Fee Only Financial Planning & Investment Management

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Resolute Connections

Season's greetings and Happy Holidays. One result of the pandemic, which may be a positive one depending on your point of view, is that many employees and business owners can now work, and live almost anywhere in the country. The first two articles, *Most (and Least) Expensive States* and *Bankruptcy Anomaly* touch on topics relevant to remote workers – the cost of living and the business environment of the various states.

With the current US debt levels, and a new administration taking over the federal executive suite in January, taxes are a hot topic in many circles. One recent tax law change that has caused consternation in some, mostly high tax states, is the limit on the deduction of state and local taxes (SALT) from one's federal tax bill. *Creative SALT Workarounds* reviews one potential strategy to reduce the tax increase this SALT limit has created for some tax payers. *Estate Exclusion Expiration* concerns a tax that currently impacts a minute portion of the population, but with its expiration may impact many of us in the near future.

Please be safe and we wish you continued health. If you have any questions about anything we have covered in the articles, or a specific situation please feel free to give us a call, or visit our website, www.ResoluteFinancial.com.

Most (and Least) Expensive States

If you could live in any U.S. state, which one would let you keep more of your money than others? The answer turns out to be surprisingly complicated.

Most people would look first at state income taxes, and if you have a decent to high level of income, then California immediately jumps to the bottom of the list; its highest state income tax bracket is 13.3%—higher than second-place Hawaii (11.0%). By this criterion, you might want to avoid New Jersey (10.8%), Oregon (9.9%) and New York (8.8%). The most attractive states—by this measure, at least—are the ones that assess zero state taxes on your income: New Hampshire, Florida, Texas, Washington, Nevada and South Dakota.

But every state has to pay its bills, so in most cases you'll find yourself paying for your state services by other means. If you move to Texas, you avoid state income taxes only to find yourself paying one of the highest property taxes in the country, a median 1.81% of the value of your home or property. Other high-property-tax states include New Jersey (1.89%), New Hampshire (1.86%) and Nebraska (1.81%). California, meanwhile, assesses a relatively modest 0.74% median property tax rate, although Louisiana (0.18%), Alabama (0.33%) and West Virginia (0.49%) are lower still.

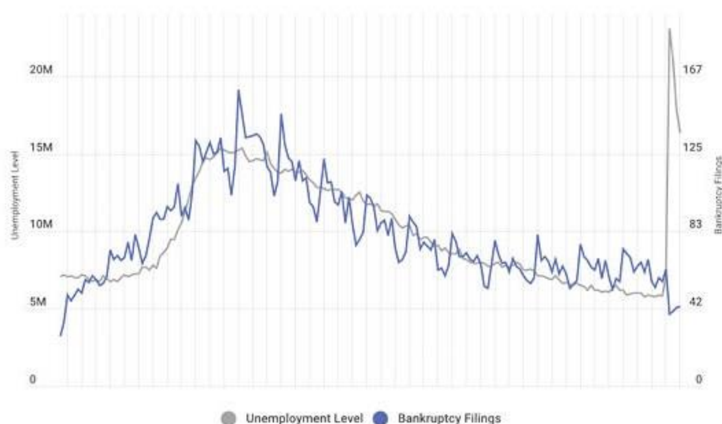
So far, Louisiana looks attractive, until you look at state sales taxes. In Louisiana, you would find yourself paying a combined 10.02% state and local sales tax rate on your purchases, which is the highest in the country. Tennessee (9.46%), Arkansas (9.41%), Washington (9.18%), and New York (8.49%) lead the nation in sales taxes, while Oregon, Montana and New Hampshire levy no sales taxes at all.

Is there any way to combine all these tax figures into one number? The WalletHub website ranks every state and the District of Columbia based on a total tax burden, by calculating total collected individual income taxes, sales and property taxes as a share of the total personal income in each state. These rankings would probably change for higher-income individuals, but they give an idea of the interrelation among the different tax burdens. By this calculation, New York is the most expensive state to live in, with taxes eating up 12.28% of its citizens' total income. Hawaii (11.48%), Vermont (10.73%), Maine (10.57%), Minnesota (10.19%), Connecticut (9.99%) and New Jersey (9.88%) are the most expensive states. Least expensive: Alaska (5.16%), Delaware (5.52%), Tennessee (6.18%), Wyoming (6.47%), Florida (6.82%), New Hampshire (6.85%) and Oklahoma (6.94%).

Bankruptcy Anomaly

You're probably thinking that the 2020 pandemic environment created a massive flood of commercial bankruptcy filings, perhaps unprecedented since the Great Depression. There have been a number of high-profile filings from well-known companies like Hertz, Neiman Marcus and JCPenney.

But the surprising truth is that bankruptcy filings, overall, are actually down from recent averages in the U.S. economy. The chart included here tracks the total number of commercial bankruptcy filings (blue line) since January 2006. You can see the Great Recession peak toward the middle left side of the graph, which is somewhat jagged since this is monthly data. To the right, you can see that the bankruptcy numbers have been trending downward ever since, and seem unaffected by the pandemic.



Will that last? The graph also shows the number of unemployed Americans for each month over the same time period, and you immediately see how closely these fluctuating unemployment numbers track the fluctuations in the bankruptcy rate—that is, until recently. Notice that the unemployment numbers went up during the Great Recession, right along with the number of bankruptcies, and then declined along with bankruptcies until 2020. As the pandemic hit, suddenly there was a sharp

divergence; unemployment spiked up to near-record highs, while bankruptcies continued along the same downward trend.

What does that mean? It's never easy to predict the future, but unless there has been a dramatic uncoupling of unemployment and bankruptcy filings, we might experience a jump in businesses throwing in the towel in the first quarter of 2021.

Meanwhile, the pandemic seems to have hit some state economies harder than others. Texas and New York have experienced bankruptcy rates, since March of 2020, of 16.65 businesses per ten thousand, and 12.48 respectively, by far the highest rates, outpacing #3 Nevada (8.84 bankruptcies per 10,000 businesses), #4 Virginia (7.56) and #5 Delaware (7.01). At the other end of the spectrum, Rhode Island was experienced zero bankruptcies since March, while businesses domiciled in Connecticut (0.34), Iowa (0.36), New Hampshire (0.52) and Oregon (0.67) seem to have been strangely unaffected by the Coronavirus impact on the U.S. economy.

Estate Exclusion Expiration

It's hard to believe, today, that in 1997 only $600,000 was exempted from estate taxes; that is, when a person died, any amount left to heirs above $600,000 would be taxed at the (then) maximum 55% tax rate. The estate situation is very different today. The Internal Revenue Service just announced that for anyone dying in 2021, the inflation-indexed exemption will be $11,700,000 per person, and any unused amount from the first spouse to die can be picked up to be used later by the surviving spouse. In addition, the maximum estate tax on amounts above that threshold has dropped to a 40% rate.

The Tax Policy Center estimates that only about 0.1% of the estimated 2.7 million people expected to die in the coming year will have to pay any estate taxes at all. And if you look at the history of estate taxes, there has never been a year when the estate tax exemption was reduced.

All of that could end in four years unless Congress passes an extension. The current exemption is set to sunset at the end of 2025, at which point the exemption would

automatically drop back to what it was prior to 2018—back to $5 million indexed to inflation. We may not have to wait that long. President-elect Joe Biden's tax plan calls for reducing the estate tax exemption amount to $3.5 million. The plan would also increase the top rate for the estate tax to 45%.

The Biden plan's dramatically reduced exemption would pull a lot more people into estate tax territory, although it is uncertain that the measure would pass in its current form, and it seems unlikely that it would affect the 2021 tax year. But the prospect of a change has set people talking to their financial advisors about gifting to heirs under today's very generous exemption, under the (reasonable) assumption that there would be no claw-back for any actions taken under current tax law. In addition, there are a number of relatively complicated estate tax strategies that can be put into place which allow people to keep control of their assets if they're needed in retirement, while allowing any increase in value to be passed on tax-free to heirs. Tax experts are quietly telling their clients to plan now rather than later.

Creative SALT Workarounds

One of the most hated tax provisions for people in higher-tax states is the so-called SALT limitation on state and local taxes. The provision was part of the Tax Cuts and Jobs Act, which only allows taxpayers who itemize their deductions to deduct a maximum of $10,000 on their federally taxed income for local property, sales and income taxes paid to state and local governments. The limitation is especially punitive to joint tax filers, because the $10,000 limitation is the same both for single and joint tax returns. If spouses file separately, each can only deduct $5,000 each of these local tax obligations.

A number of states have proposed creative workarounds for this limitation, including possibly allowing state tax obligations to be paid as a charitable contribution, which would make them more likely to be deductible. The IRS publicly frowned on the charitable workaround, so some states—Louisiana, Oklahoma, Rhode Island, Wisconsin, New Jersey, Maryland and Connecticut—managed to find a different structure—and surprisingly, it looks like the IRS is going to go along.

The workaround only works for individual owners of a pass-through businesses like a partnership or S corporation. The idea is that the business—not the individual taxpayer—could pay the SALT taxes, and take a deduction for these expenditures at the business level, and the value of the deduction would be passed through to the individual business owners.

Would that be legal? On November 9, the IRS released Notice 2020-75, which agreed that pass-through businesses could claim deductions at the business level for state and local income tax paid provided that there were state laws that would shift the tax burden from individual owners to the business entity. You can look for more states to follow the lead of the pioneering jurisdictions, and for taxpayers to set up side businesses as a way to get all or part of this valuable deduction.

Source:
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For more information on these topics or for a free consultation, contact Resolute Financial, LLC at (978) 463-8771 ext. 1003.

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