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Once you've made it — here's how to keep more of your wealth

By Martin Daks

President Joe Biden's tax proposals have received a lot of attention, especially in the wake of his call to hike personal income tax rates, reduce estate tax exemptions, and take other steps to help fund his multitrillion-dollar infrastructure plan and other goals.

Any tax hikes on the wealthy will likely affect a significant number of residents in Connecticut, which was ranked No. 3 in the nation when it comes to millionaires, according to the most recent Kiplinger report.

The Hartford Business Journal spoke with some local CPAs to find out how the wealthy try to reduce their tax bite — and what Biden's proposals may mean for them.

"In general, there are several taxes that the wealthy strive to minimize," said Brenden Healy, a tax partner in the Hartford office of Whittlesey, a regional CPA and IT consulting firm. "Federal and state income taxes probably get the most attention. However, the estate tax, or 'death tax' and gift taxes — which are transfer taxes — can also be problematic for the wealthy."

Their tax-minimization strategies often involve “deferring income to a future tax year — assuming tax rates stay the same or do not increase — or taking advantage of tax-saving incentives under the law,” he added. “If a wealthy taxpayer earns their income through wages, such as an executive at a nonprofit or a for-profit company, there may be ways to defer annual bonuses or to maximize deferred-compensation plan funding.”

But Biden has floated ideas about increasing the highest income tax bracket to 39.6%, which could flip the traditional tax-deferral strategy on its head.

“Generally, you defer income when it makes sense and take advantage of tax incentives available,” Healy noted. “If however, we know that tax rates will increase, maybe in 2022, the taxpayer should consider accelerating income if possible to take advantage of the lower 2021 tax rate, which generally tops out at 37%.”

Of course, individuals have different objectives that CPAs consider when they’re suggesting a strategy. For some, it may make sense to transfer assets to an entity they can control, like a family limited partnership (FLP) which can offer protection against creditors and potentially reduce gift and estate taxes while maintaining control over the management and distribution of the FLP’s assets.

“They may also set up trusts for the benefit of their loved ones,” Healy said, referring to an estate planning fiduciary arrangement under which the donor’s specified assets are held by a third party, or trustee, on behalf of one or more beneficiaries. Trusts can be designed to allow the assets to be shielded from estate taxes upon the donor’s death.

Growing interest in trusts

Healy said there is currently a relatively high federal estate tax exemption of $11.7 million for individuals, or $23.4 million for a married couple, but there have been discussions about reducing that to $5 million or less per person.

If the exemptions are decreased, there will probably be more interest in shifting wealth through trusts, he said.

For business owners "it is critical" to explore tax incentives to reduce income tax costs, he added.

"Tax credits like the research and development credit, the new employee retention credit and other tax incentives can permanently save money for businesses," Healy said. "Other options for a business owner may involve temporarily deferring income — if it makes sense — such as changing an accounting method for tax filing purposes."

Connecticut residents in particular tend to get hit hard by high state income taxes, according to organizations like the Tax Foundation, which ranks the Constitution State in the top 10 nationwide. Healy said his clients are concerned about this issue, but they're not exactly breaking down the doors to leave the state.

"We're constantly talking about this with clients, but it's important to quantify any potential tax savings before you seriously consider relocating," he noted. "Sometimes the savings do not outweigh the financial and emotional costs of moving out of Connecticut. Also, the issues of physically moving out of the state compared to establishing new residency for tax purposes can be very different. Like many other topics in the tax world, it's complicated."

Specific tax planning strategies may vary depending on an individual's circumstances, but there are some "fundamental planning concepts for taxpayers with a net worth of $1 million or higher," according to Jay Sattler, managing tax principal at the West Hartford office of Clifton Larson Allen, a national wealth advisory, accounting and consulting firm.

Sattler said individuals and businesses are always dealing with a shifting tax code, especially as changes associated with the 2017 Tax Cuts and Jobs Act continue to kick in, and with the prospect of some rollbacks and other changes under President Biden.

A second look

"Wealthy individuals may wish to engage in sophisticated tax planning with different trust and other vehicles to expedite their specific wishes and goals," Sattler said. "For example, an irrevocable trust [where the donor generally gives up control of the assets placed into the trust] may provide estate tax savings for the trust creator-donor and liquidity for the beneficiaries."

One such trust is a grantor retained annuity trust (GRAT), under which the donor, or grantor, contributes assets that are likely to gain in value to a fixed-term, irrevocable trust.

Under a GRAT, the grantor generally retains the right to receive an annuity stream over the trust's term and, at the end of the term, the assets will be distributed to the grantor's heirs or other beneficiaries.

In some cases, a business may be placed in a trust, or a limited liability company, as a way to shield assets from creditors, he noted.

Some of Biden's proposals — including steeper tax rates on income, expanding the range of income subject to Social Security taxes, increasing the capital gains tax rate, and eliminating the "step-up basis" for estate tax purposes (currently, the base value of an appreciated asset is readjusted, generally tax-free, to market value for tax purposes upon inheritance) — have prompted questions from some of Sattler's high-net-worth clients.

“We’ve had more discussions, but it’s difficult to give concrete advice right now since they’re just proposals,” he said. “They may not get passed, or they may pass with various modifications to the current proposal. With that said, we are actively alerting clients of potential changes and addressing their concerns to ensure they are properly positioned.”

The prospect of higher federal taxes can also have a local impact, he added.

“They may spur more interest among those who want to minimize their local taxes as well, which in some cases might prompt a review of their state tax position driven by their state of residency. Some taxpayers move to Florida or other low-tax states because they’re retiring and want to be near their family,” he said. “But another tax hike could tip the balance, especially since the pandemic-spurred spike in long-term remote work has demonstrated that people can successfully work from home. If they can run their business and keep more of their earnings, more people may be attracted to states like Florida or Texas.”


Amber Monaghan

Getting to know you

Amber Monaghan — a Hartford and New Haven tax and business partner at the national accounting and advisory firm Marcum — said the tax planning process often starts with a deep dive into a client's personality.

"When we're working with a high-net-worth client, it's often within the structure of a family office," she said, referring to a privately-held company that handles investment and wealth management. "One of the first steps is to find out about the members' risk tolerances and their goals. At the same time we familiarize ourselves with their investment structures, which may include trusts, life insurance and other vehicles."

One potentially useful approach involves an intentionally defective grantor trust (IDGT), which is often established for the benefit of the donor-grantor's spouse or descendants.

It generally contains a provision that ensures trust income will be taxed at the donor-grantor level — which makes it tax "defective" for income tax purposes — but otherwise shields the underlying trust assets from being taxed at the grantor's estate-tax rates, which potentially could be higher.

"For years this has been an effective tax strategy for wealthy families, but President Biden's proposed tax changes — if enacted — may reduce the effectiveness of an IDGT," she cautioned. "We've seen a surge of interest in people transferring their business interests to trusts — particularly during the COVID pandemic — since they may be able to value the business at a reduced amount, and when the economy rebounds and the business valuation rises, it will occur within the tax-advantaged trust structure. During this past November and December, estate-tax CPAs and attorneys were swamped with client calls."

At the same time, Monaghan warned that any specific tax law changes are not certain, and she's in no rush to lock clients into new strategies before there's some clarity.

Federal tax hikes could hurt CT

Another issue with federal tax hikes, of course, is how they might impact the Nutmeg State.

There's a lot to like about living in Connecticut, but state taxes aren't among them.

And a jump in the federal tax rate could help nudge some on-the-fence residents to pull up stakes for a friendlier location, Monaghan said.

"One large manufacturing client is seriously looking at moving their headquarters to Texas," she said. "A lot of their operations are already out of state, so this would cap the exodus. Unfortunately, moves like this are nothing new. Connecticut's property taxes are fairly outrageous, and the state's individual income taxes are pretty high. It's a chronic problem."