REFLECTIONS

Client Newsletter

WINDGATE
WEALTH MANAGEMENT
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HOW THE NEW ADMINISTRATION MIGHT AFFECT YOUR RETIREMENT

We all know that when there is a change in the White House administration, there could be changes to our day-to-day lives. And with the transition to a Biden presidency, plus Democratic control of both the House and the Senate, there are various proposals on the table that could result in significant changes to retirement plans, particularly for individuals and couples who earn more than $400,000 per year.

Just as when you approach a milestone or experience a life event, a change in our country's leadership can be a good time to reevaluate your retirement and estate plans to make sure they take tax climate and government policies into account. Here are some potential changes to keep an eye on.

Social Security Reform

Social Security trust funds have been running a surplus since 1982. Right now, the surpluses are predicted to stop in 2020 and the system will rely on incoming interest payments to make up the deficit until 2033.   At that point, if no changes are made, benefit payments may

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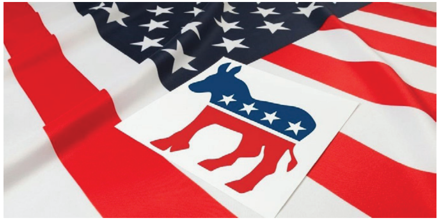


shrink to 80% of what Americans expect. If you have been following this story and are confused about the 2033 date, you did not read that incorrectly. Previous estimates were that the trust fund would be depleted by 2035, but due to the COVID-19 pandemic and related economic struggles, the timeline has been pushed up 2 years. That is not good news if you are planning to retire soon.

President Biden has proposed several key changes intended to address the general issue of long-term Social Security solvency while also making benefits available to certain populations. Biden has proposed to increase Social Security benefits to 125% of the federal poverty level, increase benefits for Americans who have been receiving payments for 20 years or more, and pay greater benefit amounts to widows and widowers. The President has proposed to fund the expansions, in part, by imposing higher Social Security tax rates on earnings between $400,000 and $600,000. Another option that could improve funding prospects for 75 years is to raise the payroll tax 1.2% for everyone—that includes both employees and employers.

Estate Tax Law Changes

The Biden plan includes changes to the taxation of intergenerational gifts and estates. The plan could include a repeal of the "step-up in basis" that currently allows heirs to legally avoid paying tax on capital gains prior to the transfer of assets. In addition, the maximum long-term capital gains (LTCG) tax rate could increase from its current 20% to a new cap of 39.6%. The lifetime Generation-Skipping Transfer Tax (GSTT) exclusion, currently set at $11.7 million for 2021, is already scheduled to sunset in 2026, resulting in the imposition of estate taxes on estates exceeding $5.8 million. Additional proposed legislation could further reduce the exemption to $3.5 million, the limit in 2009.

Changes To 401(k) Plans

The Biden administration has reportedly proposed to change the way contributions to a 401(k) plan affect tax liability. The plan would replace the traditional tax deferral with a flat 26% tax credit. The change would have the effect of equalizing tax deductions between income brackets. Since lower earners are taxed at lower rates, tax deferrals under the current structure results in greater current-year tax savings for high-income earners. The Biden plan would also create "automatic 401(k)" accounts, designed to offer the benefits of a 401(k) plan to individuals who are not offered retirement plans through their jobs.

Reinstating the Pease Limitation

An additional provision of the Tax Cuts and Jobs Act (TCJA) could be rolled back: the repeal of the Pease Limitation, which was first introduced in 1991 and has since been repealed and reintroduced twice. The Pease limit began to incrementally reduce the tax deduction value by 3% on certain itemized deductions for taxpayers whose adjusted gross income (AGI) exceeded specific thresholds (which changed each year). In 2017, the last year before the recent repeal, the AGI limit was $261,500 for single filers. If the Pease limit were reinstated, high earners would lose the tax-saving benefit of commonly itemized deductions.

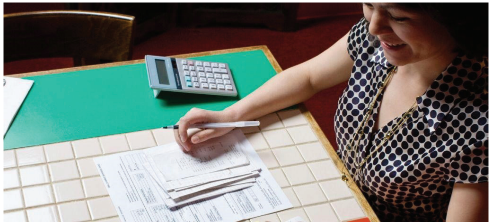
Good or Bad Markets?

While the new administration is likely to have some impact on the changes reviewed here, the ultimate effect on the market may be less definitive. History tells us that the linkage between an election result and a market impact is not always clear; there are just too many non-political variables that impact investment outcomes over merely who wins an election. As detailed in the hyperlink above, U.S. stocks have risen over the long-term regardless of the political party in charge. Instead of investing based on political narratives, we, at Windgate Wealth Management, stick to our longer-term process of building portfolios that are durable in any environment. A good investment process must consider multiple macro scenarios and assess the potential risks and returns in each.

What Does This Mean for You?

You might be scratching your head, wondering how all these figures and complicated jargon impact your retirement. Bottom line: if you have not recently reviewed your financial plan, now is the time to reassess and make sure your strategy is aligned with the potential tax law changes that we may be seeing over the next several years so you can maximize your wealth and minimize your tax liability.

5 THINGS I WISH I KNEW BEFORE SELLING MY COMPANY'S STOCK OPTIONS



Stock options, which give you the right to buy a specific number of shares of company stock at a pre-set price, are becoming a popular way for companies to reward their employees. If you are fortunate enough to receive stock options as part of your compensation, there are important considerations to keep in mind. We have helped many employees navigate what to do with their stock options, and here are some of the things they have told us they wish they had known before they sold.

Know the Difference Between ISOs and NSOs

There are two main types of stock options: ISOs and NSOs. ISOs (incentive stock options) allow you to get preferential tax treatment as compared to NSOs (non-qualified stock options). This makes them the more valuable type of option if you understand the flexibility they offer.

There is no tax impact when you are granted ISOs or NSOs. Once your options become vested, you can exercise the option and purchase company stock; you need to do this before the expiration date when the options expire and become worthless.

The difference between the option's exercise price and the value of the stock is the "bargain element." This is your initial monetary gain, and for NSOs, you will be taxed on this amount at your ordinary income levels (as high as 40% depending on your income and where you live).

With ISOs, you can have the same "bargain element" taxed at a lower capital gains rates, currently as low as 15%. The determining factor is how long you hold the stock after exercising the option. If you exercise the option and immediately sell the stock, you have made a "disqualifying disposition" and the entire bargain element will be taxed at ordinary income levels. Conversely, if you hold the stock for more than a year, it can be a "qualifying disposition" and the entire gain will be taxed at the lower capital gains rates.

Consider an 83(b) Election

An 83(b) election allows you to pay taxes on the fair market value of options when they are granted, as opposed to when you eventually exercise or sell. This is like the "starting the clock" example above because you are planning for future growth to be taxed at the lower capital gains rate.

Opting for an 83(b) election makes sense if you feel the value of the underlying stock will increase over time. Keep in mind, though, that prepaying your tax obligation could backfire if the stock falls after you pay taxes on the current value. You typically need to make an 83(b) election shortly after the shares are granted, so be sure to be aware of timing.

ISOs and the AMT

Before you take advantage of the preferred tax treatment of ISOs, you need to be ready to navigate the Alternative Minimum Tax (AMT). With ISOs, when properly planned for, the AMT is essentially just a pre-payment of taxes that can get credited back. It can, however, add headaches, complications, and a need for cash flow when exercising large amounts of ISOs.

As discussed, when you exercise ISOs and continue to hold company stock, the bargain element is not taxed as ordinary income. It is, however, considered for the AMT, and likely taxed at a 26% or 28% rate. Ultimately, a "qualifying disposition" is still taxed at the capital gains rate, not the AMT rate. So, if you hold the stock for a year or longer before selling, you are entitled to a credit between the AMT rate you paid in the year of exercise and the lower capital gains rate at the time of sale.

AMT projections and planning should be done with a tax advisor. The AMT does not generally kick in until about $200k of income, so it often makes sense to annually exercise any ISOs you can under the AMT limit, to start the clock on the one-year holding period without having any AMT due. Separately, planning around the cash needed for AMT due in the year of exercise can have a big influence in helping you determine how many ISOs to exercise in a given year.

Understand Your Cash Flow Requirements

Exercising your options and selling can be a great liquidity event to take some cash out of your company to use toward other financial goals. However, there will likely be cash requirements you should plan when deciding how many options to exercise or sell.

When you exercise options, you need to pay the exercise price for the right to buy shares. This is a cost to consider that will lessen your liquidity. You may have an ability for a "cashless exercise" and use some of the stock value to pay the exercise cost. In addition to the exercise cost, you will likely trigger a sizeable tax due (either in ordinary income for NSOs or AMT for ISOs) for which you need to plan, as the bill does not come due until the following April. Getting $500K liquidity to spend on other investments or financial goals can be a problem if you have not set any money aside for the next tax bill.

Diversification and Company-Specific Risk

Company stock options are an incredible way to build wealth as you participate in the success of your company. Yet as in all investment decisions, you need to consider how much of your portfolio you have tied up in a single company and the risk you are taking if it does not meet your goals.

Exercising and selling stock options is a way to diversify and de-risk your portfolio. This does not need to be an all-or-nothing decision. We often encourage employees to consider their future if they take just a portion of risk off the table. Will you still be able to meet your financial goals if you sell 25% of your company stock, for example? If yes, there may not be a need to take on the additional risk of holding of the stock. If the company stock soars, yes you will have lost out on some upside. But if the amount you still hold is life-changing anyway, that regret can be minimal. There is value in being able to sleep soundly at night knowing you have a plan. And in the worst case, if the stock ultimately fails, you have cashed out some investments that can still be working for you.

Unfortunately, you may choose to exercise a stock option only to see your shares fall in value. If that happens to you, and you want to or need to sell those shares, you can "harvest" those losses by applying them against any capital gains you have, up to $3,000 a year. Using this "tax-loss harvesting" strategy can help reduce your overall tax liability.

Stock Options and Your Financial Plan

Decisions around selling stock options should be considered as part of your overall financial situation. We can help you analyze the options your company has granted you, and work with a tax specialist to help you make the best decision for your situation.

SUPERCHARGE YOUR ROTH IRA

Don't let Roth IRA income limits prevent you from gaining tax-free growth

The Roth IRA is perhaps the most attractive retirement savings vehicle for investors. Unlike traditional IRAs which provide tax-deferred growth (you pay the tax eventually), Roth IRA assets grow tax-free. Assets with this favorable tax characteristic can provide desirable flexibility in retirement years, where the future state of tax rates is very uncertain. The Roth IRA protects you from paying future income taxes, and this protection also continues for your heirs.

While everyone should get in the Roth game, as Mr. Slott proposes, for high-income earners it has not always been so easy. Roth IRA contributions are not allowed once a married couple has an AGI over $206K (or $139K for an individual). IRA conversions – changing an account from an IRA into a Roth IRA – were not possible for high-income earners until recent changes in the tax law removed income limitations. Here, the "backdoor IRA" strategy was born.

BACKDOOR IRA: HOW IT WORKS

The Backdoor Roth IRA strategy allows those who earn more than the Roth limitations to contribute to a Roth IRA anyway, with one small workaround. While contributing to a Roth IRA is prohibited for high-income earners, anyone can make contributions to a Traditional IRA. In addition, anyone who has funds in an IRA can "convert" the assets into a Roth IRA. Put together, high-income earners can sidestep the Roth income limitations by contributing to an IRA and then converting it to a Roth. IRA limits are currently $6000 ($7,000 for those aged 50 and over), and the strategy can be repeated every year.

> "It's the best motivation to save for retirement that we've seen in America. Everybody should be in the Roth game if they can."
>
> -IRA expert and financial-industry speaker, Ed Slott

The main obstacle to making a "backdoor" Roth contribution is the pro-rata rule, which can limit the effectiveness of the strategy. The pro-rata rule forces all IRAs to be counted as one account, so a $6,000 Roth conversion will be considered as a partial conversion of all existing IRA assets, not as a standalone transaction. The downside here is the tax benefits are issued on a pro-rata basis, meaning if $6,000 represents 5% of all your combined IRAs, only 5% of the $6,000 can be converted tax-free into a Roth (the remainder will be considered a taxable distribution – not the desired outcome). Note the rule only aggregates IRA accounts, so 401(k)s, spouse's accounts, or other Roth accounts are not counted (SIMPLE and SEP IRA assets are included).

ROTH SUPERCHARGE STRATEGY: UNLOCK EXTRA SAVINGS FROM YOUR 401(K)

Investors can save $6,000 per year into a Roth via the backdoor strategy; this a good start, but high-income earners may want to do more. If your 401(k) allows for both after-tax contributions and in-service distributions, you can quickly accumulate significant Roth IRA assets by using a supercharged strategy.

Many people are familiar with the $19,500 limit for 401(k) contributions ($26,000 for those over 50). But there is a lesser-known overall limit of $57,000; this includes employee contributions, employer match and profit sharing. If a 401(k) plan allows for after-tax contributions, an employee can make additional contributions above and beyond the standard $19,500 limit. Here is an example of how it works:

William is age 49 and maxing out his 401k salary deferrals……………………..$19,500

The company matches at 50%……………………………………………………$9,750

Amount under overall $56K limit William can contribute "after-tax"………… .$29,250

If the 401(k) also allows for "in-service distributions," William can then rollover the $29,250 after-tax 401(k) contribution into his Roth IRA, regardless of his income level. Combined with the $6,000 backdoor Roth strategy, William can now put away $35,250 into a Roth IRA, every year!

Not everyone will have this opportunity as it depends largely on your 401(k) plan's flexibility and design. But for those eligible it can be an outstanding way to accumulate assets into a Roth IRA. Ask your 401(k) administrator if your plan allows for 1.) after tax contributions and 2.) in-service withdrawals.

The Backdoor Roth IRA strategy allows those who earn more than the Roth limitations to contribute to a Roth IRA anyway.

IRA CONTRIBUTIONS DEADLINE

The tax filing deadline has been extended to May 17, 2021, meaning you have extra time to potentially contribute to an IRA or Roth IRA. Maximum contributions are $6,000 per individual ($7000 if you are age 50 or over). Income limits for contributing to Roth IRAs or making deductible contributions to Traditional IRAs are below. You can also still benefit from tax-deferred growth in a traditional IRA by making non-deductible contributions should your income exceed the limits. Remember, contributions can be made from both cash on hand or from your taxable investment accounts. Give us a call to determine if this is the right option for you.

IRA 2020 INCOME LIMITS

Filing Status	Roth IRA Can contribute if your Modified AGI is	TRADITIONAL IRA Can deduct contributions* if your Modified AGI is
Single or Head of Household	<$124,000	<$65,000
Married Filing Jointly	<$196,000	<$104,000
Spousal IRA (Those with spouse who earns no income)	N/A	<$196,000

*If you are not covered by an employer plan, you can deduct 100% of IRA contributions regardless of income.

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