about $240,000 of gain. You also own an $800,000 international stock mutual fund with a $330,000 embedded loss. If you combine your sale of $300,000 of Netflix stock with the sale of the international mutual fund, you will owe no taxes. You will also have a $90,000 loss that will offset future gains.

Instead of holding on to the $90,000 of excess loss for future use, you can instead sell additional Netflix shares, realize $90,000 of gains currently, and re-buy the Netflix stock immediately. This effectively resets the cost basis on some of your Netflix stock.

Although you're allowed to sell stock at a gain and re-buy it at a higher basis immediately, the wash sale rule prohibits investors from selling stock at a loss and purchasing the same stock within 30 days and taking the loss. That means you cannot re-buy the same international mutual fund you sold within 30 days and still use the $330,000 loss. Instead, you'll need to purchase a different fund with the $800,000 proceeds.

5. Convert your regular IRAs into Roth IRAs

When you convert regular IRAs into Roth IRAs, you pay taxes on the entire conversion amount. This conversion makes sense when both asset values and tax rates are low — currently the situation in which we find ourselves. By paying the taxes on those assets now, you can withdraw them tax-free later when the market rebounds and the value of your assets are higher. Additionally, higher tax rates in the future is a good possibility given all the debt the U.S. government is incurring to shore up the economy during the pandemic .

Are We Having Fun Yet?

Although watching the value of your stock portfolio drop is never enjoyable, the estate and tax planning opportunities abound. Even in the current market environment, there are plenty of techniques to help you preserve and even grow your wealth. And given the uncertainty of our current circumstances, the time to make those changes is now.

St. Louis Trust & Family Office is an independent, multi-family office and trust company that advises clients on more than $10 billion of investment assets and more than $12 billion of total wealth. Founded in 2002, St. Louis Trust & Family Office provides holistic, high-touch client service including customized, independent investment management and a full range of family office and fiduciary services. The firm serves a limited number of clients with substantial wealth in order to *maintain very low client-to-employee ratios. Visit stlouistrust.com to explore how the firm manages complexity with unmatched expertise and focuses on Family, Always.*