The Planning Quarterly

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Peapack Private

Wealth Management

Welcome to the February 2022 issue of the Peapack Private Planning quarterly. Planning issues arise at every stage of life—the articles here address a few of them. With tax season getting underway, we're primarily focused on those issues. Please reach out to our authors—or to any of our investment and planning professionals—with your questions. Our guidance can help you achieve your financial goals.

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Withholding - Understanding Form W-4

Cynthia Fusillo CPA, MBA, ChSNC®

If you've been employed, you've undoubtedly encountered the Employee's Withholding Certificate, more commonly known as Form W-4. It is among the many forms your employer will ask you to complete upon starting a new job. Its purpose is to calculate the amount of federal tax to be withheld from your wages each pay period. Form W-4 saw its most recent revision in December 2020 when it was tweaked to be noticeably different than its predecessor, in an effort toward simplification. This article will discuss the revisions and reasons for them, as well as when to consider increasing or decreasing your withholdings, and how to account for non-wage income when completing this form.

One of the biggest complaints with the prior W-4 was its complexity. It contained worksheets that were unnecessarily complicated and that folks felt compelled to complete. It had its foundation on a system that used withholding allowances, which were based on the then available personal and dependent exemptions. These exemptions were eliminated after December 31, 2017 as part of The Tax Cuts and Jobs Act. In simple terms, the more exemptions you claimed, the more withholding allowances you were allotted, resulting in less withholding as that allowance number grew. Withholding allowances are gone, along with the personal and dependency exemptions they were based on.

The current version of Form W-4 accounts for various scenarios. If you have more than one job, or you are married and both of you work you can indicate as much on the form. This is important because as income rises, your income tax rate will go up accordingly as you move through the marginal brackets. A higher tax bracket may prompt you to want more withholding, so you are not caught short at year end. If you don't have enough withheld and owe too much upon filing your tax return, you could be subject to a penalty for underpayment of estimated tax.[1]

The new and improved form also has a section for taxpayers who may qualify for the child tax credit and/or the credit for other dependents. Individuals and couples qualify for these credits based on income AND the ages of their dependent children. Credits are dollar for dollar reductions against tax. Form W-4 considers these credits because to the extent you qualify for them, it may make sense to have less tax withheld, resulting in a higher net take home pay.

In addition to holding more than one job and having a working spouse, you may also have significant income that is not subject to withholding, such as investment income (interest, dividends, capital gains), or self-employment income. The new form explicitly allows you to account for this income. You may already be making quarterly estimated payments to cover your other income, in which case there would be no need to include it on your Form W-4. Or you may feel that you don't want to divulge your outside income to your employer. Either way there is certainly no requirement to do so.

There are also situations that might cause you to decrease your withholding. Itemizing your deductions, especially if they amount to significantly more than the standard deduction, could result in being over-withheld. Itemized deductions are below the line items that reduce your Taxable Income. Similarly, if you are eligible for credits such as the child tax credit or tuition related credits, you might find that you are over-withheld.

Finally, there are folks who intentionally plan for a large refund upon filing their tax returns. Perhaps they view this as a means of forced savings to make a large purchase or take a vacation. Over-withholding means you've provided the federal government with an interest free loan, in some cases for as long as fifteen and a half months. Far better to set up an automatic investment plan for the excess funds you'd otherwise withhold. Still, if you insist on over-withholding, the easiest way to accomplish this on the new Form W-4 is to add an additional dollar amount you'd like withheld each pay period on line 4(c).

[1] These rules can be complex; you may want to consult with a tax advisor to be sure you have enough withheld or paid in via quarterly estimated tax payments.

Still confused? The IRS provides a Tax Withholding Estimator, which can be found by visiting www.irs.gov/W4app. This estimator tool can be helpful if you find you didn't quite get your withholding right in the prior year or would just like to fine tune it a bit more.

Please note that form W-4 is for calculating withholding on regular salary. If your compensation includes a bonus component, it is subject to a flat, statutory federal withholding rate of 22% (37% once the bonus exceeds $1,000,0000). This may be more or less withholding than you need, depending on your tax bracket, and is often negotiable upwards, meaning many employers are willing to bump this percentage up if you request it and if you provide enough lead time. It is not negotiable downward. Withholding is different from quarterly estimated payments, in that it is considered paid in ratably over the course of the year. This can be a powerful planning tool because adjusting bonus withholding upward toward year-end is treated as if that additional amount was withheld over the course of the year. This can be very helpful in minimizing or even preventing the penalty for underpayment of estimated tax mentioned earlier.

If your withholding seems right, there is no requirement to complete a revised Form W-4 for an existing job. But if you are starting a new job, you could simply complete part 1 and sign. In that case your withholding will be calculated based upon the filing status you indicate in part 1 using the applicable standard deduction. The assumption would be that your tax situation is straightforward; meaning you are not an itemizer, there are no tax credits available to you, you likely have one job, and no significant income outside of your job.

It's also important to note that the various states have their own version of the Employee's Withholding Certificate, so keep in mind that modifying your federal withholding will have no bearing on your state withholding. (New Jersey has its NJ-W-4 and the New York version is IT-2104). You'll need to make a change at the state level specifically if that's your intent.

Don't be shy about asking your CPA for assistance with preparing your Form W-4. He or she expects it.

Contact Cynthia at (908) 642-8861 or cfusillo@pgbank.com with any questions.

A Tax Planning Reprieve

Christopher J. Colombo, MBA, CPA

As we turn the page on 2021 and begin the march towards November 2022 and the midterm elections, the probability of Congress enacting new tax laws—or seemingly much of anything—becomes less likely. The good news for investors is that certain planning techniques expected to be curtailed and/or abolished through new legislation remain viable for the time being.

Obviously, sentiment and actions can turn quickly and tax proposals that fail to pass one year often times reappear unexpectedly. With that said, even if Congress fails to act in the near term, changes that went into effect in 2017 following the Tax Cuts and Jobs Act (TCJA) are scheduled to terminate at the end of 2025. Therefore, individuals with a net worth more than $5 million ($10 million for a couple) should be talking to their financial, legal, and tax advisors about the applicability of any or all of the techniques and issues highlighted here.

Reduction of Lifetime Exemption

In 2022 an individual can give during life, or transfer at death, $12.02 million before paying an estate or gift tax. A married couple can share their exemptions and in effect transfer $24.04 million tax free to heirs. These amounts are indexed for an inflation factor and scheduled to halve beginning in 2026 when the TCJA terms sunset. The administration had proposed cutting the exemption amount to as low as $3.5 million per person thereby exposing significantly more assets (and estates) to federal estate and gift taxation. Taxpayers who would be negatively impacted by a reduction in the exemption amount through new or expiring legislation should discuss with their advisors planning options that make efficient use of exemptions at these elevated levels.

Annual Gifting Limitations

Presently, individuals can gift up to $16,000 annually per donee (with limited restrictions) without using any portion of their lifetime exemption. That means a married couple can give up to $32,000 per individual per year. A special rule exists for funding 529 college savings accounts whereby a donor can "front load" five years' worth of contributions ($80,000) to these accounts without eroding any of their lifetime exemption.

Recent proposals, if enacted, would significantly reduce this annual gifting capability by limiting total annual gifts per donor to $20,000; with no more than $10,000 going to any one donee. Many estate plans that rely upon the ability to make such annual gifts in order to fund common planning techniques (i.e. life insurance trusts) would be negatively impacted. Those individuals using annual exclusion gifts within their estate plans should meet with their advisors and discuss alternative funding arrangements should circumstances dictate.

Retirement Plan Limits

The administration has proposed a variety of limitations and restrictions on retirement plans of all types. Some proposals would restrict or eliminate further contributions for individuals with retirement asset balances above $10 million. In addition, individuals with such balances would be required immediately to withdraw 50% of the amount over $10 million, accelerating taxation on that portion distributed. Other changes designed to restrict the ability to fund Roth IRAs either through direct conversion or after-tax contributions to a 401(k) plan that are then rolled out to a Roth (so called "back door Roth" conversions) fortunately remain only proposals at this time.

Higher Tax Rates for the Wealthy and for Trusts

Earlier in 2021, the administration proposed raising the top income tax bracket to 39.6% for taxable income above $509,300 (married filing jointly), $452,700 (single), or $200,000 (trusts). In addition, there were discussions of increasing the long-term capital gains tax rate from 20% to 25% while eliminating the preferential long-term capital gains rate altogether by treating these gains as ordinary income for incomes above $1 million ($200,000 for trusts). Finally, the administration proposed imposing a surcharge tax starting at 3% on incomes over $5 million (individuals) or $100,000 (estates/trusts). The good news for individuals is that these potential rate changes have been tabled at present and are seemingly no longer being considered.

Curtailing Valuation Discounts

Wealthy individuals have often utilized/created family limited partnerships (FLPs) or limited liability corporations (LLCs) to hold ownership of active businesses, illiquid assets and other financial assets in one entity. When planning with these interests, the owner/founder of the FLP or LLC typically retains control of the entity as managing member and gifts non-managing member interests to younger generations. These non-managing member interests are typically discounted for gift tax purposes to reflect a lack of marketability and/or control. The administration has proposed to eliminate discounts entirely for investment assets transferred in this manner.

Dynasty Trust Limits

Under current law, it is possible for trusts created in certain state jurisdictions to continue indefinitely, potentially escaping estate taxation for generations—hence the term Dynasty Trust. One proposal would tax these trusts at least every ninety years, retroactive to trusts created in 1940, while another planned to impose taxation every 50 years for new trusts formed after the date of enactment. In either scenario, trust assets would be marked to market and treated as if they were sold, with capital gains recognized on all appreciation. Coupled with the aforementioned proposed income tax rate increases, the combined result would be onerous if this type of change comes to fruition.

Grantor Trusts

Some of the more significant changes proposed pertain to trusts that are considered "grantor trusts" for income tax purposes. The grantor trusts in question are trusts whose assets are not included in the Grantor's estate however the income tax owed on income earned inside the trust is the Grantor's responsibility. Under proposed changes, assets held in these types of trusts created after the date of enactment would be included in the Grantor's taxable estate. In addition, any distributions from these trusts would be treated as taxable gifts during the Grantor's lifetime.

If these provisions were to become law, they would reduce, or outright abolish, the use of many creative estate planning techniques such as spousal lifetime access trusts; grantor retained annuity trusts; qualified personal residence trusts; and asset sales to intentionally defective grantor trusts. In its unaltered state, proposed changes would also negatively impact irrevocable life insurance trusts.

Whether any of these provisions become law (and the timing thereof) is the great unknown. While Congress wrestles with a variety of issues both domestic and abroad, the likelihood of enacting significant tax legislation in 2022 seems to have been reduced. This temporary shift in focus away from immediate tax reform provides a valuable opportunity for those who would be impacted to confer with their advisors and assess whether certain techniques and strategies are prudent for their particular financial situation.

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A Transfer Tax Primer

Claire E. Toth, JD, MLT, CFP™

American citizens are potentially exposed to three different federal transfer taxes—the estate tax, the gift tax, and the generation skipping tax. The (lifetime) gift tax and the (at death) estate tax segue onto each other; the generation-skipping tax is layered on top of it, for those who make too many of the wrong kind of transfers. Although very few will pay any of these, understanding how they interconnect makes common estate planning techniques more transparent.

Before any transfer tax comes into play, everyone has a lifetime exemption amount. You must give away more than that before any transfer tax applies. For 2022, the lifetime exemption is $12.06 million per person. If you manage to give away more than that, during life or at death, the transfer tax rate is 40 percent of the excess. Moreover, the lifetime exemption amount adjusts annually with inflation. It is scheduled to halve in 2027, when the 2017 tax law provisions lapse. The Biden administration has proposed reducing the exemption amount to $3.5 million, although that provision has not made it into any legislation before Congress. Any gift made directly to a spouse is totally free of transfer taxes and does not use up any exemption.

Confusing? Let's illustrate. Pat and Casey GotRocks, a married couple, are worth $25 million and $10 million, respectively. They have two children and four grandchildren. Pat and Casey want to minimize transfer taxes.

If Pat and Casey were hit by the bus today, Pat would exclude $12.06 million of that $25 million net worth from estate tax. Casey only has $10 million to exclude, but a special rule allows spouses to share unused lifetime exemption amounts at death. This permits the GotRocks to exclude the maximum $24.12 million from estate tax—their remaining $10.88 million would be taxed at forty percent. Although that $4 plus million tax bill seems like a lot of money, it is less than 12.5 percent of their combined net worth. Under current law, non-retirement assets inherited from the GotRocks get a new cost basis, equal to fair market value at death. That means their children can sell inherited assets without paying capital gains taxes.

Now assume the GotRocks remain healthy but are concerned their $12.06 million exemption amounts will shrink in coming years. They choose to give away $24.12 million to their children today. Even if future lifetime exemption amounts decrease, the IRS has stated it will not assess taxpayers retroactively for gift tax. Giving assets away during life has the added benefit of removing future appreciation from transfer taxes altogether. The trade off is that if the GotRocks gift assets to their children, their children have the same (presumably low) cost basis in them their parents have. That means there is an eventual capital gains tax to be paid, though the children can decide when to sell assets and pay the tax.

Chances are, the GotRocks won't just hand $24.12 million to their children outright. Instead, they'll set up trusts that benefit their children for life, followed by their grandchildren and perhaps future generations. These gifts to generations younger than their children are called Skip Gifts and potentially trigger the generation-skipping tax.

The generation-skipping tax, like the gift/estate tax, is forty percent and can be layered on top of those taxes—for a total tax rate of 80 percent. This means the GotRocks want to be careful how they structure gifts and limit those that could trigger the generation-skipping tax. The generation-skipping exemption amount is the same as the gift/estate tax exemption amount, with one important distinction. A married couple cannot share the generation-skipping exemption. They each have their own. Thus, Casey's generation-skipping gifts are limited to $10 million (unless Pat makes a gift to Casey of enough to bring that up).

Whether or not the GotRocks pay gift tax during their lives, they must file gift tax returns when they make these large gifts. Lifetime gifts are added to a person's estate at death to determine what estate taxes are due. The gift tax return is merely a way of tallying gifts, to determine how much of a person's lifetime exemption amount remains available. Very few individuals ever pay gift tax. In 2019, that number was 1,026.[1]

[1] IRS, 2019 Gift Tax Statistics.

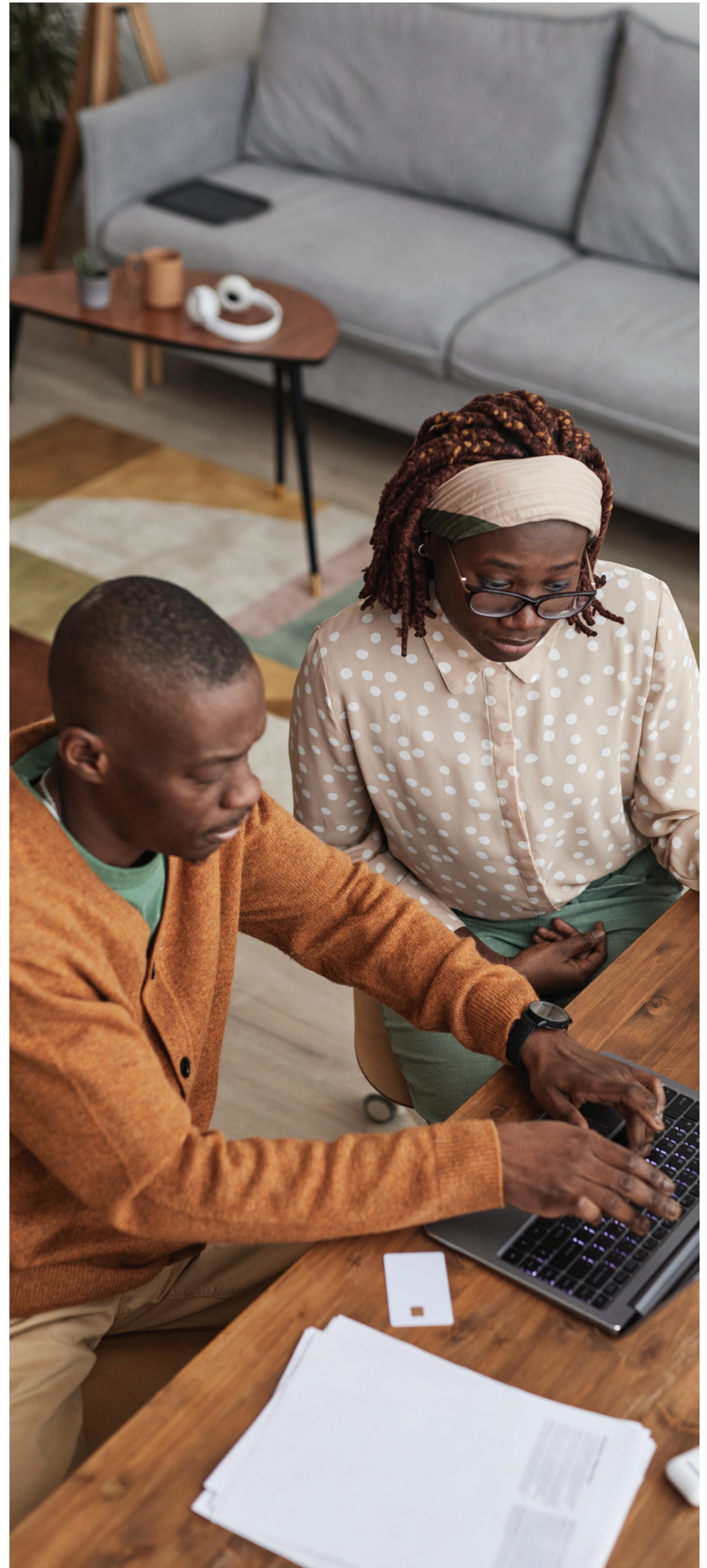
There can be times when taxpayers will want to file a gift tax return, to establish a low basis for a gifted asset and use less lifetime exemption. Assume the GotRocks own a hard-to-value asset, such as art or a private business. Different appraisers would value these assets differently. If the GotRocks give it to their children and file a gift tax return, they declare the value of the gift and attach an appraisal at the low end of the range. The IRS then has three years to challenge the declared value. If there is no gift tax due, the IRS has little incentive to audit the return.

Beyond larger gifts, the GotRocks can make gifts of $16,000 per year to as many individuals as they choose, without having to file a gift tax return at all. This is the annual exclusion amount, and it does not count towards that lifetime exemption for gift, estate, or generation-skipping taxes. Annual exclusion gifts must be of a present interest—that means the recipient must be able to access it immediately. When taxpayers make annual exclusion gifts to a trust, there is a bit of a dance to notify the recipient of the gift and the ability to withdraw it.[2] Here, the GotRocks would likely each give $16,000 annually to each child, perhaps to each child's spouse, and to their grandchildren. This allows the GotRocks to give away $256,000 annually on top of their lifetime exemptions. Consistent annual exclusion gifts go a long way towards reducing any potential transfer tax liability.

"Very few individuals ever pay gift tax. In 2019, that number was 1,026."

Further, certain payments don't count as gifts at all. If the GotRocks pay tuition or certain medical bills on behalf of family members, those are totally outside the transfer tax arena. Those payments must be made directly to the service provider; they cannot go through a family member's hands.

No one will successfully give away $35 million in $16,000 increments. Still, many wealthy families focus on large, complicated gifts to the exclusion of smaller, consistent ones.



[2] This is way into the weeds: the donor must notify the trust beneficiary, in writing, that the gift was made and that the trust beneficiary has a set time period in which to demand the gift outright. If the beneficiary does not act, the gift stays in the trust. That is called the Crummey notice, after D. Clifford Crummey, the taxpayer who first successfully used this technique.

Paying For College

Lisa McKnight, MBA, CFP™

Paying for college is a challenge, with many options and no right or wrong answer. Most families will piece together funds from multiple sources, so it is important to know your options.

Saving

A 529 plan is the most common and tax efficient college savings vehicle. Your contributions go in after tax and grow tax deferred. When used for qualified educational expenses, withdrawals are tax free. The best advice is start early and contribute regularly. To the right is an example of funding needed to cover 4 years of an education expense:

Age at start of college saving:.. 1

Education expense now:.................................. $55,000

Rate of inflation for education:................................4%

Investment growth rate:..6.5%

Total funding needed by 2040 (age 18):............$473,150

Monthly savings need to reach goal:........................$947

In addition to a 529, there are many other options that can help fit your situation and preference[1].

Feature	529 Plan	UGMA/UTMA	Coverdell Savings Account	Parents' Investment Account
Maximum Investment	Established by the program - several in excess of $250,000 per beneficiary	No Limit	$2,000 per beneficiary per year combined from all sources	No Limit
Internal Investments	Menu of investment strategies developed by the program	As state law permits	Large range of securities and certain other investments	All publicly traded securities
Qualified Expenses	Tuition, fees, books, supplies & equipment at an eligible K-12 school of up to $10,000 limit per beneficiary per year.	No Restrictions	Same as 529 plan plus additional categories of K-12 expenses	No Restrictions
Non-Qualifying Expenses	Withdrawn earnings are subject to federal income tax and 10% penalty	Funds must be used for the benefit of the minor; minor can control funds at age 18 or 21	Withdrawn earnings are subject to federal income tax and 10% penalty	No Restrictions
Current Taxation on Earnings	Earnings are tax deferred until withdrawn. Withdrawn earnings are tax-free if used for qualified expenses.	Kiddie tax applies to children under age 19 (under 24 if full-time student).	Earnings are tax deferred until withdrawn. Withdrawn earnings are tax-free if used for qualified expenses.	Taxed at owner's rate
Federal Gift Tax Treatment	Contributions treated as Completed gifts - apply $16,000 annual exclusion, or up to $80,000 with 5-year election.	Transfers treated as completed gifts - apply $16,000 annual gift exclusion	Contributions limited to $2,000 per year for each beneficiary and are treated as completed gifts - apply $16,000 annual gift exclusion	None: direct payments of tuition not considered a gift
Ability to Change Beneficiary	Yes: only to another member of the beneficiary's family	No: represents an Irrevocable gift to the child	Yes: only to another member of the beneficiary's family	Not applicable
Income Restrictions	None	None	Ability to contribute phases out for incomes between $190,000 and $220,000 (joint filers)	None

[1] Chart from eMoney

Scholarships

Free money is the best money. If you are weighing acceptance offers from various schools, it may be beneficial to identify schools where your child is well above average academically, or where he stands out in some other way from that college's typical student. This can maximize scholarship offers. There are also scholarships found within your local community based on a variety of qualifications — academics, athletics, cultural and community experiences, background, location, desired major or area of study and accomplishments. High schools typically have resources for students to help them find scholarships they may be able to qualify for. Plus, there are many resources available on the Internet, such as Collegeboard.org.

Work Study / Work During School

Student employment through the university is a great way to help fund college expenses. The Federal Work-Study program offers job opportunities to full-time and part-time students to help finance their education. The jobs offered may also fit with the student's area of study, giving some extra experience. Your student may also want to consider working part time outside of a work study. This can be a great way to cover at least some college expenses.

Payment Plans

Although most schools like to bill for each semester, coming up with a full semester's payment all at once can be difficult. If you can afford to devote a fraction of your monthly disposable income toward college tuition, you should consider enrolling in the college's monthly payment plan. Most colleges offer such a plan to students, allowing them to stretch payments out over the course of 10 months or a year. There is usually a small service fee to sign up (maybe $50).

Loans

Loans are used by families of all income levels to help pay for college. Even parents who can afford to pay for college out-of-pocket may choose to make student loans part of their college payment strategy to avoid selling assets or to give their child some responsibility for his or her own education.

There are many types of Federal student loan programs, but most are provided only when there is exceptional financial need. However, a direct federal loan is available to all undergraduate and graduate students.

- Direct Subsidized Loan – are for undergraduate students who have financial need. The US Dept of Education pays the interest while borrower is in school and during grace and deferment periods. Interest rate is 3.73%, and there are annual borrowing limits
- Direct Unsubsidized Loan – is for undergraduate and graduate students. Financial need is not required. Borrower is responsible for all interest and interest accrues while student is in school. Interest rate is 5.28% (undergraduate), also with annual borrowing limits.
- Direct Parent Plus Loan – is for parents of dependent undergraduate students and for graduate or professional students, with relatively good credit. The borrower is responsible for all interest and interest accrues while student is in school. Interest rate for the Plus Loan is currently 6.28%. There are no set limits on these loans.
- Home Equity – There are pros and cons to using home equity to fund college. A home equity loan may be cheaper and easier to secure then a federal loan with fewer restrictions. However, there are cons associated with this. Home equity loan debt is secured by your home, giving the lender a legal claim to it if you default. You are basically putting your home on the line, and you are trading a hard asset (your home) for a soft asset (education).
- Private loans – are offered by a variety of banks. Interest is variable and, in most cases, requires a parent as co-signer. You can visit collegeloan.com to evaluate your options.

Roth IRA

A Roth IRA can be a vehicle to pay for education. If you are using a Roth to save for college for your children, you can withdraw the Roth IRA contributions at any time without penalty or tax. You can also withdraw earnings without the 10% penalty if they'll be used to pay for qualified education expenses. You will pay tax on the earnings. Contributions come out before earnings, so track them.

401(k) – This Should Be Your Last Resort

Your 401k should be dedicated primarily to your retirement. There are significant drawbacks; if you withdraw funds from your 401(k) before you are 59½, you will probably owe a 10 percent premature distribution penalty. The penalty is in addition to income taxes you will owe on the withdrawal. Frequent dips into your 401(k) reduce the amount of money you ultimately have for your retirement. A loan from your 401K may be a better option. Plan loans are not taxed or penalized if you repay the funds within a specified time period (typically 5 years). Borrowing from your 401k will incur double taxation, given that you are repaying the loan with after tax money and then will be taxed again when you withdraw the funds in retirement. If you quit or lose your job the loan balance may need to be repaid in full within 60 days. Ensure that you aren't putting yourself at risk in your effort to assist your children with paying for school.

"There are many options for funding college education and most likely will come from multiple sources."

Bottom line: you should have a solid financial plan to save for retirement before getting started with any savings plans for college. While it is possible to borrow money for college, there is no loan program out there to fund your retirement.

Contact Lisa at (908) 642-1137 or lmcknight@pgbank.com for more information.

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