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Planning in Challenging Markets

The first half of 2022 has been a challenging period for financial markets. Investors have watched as values of both traditional equity and fixed income have fallen in recent weeks and months under the backdrop of a difficult macro-environment.

The volatility in traditional financial markets has spilled over into cryptocurrency, as digital currency and related assets are under similar pressure giving up substantial parts of recent years' gains. Further, inflationary concerns have increased and for the first time in many years, we are living through a period of rising interest rates.

While this challenging environment has in many cases negatively impacted investment portfolios, it has also presented individuals and families with unique opportunities to implement thoughtful and effective planning strategies. The following Rockefeller Insight provides details on a selection of those planning strategies and highlights a sampling of financial plan components that individuals and families may want to turn their attention towards given the recent market downturn.

As the old saying goes, "When life gives you lemons, make lemonade!"

Capitalizing on Opportunities

Roth Conversions at Depressed Values

The Roth IRA was introduced to the tax code in 1997 and has played a role in helping investors generate tax advantaged returns for many years. Over the past several years, however, investors have been turning more and more of their attention to these retirement accounts.

The increased attention could be a result of ProPublica's reporting on Peter Thiel's $5 billion Roth IRA and how he used the account to invest in pre-IPO shares of PayPal and Facebook. Perhaps it is due to the anticipation of potentially higher future income tax rates. Or maybe it is due to taxpayers revisiting their estate plans after the SECURE Act eliminated the opportunity to "stretch" the taxation of traditional IRAs to most non-spousal beneficiaries. Likely it is a confluence of many factors; no matter the catalyst for the attention, the increased focus is undeniable.

With this increased focused, individuals looking to participate in the tax benefits of Roth IRAs have increasingly turned to what is known as a "Roth IRA Conversion".

A Roth IRA conversion occurs when a taxpayer takes all, or a portion, of an existing Traditional IRA, 401(k) or other qualified plan account and transfers it to a Roth account. By making the conversion, the taxpayer can take advantage of beneficial tax characteristics of Roth IRAs; most notably, and differentiated from traditional accounts, is that future distributions from the Roth are not taxable and Roth's are not subject to the Required Minimum Distribution regime.

The balance transferred to the Roth account is taxable for federal, and potentially, state income tax purposes in the year the conversion occurs. Even if the conversion occurs prior to the taxpayer turning 59 ½, the transfer is not subject to the 10% penalty on early distributions, nor is it subject to the Roth IRA contribution limits.

Importantly, especially given the current macro-environment, the taxable income generated from the conversion is tied to the fair market value of the assets at the time of conversion. This means that the "tax cost" of a full or partial conversion is decreased when asset values are depressed. Those who have completed or considered Roth conversions in the past should treat the current market downturn as a great opportunity to revisit the strategy and look to capitalize on temporarily reduced values in their traditional IRAs and similar accounts.

Whether a Roth conversion is an attractive planning strategy is entirely dependent on a taxpayer's unique financial landscape and impacted by factors including, but not limited to, present and expected future income tax rates, the ability to pay the associated income tax with non-IRA assets, and the intended use and investment horizon for the IRA assets.

That said, if after careful consideration a Roth conversion is the right strategy, the recent challenges in financial markets present a great opportunity to execute at a reduced-up front tax cost, while capturing increased long-term income tax benefits.

Grantor Retained Annuity Trusts

While Roth conversions present a great opportunity to capture income tax efficiency when financial assets are at temporarily depressed values, Grantor Retained Annuity Trusts (GRATs) allow individuals and families to take advantage of temporarily reduced asset values through potential estate and gift tax savings.

A GRAT is a well-established estate planning technique that allows a taxpayer to remove substantial asset income and appreciation from his or her taxable estate without making a more than nominal taxable gift. In a GRAT structure, a grantor contributes property to a trust in exchange for a set of annuity payments over a set period of time. The annuity stream is valued using an interest rate established by the Internal Revenue Service (more on this later) and when structured correctly the annuity value retained by the grantor is essentially equal to the fair market value of the property on the date of contribution.

As a result, a GRAT is often referred to as a "freeze" technique in that it allows an individual to freeze the value of an asset at a specific point in time for estate and gift tax purposes. Any appreciation and income over and above the IRS prescribed interest rate passes gift and estate tax free to the trust beneficiaries.

It is the "freeze" concept that makes GRATs particularly attractive during market downturns as they provide taxpayers with the ability to identify assets that have currently depressed values and lock those values in from an estate tax perspective. Thought being that the identified assets have the potential to recover and experience substantial growth in the short to medium term and that growth will occur outside of the taxpayer's taxable estate.

Many individuals find GRATs attractive due to limited downside of the strategy. If the assets contributed to a GRAT do not appreciate enough to outpace the set interest rate, whatever is left in the trust at the end of the GRAT term simply flows back to the individual's estate as if no trust was ever established. In essence, even if a GRAT is unsuccessful the taxpayer will not be worse off (other than the cost of setting up and administering the GRAT) than had they not implemented the strategy creating a set of outcomes that could be described as "heads you win, tails you tie."

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Making Gifts & Utilizing Lifetime Gifting Exemption

Similar to the use of GRATs in a down market cycle, traditional gifting strategies can be more effective during a market downturn. For tax year 2022, the lifetime gift exemption, the amount individual taxpayers can gift during their lifetimes without having to incur and pay a gift tax, is $12,060,000 ($24,120,000 for married taxpayers)[1]. When a taxpayer makes a gift, it is essential to note a few concepts: (1) the value of a gifted asset for gift tax purposes is the fair market value of the asset on the date of the gift[2], (2) not only is the fair market value of the gifted asset on the date of gift not included in the donor's estate at death, but all the appreciation on the gifted asset after the date of the gift is also not included in the donor's estate, and (3) the donee of a gifted asset takes the asset with same income tax basis as the donor had in the asset ("carryover basis").

With those fundamental tenets in mind, the ideal asset to gift using traditional gifting strategies has the following characteristics: (1) a depressed fair market value, (2) likely to significantly appreciate in value and (3) a relatively high-income tax basis. As such, it is easy to see while the current down market may be the ideal and most effective time to make strategic gifts of marketable securities. Combine this with the scheduled reduction of the temporary increased gift tax exemption in the next three years and now just might be the most opportune time to make significant gifts of marketable securities.

Advanced Planning with Rising Interest Rates

While the current market downturn presents opportunities for Roth conversions, GRATs and traditional gifting, the current rising interest rate environment presents opportunities for some advanced wealth transfers strategies. Namely, Qualified Personal Residence Trusts (QPRTs) and Charitable Remainder Trusts (CRTs).

IRS Interest Rates Generally

Each month, the Internal Revenue Service publishes short-, mid- and long-term rates (the Applicable Federal Rates, or AFRs) and the Section 7520 rate. The AFRs reflect the minimum interest rate that must be charged for loans between related parties. The Section 7520 rate, which is equal to 120% of the mid-term AFR, is used when implementing several estate planning techniques and the effectiveness of these techniques will change when this rate changes[3].

[1] Without additional legislation action in the meantime, the current $12.06MM gift tax exemption will revert to approximately $6MM per taxpayer on January 1, 2026.

[2] For gift tax calculation purposes, the fair market value of a marketable security is equal to the mean between the highest and lowest quoted selling prices of the security on the date of the gift.

[3] Generally, the rate that will apply to a specific strategy is the rate in effect on the date the strategy is effectuated. Charitable remainder trusts and charitable lead trusts are exceptions to the general rule and the IRS permits the use of the current rate or the rates from the prior 2 months when implementing these strategies.

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Qualified Personal Residence Trusts

A QPRT is an estate planning technique that involves creating an irrevocable trust that is established to reduce the gift and estate tax liability of a donor by transferring a personal residence out of his/her taxable estate. The QPRT lasts for a term of years, during which the grantor continues to use the residence as his or her own. After the initial QPRT term, the residence passes to the designated remainder beneficiaries.

For gift tax purposes, the initial transfer to the QPRT is a taxable gift equal to the value of the remainder interest that passes to the remainder beneficiaries. This is calculated using the Section 7520 rate in effect at the time of the initial transfer to the QPRT, as well as the QPRT term and the then current fair market value of the residence. The higher the Section 7520 rate, the higher the value of the grantor's right to use the residence as his or her own during the QPRT term, and the lower the value of the gift of the future remainder interest. So as the Section 7520 rate increases, the taxable gift decreases, making the QPRT a more attractive strategy with higher interest rates.

For example, assume a 65-year-old individual transfers his/her $1,000,000 personal residence to a QPRT retaining the right to use the residence for the next 10 years. If the Section 7520 rate at the time of funding was 1.6% (the Section 7520 rate for January 2022), the present value of the remainder interest, and the amount of the taxable gift, would be equal to $669,940. If instead the Section 7520 rate at the time of funding was 3.6% (the Section 7520 rate for June 2022), the present value of the remainder interest, and the amount of the taxable gift, would be equal to $551,280.

Charitable Remainder Trusts

A CRT is an estate planning technique that involves creating an irrevocable trust where the donor (or his/her designated individual beneficiaries) retain the right to receive an income stream from the trust for a term of years (or their life/lives). At the end of retained income term, the remaining assets are distributed to a designated charitable beneficiary.

Upon creation and funding of the trust, the donor receives an income tax charitable deduction equal to the present value of the remainder interest that passes to the designated charitable beneficiary. This is also calculated using the Section 7520 rate in effect at the time of the funding of the CRT (or the Section 7520 rate for one of the prior 2 months if those rates result in a better result for the donor and the donor so chooses). The higher the Section 7520 rate, the higher the value of the charitable remainder interest. So as the Section 7520 rate increases, the donor's income tax charitable deduction increases, making a CRT a potentially more attractive strategy with higher interest rates.

For example, assume an individual transfers $1,000,000 to a CRT receiving the right to receive a 5% annuity payment for the next 10 years. If the Section 7520 rate at the time of funding was 1.6% (the Section 7520 rate for January 2022), the present value of the remainder interest passing to charity would be $541,325, creating an income tax charitable deduction for the donor in the same amount. If instead the Section 7520 rate at the time of funding was 3.6% (the Section 7520 rate for June 2022), the present value of the remainder interest passing to charity (and the accompanying income tax charitable deduction for the donor) would be $586,260.

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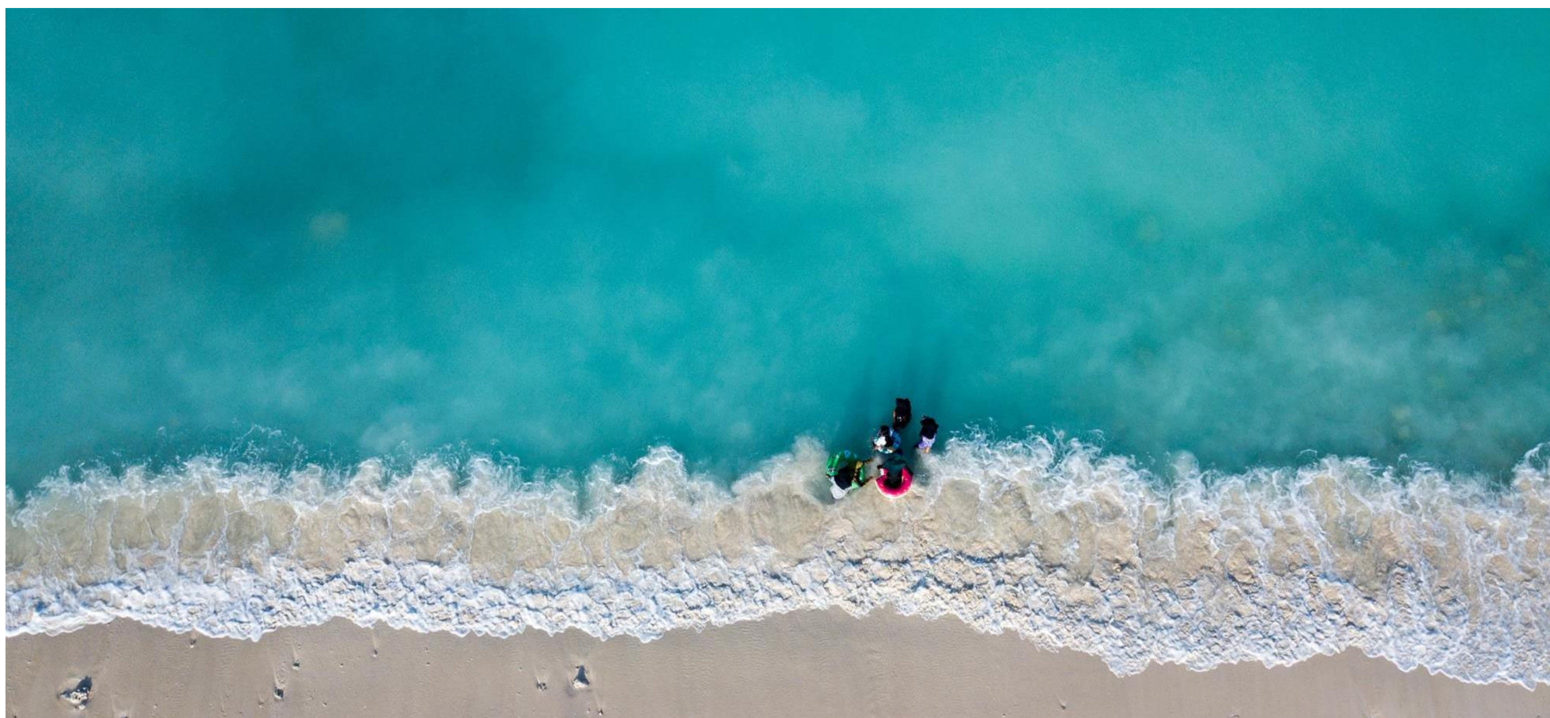
Tax Loss Harvesting and Wash Sales

Tax loss harvesting during a down market is another opportunity to turn lemons into lemonade. Tax loss harvesting is the process of selling underperforming investments at a loss and using those capital losses to offset taxable capital gains elsewhere in the taxpayer's portfolio. In a year when a taxpayer's capital losses outweigh their gains, the IRS will allow the taxpayer to apply up to $3,000 in net capital losses against ordinary income. Any unused capital losses can be carried forward to be used in future tax years.

When implementing a tax loss harvesting strategy investors must always be aware of the "wash sale" rules. A "wash sale" is the sale of stock or a security at a loss where the taxpayer acquires a "substantially identical" share or security within 30 days before or after the date of the sale, leaving the taxpayer's investment position substantially unaltered. If a wash sale occurs, the taxpayer will not be able to currently deduct the loss on the applicable sale and instead the loss is generally deferred until the replacement security is sold.

While the "wash sale" rules may limit a tax loss harvesting strategy if a client ultimately wants to retain a particular stock or security, the same is not true for any cryptocurrency in a client's portfolio. Under current law, the IRS views cryptocurrency as "property" for tax purposes and the "wash sale" rules do not currently[4] apply to cryptocurrency transactions as a result of this classification. As such, investors with cryptocurrency in their holdings can currently be very strategic with a tax loss harvesting strategy.



[4] There was a proposal in the House of Representatives' version of the Build Back Better Act that would make cryptocurrency subject to the "wash sale" rules, but that proposal has not been signed into law as of the publication date of this Rockefeller Insight.

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Revisiting Components of Your Financial Plan

Down Markets and the Health of Permanent Life Insurance

Down market cycles and potentially reduced expected growth rates can affect multiple areas of a planning process beyond just investment portfolios. Many individuals and families have instituted the use of life insurance for a multitude of reasons, including, estate planning liquidity needs. Insurance illustrations are usually built using assumed static growth rates. If an individual is using variable life insurance in their planning process, the longer the real investment returns underperform the assumed growth rate of the policy, the less likely the illustration will reflect the potential true outcome of the policy. In challenging markets, it can become very important to request current in-force illustrations using the reduced policy values to assess the potential impact on the policy.

Debt Securitized by Investment Portfolios

Investors have also used their investment portfolios to effectuate other parts of the planning process. Some have financed homes or other assets using loans secured by the value of their portfolio. Margin has been used to create further investing. In this rising rate environment, the cost associated with these loans, while generally still favorable as compared to other types of loans, is on the rise. With portfolio values having decreased, investors may also be in a position where further collateral could be required to keep the loans in place. Given the market volatility and prevailing interest rate environment, investors with debt securitized by investment portfolios should take a moment to take stock of their financial plans and ensure their leverage is still appropriate and effective.

Conclusion

While market downturns, like we have experienced thus far in the first half of 2022, undoubtedly have negative impacts on the value of many investors' portfolios, they nevertheless offer an opportune time to focus on financial planning strategies.

The potential impact of gifting strategies to facilitate efficient estate tax planning can be enhanced by acting in a down market cycle. Additionally, the current environment presents individuals with the opportunity to deploy strategies aimed at planning around income taxes such as Roth IRA conversions, tax-loss harvesting and increased income tax charitable deductions with CRTs. It is also a time when individuals and families should be re-examining their financial plans more broadly to ensure they are appropriately constructed given current market conditions.

As we all know, financial planning is not a "set it and forget it" exercise and encompasses far more than just the performance of investment accounts. The importance of continuous monitoring and seizing opportunities to implement effective planning strategies is rarely more evident than in periods of challenging market conditions like we are currently experiencing.

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