CHIEF INVESTMENT OFFICE

Wealth Strategy Report

Inflation, Market Volatility and Rising Interest Rates: Tax Consequences and Favored Planning Techniques

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INTRODUCTION

Many tax planning strategies are based on the underlying economic environment. Whether a particular strategy will or will not succeed is often dependent on economic conditions that are currently in existence or that may occur in the future. Three such economic conditions we are currently experiencing are inflation, market volatility and rising interest rates. In this Report, we discuss these economic conditions and explain how they may affect taxes and tax planning techniques. Specifically, we address various planning techniques that are favored in the current economic environment.

Inflation and Income Taxes

An inflationary environment can be mixed news for taxpayers. It is often viewed as an additional figurative "tax" on individuals since it decreases purchasing power. However, it can have a real impact on actual tax payments on the federal and state level, particularly for individuals that have seen their compensation increase to address the recent surge in inflation.

Federal Income Taxes

The good news is that federal tax brackets and many federal tax benefits are adjusted for inflation. For instance, thresholds for determining the 0%, 15% and 20% capital gains brackets will increase, and the standard deduction, IRA contribution limits and retirement contribution caps should all be adjusted upwards. But that adjustment, itself, might not keep pace with the inflation you feel. Due to a 2017 change in the manner in which the tax code determines inflation, the increase generally will not be reflective of the actual change in the consumer price index.

There are also many tax items which are not adjusted for inflation, which can result in an increase in actual taxes paid. That is the dark side of inflation. For instance, the threshold for determining if a taxpayer is subject to the 3.8% net investment surtax is set at $250,000 ($200,000 for singles) and not adjusted for inflation. Thus, with incomes pushed up by inflation adjustments, more taxpayers will be subject to the surtax. The $500,000 ($250,000 for singles) exclusion from gain on the sale of a primary residence is also not indexed for inflation. So if inflation has increased the value of a home, a greater portion of its proceeds could be subject to capital gain taxes. Furthermore, the tax thresholds at which social security benefits are subject to federal income taxes are also not adjusted for inflation, so a greater portion of these benefits will be taxed in an inflationary environment.

State Implications

Unlike federal rules, there are many states that do not inflation-adjust their tax brackets, standard deductions or personal exemptions. According to the Tax Foundation, 15 states and D.C. fail to adjust tax brackets for inflation, 10 states leave their standard deduction unadjusted, and 18 states have an unindexed personal exemption. New York, New Jersey, Connecticut and Virginia are among the states that do not index any major items in their tax rules.

Social Security

Payments to social security recipients are adjusted when the cost of living rises. These federal benefits increase when the cost of living rises, as measured by the Department of Labor's Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W). Such was the case in 2022, when recipients saw an adjustment of nearly 6% — the largest in about four decades. And, a further increase of close to 10% is expected in 2023 (the last time benefits rose by double digits was in 1981). Along with a potentially higher payment comes the potential for a greater portion of the benefits to be subject to federal income taxes, as noted above.

INFLATION, MARKET VOLATILITY AND RISING INTEREST RATES: FAVORED PLANNING TECHNIQUES

Strategy	How it works	Why it is favored
Tax Loss Harvesting	Assets which have gone down in value may, depending upon your basis, be sold at a loss. Such losses might then be used to offset current or future gains realized elsewhere. After selling assets, if you want to remain invested in similar holdings, you can purchase such holdings, but beware of the wash sale rule. The wash sale rule is designed to prevent you from getting a tax benefit from a capital loss if you have not effectively changed your economic position (i.e., you owned the stock before the wash sale and you still own the same stock after the wash sale). In order to trigger the wash sale rule, the following need to occur: (1) you sell a security for a tax loss; and (2) within the 61-day period beginning 30 days before the sale and ending 30 days after, you reacquire, or enter into an option to reacquire, the same security or one that is "substantially identical."	In a bear market, assets may have temporarily decreased in value below the acquisition cost, making them potential candidates for tax loss harvesting.
Roth Conversion	Traditional IRAs are primarily funded with pre-tax dollars, and grow tax deferred. Generally, when you convert a Traditional IRA to a Roth IRA, you will recognize ordinary income equal to the value of the assets converted from the Traditional IRA on the conversion date. If the Traditional IRA has any tax basis from after-tax contributions, the conversion income will be reduced by that basis. This raises the question of why one would accelerate the tax due. Generally, it is considered better to defer, not accelerate, income tax due. However, with respect to a Roth conversion, this general rule may not apply depending upon your circumstances. Conversion may benefit you during retirement years by potentially reducing future income taxes, potentially increasing retirement assets, increasing flexibility, and diversifying retirement vehicles.	Since a Roth conversion triggers income based on the value of the assets on the conversion date, if assets have declined in value, there would be less income recognized. Additionally, any recovery in the value of the assets after the conversion, as well as any additional future appreciation of any assets inside the Roth account, should escape future income tax when withdrawn from the Roth.

Strategy	How it works	Why it is favored
Portfolio Rebalancing	Due to the general reduction in market valuations, that may mean that your portfolio no longer reflects your desired asset allocation targets. In most cases, your original equity allocation percentage may be less than originally intended. Accordingly, it may be advisable to make purchases and sales in order to restore your allocation goals.	If assets have declined in value so that you would like to rebalance your portfolio, it may be advantageous to do so while asset values are low. Generally, rebalancing your portfolio in response to a market decline is done to restore your portfolio to your target asset allocation. An added benefit is that the rebalancing process will typically result in reducing your allocation to assets that have either appreciated or declined by less, and purchasing assets that have declined substantially; effectively buying low and selling high.
Charitable Lead Annuity Trust (CLAT)	A CLAT is a planning technique that can combine charitable goals with (i) wealth transfer planning, and (ii) income tax planning. You establish an irrevocable trust and fund the trust with assets such as securities. This can be done during your lifetime or upon your death. The trust will make an annual payment to the charity or charities that you designate in the trust, for the term of the trust. This annual amount can be a fixed amount, called an "annuity." The term of the trust can be for a term of years or for the lifetime of an individual. After the trust ends, any remaining assets will pass to your named beneficiaries, generally your children, either outright or in trust for their benefit. For gift or estate tax purposes, the present value of the charitable "lead" interest is considered a charitable gift and is not subject to gift or estate tax. However, the present value of the remainder interest to your family will constitute a taxable gift at the time the CLAT is funded. Often the amount of the annuity is established so that its present value equals or almost equals the value of the assets contributed. This means the present value of the remainder interest is $0 and the taxable gift to your family is $0. This is known as a "zeroed-out" CLAT. If the assets contributed to the CLAT earn a total return each year equal to the IRS interest rate, then every dollar in the CLAT would be paid to charity as part of the annuity payments. In that case, nothing would be left at the end of the trust term for the remainder beneficiaries. If, however, the assets earn more than the IRS interest rate, then the wealth remaining after the term would pass to the remainder beneficiaries free of gift or estate tax. This is the wealth transfer goal of a CLAT — for the assets to earn a total return greater than the IRS rate.	If assets have declined in value, it may be advantageous to create a CLAT while asset values are low. This reduction in value will mean that a zeroed-out CLAT can be created based on a lower initial value of the assets. In effect, this reduction in value may be viewed as a tax-free gift, assuming that the valuation is subsequently increased during the term of the CLAT. In a rising interest rate environment, if possible, it is desirable to create the CLAT while interest rates are still low. This is because the IRS interest rate serves as the "hurdle" rate. In order to create a CLAT which outperforms the IRS rate, it is advantageous to create the CLAT when interest rates are low, so that the hurdle rate would also be low.

Strategy	How it works	Why it is favored
Lifetime Gifts	Lifetime gifts may be made, either outright or in trust. Such gifts may be made to lock-in the current high gift tax exemption. The exemption is currently $10 million, indexed for inflation. In 2023, the exemption is $12,920,000. Beginning in 2026, the exemption is scheduled to be reduced to $5 million, indexed for inflation. In order for gifts to lock-in the higher exemption, such gifts must comply with the IRS anti-abuse proposed regulations, assuming the regulations are adopted as final. If gifts do not comply with these rules, they may be subject to recapture (also known as "clawback") at the time of death.	If assets have declined in value, it may be advantageous to make gifts while asset values are low. This reduction in value may be viewed as a tax-free gift, assuming that the valuation is subsequently increased after the gift is made.
Grantor Retained Annuity Trust (GRAT)	A GRAT is an irrevocable trust to which a grantor contributes property and retains the right to be paid an annuity for a specified term. The assets remaining in the trust at the end of the term may either be paid outright to, or continue to be held in trust for the benefit of, the beneficiaries, usually children or other family members. At inception, the present value of the remainder is a taxable gift, the amount of which can be controlled by varying the term and/or amount of the annuity. The resulting value is based on an applicable interest rate published by the IRS each month. If the investment performance of the trust exceeds the IRS interest rate, that enhanced performance is in effect a tax-free gift to the trust beneficiaries. Unless the Grantor dies during the term of the trust, the trust assets will not be includible in the Grantor's estate for estate tax purposes. It is generally desirable to structure the GRAT so the Grantor's contribution of property is not treated as a gift for gift tax purposes (often referred to as a zeroed-out GRAT.) This requires that the Grantor retain a sufficient annuity amount that would consume the entire property, plus interest at the applicable interest rate for the month in which the GRAT is created. The GRAT will generate a tax-free gift for the remainder beneficiaries if its investment performance exceeds the applicable IRS interest rate.	If assets have declined in value, it may be advantageous to create a GRAT while asset values are low. This reduction in value will mean that a zeroed-out GRAT can be created based on a lower initial value of the assets. In effect, this reduction in value may be viewed as a tax-free gift, assuming that the valuation is subsequently increased during the term of the GRAT. In a rising interest rate environment, it is desirable to create the GRAT while interest rates are low. This is because the IRS interest rate serves as the "hurdle" rate. In a rising interest rate environment, you would want to create the GRAT while interest rates are still relatively low.

Strategy	How it works	Why it is favored
Sale to Intentionally Defective Grantor Trust ("SIDGT")	In a SIDGT, a Grantor sells property to a trust in exchange for the trust's promissory note. Since the trust and the Grantor are considered the same taxpayer, the Grantor does not incur any capital gain on the sale and is not taxed on the interest payments. The note is structured so that there is no gift for gift tax purposes. If the investment performance of the trust exceeds the interest on the note, there is in effect a tax-free gift to the trust beneficiaries. The promissory note should bear interest based on the applicable federal rate in effect on the date of the sale. Accordingly, the success of this technique will depend on whether the property sold to the trust generates a return that is greater than the applicable federal rate. Any such over-performance will in effect be a tax-free gift from the Grantor to the trust beneficiaries.	If assets have declined in value, it may be advantageous to implement a SIDGT while asset values are low. This reduction in value will mean that a SIDGT can be implemented based on a lower initial value of the assets. In effect, this reduction in value may be viewed as a tax-free gift, assuming that the valuation is subsequently increased during the term of the SIDGT. In a rising interest rate environment, it is desirable to implement the SIDGT while interest rates are low. This is because the IRS interest rate serves as the "hurdle" rate. In a rising interest rate environment, you would want to implement the SIDGT while interest rates are still relatively low.
Qualified Personal Residence Trust (QPRT)	With a QPRT, you make a gift to family members (typically your children) of a personal residence (your principal residence or a vacation residence). You make this gift by transferring the residence to a trust and retaining the right to live there rent-free for a term of years. The trust cannot own any assets other than this residence, nearby acreage and secondary buildings, and cash necessary for near future expenses. After the term of years, the house either passes to the trust's remainder beneficiaries outright, or it can remain in trust for their benefit. When you first fund the QPRT by transferring a residence into a trust, you make a taxable gift of the remainder interest that the beneficiaries will receive at the end of the term. The value of your retained interest (the right to live there rent-free) is not a taxable gift. Rather, the value of the taxable gift is the current, discounted present value of what the trust beneficiaries will receive in the future.	The calculations for a QPRT depend in part on an IRS rate that is adjusted monthly (the rate in effect for the month the QPRT is funded would govern). QPRTs work best for transfer tax purposes in a high interest rate environment. That is because the value of your retained interest (which reduces the value of the gifted remainder interest) is valued greater in a high interest rate environment.

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Important Disclosures