REFLECTIONS
Client Newsletter

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WINDGATE
WEALTH MANAGEMENT
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MARKET RECOVERY / MARKET UNCERTAINTY

In the depths of the March sell-off, we likely had a conversation about the extreme uncertainty in the markets and its effect on your financial plan. The oft-repeated message served, we hope, as a calm within a storm: remember that your plan comes first. If you are drawing retirement income from your portfolio, you will still get your monthly check. If you are saving for your future, your recent contributions were used to buy stocks on discount. Stay the course, markets will come back.

We knew this to be true based on history and experience. What we did not know was that it would only take a matter of months for the full recovery. Now the question remains, will it sustain?

After the sharp draw down in February and March (the S&P 500 Index plunged 34% after hitting an all-time high on February 19, the fastest 30-day decline in history), equities have posted gains for five straight months. As of this writing, investors are now likely to see account balances back above where they were pre-pandemic. A relief, to be sure, yet this puts us in a difficult state: stock valuations are high and market expectations appear to ignore any risks, all making the prospects of future stock returns volatile.

INSIDE THIS ISSUE

If you have any questions or comments, or if you know of any friends or family that might benefit from our services, please give us a call at 844.377.4963

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Never have we experienced a stock market high in the depths of recession. The virus-induced shutdown of the economy resulted in its worst ever period, with real GDP falling 32.9% annualized during the second quarter. For comparison, the worst quarter during the financial crisis was a decline of 8.4% during the fourth quarter of 2008. The second quarter will likely mark the worst from an economic standpoint as we slowly recover. However, the level of uncertainty is as high as its ever been.

A defining characteristic of the market's recovery is the extreme technology stock performance. While investments of all types have seen solid recoveries since the bottom, technology stocks have risen drastically, reminiscent of the late 1990s tech-boom. As of this writing:

•Tech stocks are now worth more than the entire European stock market.
•The market cap of Apple is greater than the entire Russell 2000 Index of 2,000 small companies.
•The top 5 tech stocks make up 25% of the S&P 500 Index, the highest in its history.

History is littered with periods where specific themes or industries rule the landscape, only to provide disappointing future returns for investors. After all, great companies make great investments only at great prices. Eventually a seemingly overvalued segment of the market must come down to earth, often very quickly. Of course, we can never know when.

Investing is about making decisions while under a cloud of uncertainty. It appears that the current attitude is to act as if uncertainty doesn't exist. Long term investors know that the best defense against uncertainty is diversification, keeping a margin of safety, and aligning your portfolio with your personal goals and cash needs. We do know when this approach works: today, tomorrow, and always.

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SHOULD YOU DO A 401(K) ROLLOVER?

With the average working adult changing jobs 12 times during their career, knowing what and how to do a rollover with your investment accounts is crucial. We can all agree that we want to have our financial portfolio as streamlined as possible while paying less in fees, with more options for investing, and tailored to our specific situation.

What is a 401(k) Rollover?

A 401(k) rollover is an option you have when you leave a company and want to transfer your retirement investments into an individual retirement account (IRA). Normally people do this if they are leaving a company, switching to a new company, or retiring, but you can also do a 401(k) rollover into another 401(k) with a new employer.

Pros and Cons of a Rollover?

The main benefits of a rollover from a 401(k) to an IRA are the following:

- **More options** - Most 401(k) plans have a limited selection of mutual funds to invest in. IRAs offer these funds plus a much wider spectrum to choose from, including stocks, exchange-traded funds, and individual bonds.
- **Lower taxes and fees** - This will vary depending on your 401(k), but usually having an IRA decreases management fees, administrative fees, and expenses related to each fund you have. An investment advisor can typically analyze your situation on fees very quickly with a review of your account statement.
- **Transition from a traditional IRA to a Roth account** - Many contributions to a 401(k) plan are done using pre-tax dollars, so although you get a tax deduction, you must pay taxes when you withdraw that money. Rolling money from a 401(k) into a traditional IRA and doing a partial or full Roth Conversion gives you the option of paying taxes now, letting all that money grow tax-free and not be taxed when you withdraw.

There are many benefits to doing a rollover and not leaving your accounts with an old employer's plan. On the other hand, there are two main reasons why you may want to choose to keep your funds in a 401(k).

1) If you plan to retire early, you can avoid some tax penalties. There is a 10% tax penalty if you withdraw money from your 401(k) or IRA before the age of 59½. However, if you retire at 55 or later, you can take penalty-free withdrawals from your current 401(k) sponsored retirement plan. You do not get this option with an IRA.

2) If you plan to retire late, you can avoid required minimum distributions (RMDs). If you are still working at the age of 70½, you must start taking required minimum distributions from your previous 401(k) and IRA accounts. The exception to this rule applies to your current 401(k), from which you do not have to take RMDs if you are still working. If you had chosen to roll over 401(k) investments from previous employers into your current employer's 401(k) plan, none of that money would be subject to RMDs. Traditional IRAs (which means no taxes have been paid on the money yet) do not allow you to withdraw early without incurring a penalty, and you will have to take RMDs at the age of 70½.

How to do a 401(k) Rollover

Completing a rollover is a simple process and you won't have to pay any taxes or (most likely) fees. Once you have chosen a financial institution to open your IRA, contact your 401(k) plan administrator to let them know where you want your funds transferred.

You can choose to do either a direct or indirect transfer. A direct transfer is highly recommended because it is the simplest form of getting money from one point to the next, and you do not have to worry about how or when to deposit funds. With an indirect transfer, a check is made out to you and sent to your address. Then you have 60 days to make sure it is deposited where you want it or incur a 20% penalty on that money, because the tax collectors are assuming you wanted to make an early withdrawal. The bottom line: stick with a direct transfer so you do not have the potential of incurring that penalty.

HOW THE CARES ACT AFFECTS YOUR RETIREMENT ACCOUNT DISTRIBUTIONS

On March 27, President Trump signed into law the largest economic stimulus package in the history of our nation. The Coronavirus Aid, Relief, and Economic Security (CARES) Act provides $2 trillion to help stem the economic fallout of our nationwide attempts to slow the spread of COVID-19. T he stimulus package is very broad, doing everything from strengthening the ailing airline industry to providing rebate checks to individual taxpayers, and offering forgivable loans so that small businesses can meet payroll. In this article, we look at how the CARES Act affects retirement account distributions.

Required Minimum Distributions Waived

For those of you who have no need for the money in your retirement accounts this year, you are in luck. The CARES Act waives required minimum distributions (RMDs) from traditional IRAs, SEP IRAs, SIMPLE IRAs, and 401(k), 403(b), and governmental 457(b) plans for the year 2020. The waiver also applies to beneficiary account owners in addition to original account owners. Therefore, no one has to take RMDs for 2020.

This waiver even applies to those who were supposed to take their first RMDs in 2019 but chose to put it off until 2020. Any RMDs that were supposed to be taken in 2020 no longer have to be taken.

What if you have already taken your 2020 RMD? You can put it back. Owners had until August 31st to simply put their RMD back into their IRA to reverse any taxable income. If you missed the window, you can potentially still redeposit in as a qualified coronavirus-related distribution, as explained below.

Coronavirus-Related Distributions

For those of you who need money from your retirement accounts, even if you have not reached retirement age yet, the CARES Act has you covered as well. The stimulus bill provides special rules for coronavirus-related distributions of up to $100,000 from IRAs and employer-sponsored retirement plans. To be considered coronavirus-related, the distribution must be made in the year 2020 by people who either:

- have been diagnosed with COVID-19
- have a spouse or dependent who has been diagnosed with COVID-19
- experience adverse financial consequences as a result of being quarantined, furloughed, laid off, or having to work reduced hours because of the disease
- are unable to work because they lack childcare as a result of the disease
- own a business that has closed or been forced to operate under reduced hours because of the disease
- or meet other criteria that the IRS approves

These are the special rules in place for coronavirus-related distributions:

- They are not subject to the usual 10% penalty for distributions made before age 59½.
- They are not subject to mandatory tax withholding, which is normally 20%.
- There is a 3-year window in which you can replace any distributions that you take. The 3 year period begins the day after the distribution is made.
- Any income taxes due on the distribution can be spread over a 3-year period or paid immediately, depending on what is most beneficial for the individual taxpayer.

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GUIDE TO GRATS: ESTATE PLANNING FOR BUSINESS OWNERS

How you plan your estate can have a significant impact on how much your family must pay in taxes. This is especially true if you have substantial assets that may be subject to estate taxes, or own assets that you expect to appreciate substantially.

A Grantor Retained Annuity Trust, or GRAT, is an appealing option for passing down assets to the next generation, especially in today's low-interest rate environment. It can allow business owners to retain control, receive cash flow, minimize estate tax and preserve family history. Here is a guide to how it works.

Basics of a GRAT

A GRAT allows you to freeze the value of an asset for tax purposes and receive an annuity payment in return.

Currently, estates above $11.58 million held by an individual ($23.26 million for a married couple) are subject to federal estate tax. These limits will expire in 2026 down to approximately half of current levels. At a hefty Federal tax rate of 40%, and many states adding additional state tax, a substantial portion of a wealthy family's assets are likely to go toward taxes rather than to their heirs. Most of the future appreciation of an asset in a GRAT escapes the estate tax and gift tax.

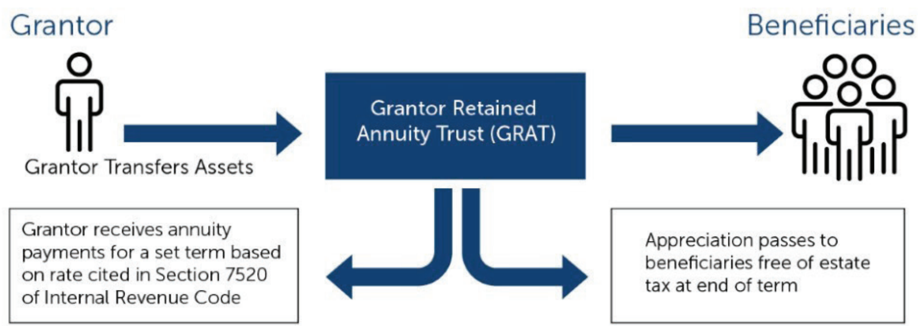
Here is how a GRAT mitigates these taxes:

- You, as the grantor, deposit assets you expect will appreciate to an irrevocable trust.
- The principal you give to the trust, plus interest, must be returned to you over a set period.
- To accomplish this, you receive annuity payments drawn from the trust assets each year. The payments are determined by the current Section 7520 rate, a figure set by the IRS, which is currently hitting all-time lows, at 0.6% as of the time of this writing.
- At the end of the set term, any growth in assets above the returned principal and interest is transferred to your beneficiaries outside of your estate, avoiding estate taxes.

Assets with a low current valuation compared to their expected future value (such as stock in a privately held firm) are particularly well suited to putting into a GRAT. This is because assets with the potential for great appreciation also have the potential for triggering large estate tax liabilities, and a GRAT allows you to bypass these future taxes.

The currently low interest rates make a GRAT especially appealing right now, as it creates a smaller payment requirement and therefore leaves more of your appreciated assets to pass estate-tax free to your heirs.[1]

[1] https://www.irs.gov/businesses/small-businesses-self-employed/section-7520-interest-rates



GRAT Risks and Potential Downsides

A GRAT is only a smart option if you have enough assets to achieve your desired lifestyle beyond what is given to the trust. As an irrevocable gift, you cannot get a "do over" and take the assets back for personal use as needed.

The largest uncontrollable risk in GRAT planning is life expectancy. If you die before the trust's term expires, your assets in the trust will be included in your estate and pass to your heirs without any additional tax benefit. This would make the entire strategy ineffective. It therefore requires a strategic balance between keeping a GRAT term short, versus keeping it longer so your assets have more time to grow and maximize the benefit.

Intentionally Defective Grantor Trust (IDGT) Alternative

One way to get around the life expectancy risk of a GRAT is to utilize an Intentionally Defective Grantor Trust (IDGT) as an alternative. Just like in GRAT planning, you place an asset into an irrevocable trust, which is then removed from your taxable estate. However, with an IDGT, you sell your asset to your trust, in exchange for a promissory note from the trust that agrees to make interest-only payments for a defined period. Because a promissory note is more flexible than a fixed annuity payment (as required by a GRAT), this strategy can offer several benefits:

- If you die before the trust expires, the assets remain outside of your estate and the strategy continues to meet its tax-savings goal.

- The repayment of the principal asset can be deferred and paid over a longer period. This means you can wait to have the trust pay you back until there is a liquidity event creating adequate cash flow.

- For the sale of your ownership stake to an IDGT trust to be legitimate, the trust must already have some liquid assets. Therefore, it is common practice to "seed" at least 10% of the expected purchase price into the IDGT as a separate gift before the sale transaction occurs. This "seeding" is subject to gift tax.

The "intentionally defective" part of the trust's name comes because it was created by an attorney with a design "defect" that ensures the trust grantor continues to pay taxes on the income generated by assets in the trust. This defect is a good thing, because when the grantor pays the trust's income taxes: 1) the trust is growing tax free for the beneficiaries; and 2) the dollars used to pay taxes will be removed from your taxable estate.

A GRAT allows you to freeze the value of an asset for tax purposes and receive an annuity payment in return.

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