2022 Year-End Planning Guide

The end of the year is always a good time to pause and reflect on the financial moves you have made all year and be mindful of choices you will make going forward.

Unfortunately, we've had several years of uncertainty with the COVID-19 pandemic and political unrest, plus the additional strains of the war in Ukraine and increasing crime. Throughout this year we've experienced ongoing market volatility and high inflation coupled with the Fed's aggressive rate hike schedule to combat inflation. The newly passed Inflation Reduction Act ("IRA") also brings some opportunities to claim credits for energy saving actions. In this year's guide we'll look at steps you can take while engaging in:

- Financial and estate planning in a rising interest rate environment
- Tax planning considering the Inflation Reduction Act
- Retirement planning under a potential recession

Financial and Estate Planning in a Rising Interest Rate Environment

After an extended period of historically low interest rates, the Fed has reversed course and cranked up interest rates to combat rising inflation, which reached as high as 9.1% in June. At the September 21st meeting, the Federal Reserve increased rates by 0.75%, its third time raising rates by this amount in 2022. Five consecutive rate hikes in 2022 have pushed borrowing costs to their highest level since 2009.

So, what steps can you take to adjust your financial planning if interest rates are rising? Below are some factors to consider as you evaluate and adjust your plan for 2023.

1. **Lock in Low Rates Now**

   Although the Federal Reserve has raised rates by 2.25% in a short space of time, overall rates are still reasonable, and have fluctuated in the 5-6% range throughout the latter part of this year. When you look historically, rates rose as high as 16-18% in the 1980's, and in the early 2000's in the 6% range were considered normal.

   If it makes financial sense, lock in any loans (car, HELOC, etc.), mortgages, or refinances at current rates, as we'll likely see rate hikes through the end of the year at least. The main idea to keep in mind here is "if it makes sense". There's no need to rush to secure a loan or refinance just to lock in rates. Run the numbers on your budget and consider if and why a financed purchase or refinance at this time is effective for you. There's more to the decision than interest rates, and you want to go into the arrangement having fully considered all implications.

2. **Consider Estate Planning Strategies Effective for High Interest Rates**

   There are many wealth transfer strategies that enable you to transfer assets or money to the next generation in a tax-efficient manner, often while retaining as much control as possible. Some of those strategies, such as the Grantor Retained Annuity Trust or the Intra-family Loan, work best in a low-interest rate environment. However, there are a few that work well in a rising-interest rate environment.

   With the possibility that the doubled estate tax exemption amount may sunset when some of the provision of the Tax Cuts and Jobs Act (TCJA) expire at the close of 2025, now may be a great time to consider implementing one or more estate reduction techniques. Here are some options to consider.

   - **Qualified Personal Residence Trust** (QPRT). A QPRT is a trust used to transfer a personal residence to trust beneficiaries. The QPRT is created for a set term of years, and during that time the grantor continues to use the residence as their own. At the end of the trust term, the residence passes to trust's remainder beneficiaries. Grantors who want to continue living in the home must pay rent to the beneficiaries at fair market value.

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When the grantor transfers the residence to the QPRT, she is taxed on the gift value of the remainder interest, calculated using the §7520 rate. If the §7520 rate is high, then the grantor's retained right to use the residence is also valued high, and the future remainder interest or gift is valued low. Thus, the higher the §7520 rate, the lower the taxable gift. The inverse proportion makes the QPRT a more attractive strategy in a high interest rate environment.

Remember you can put up to two residences into a QPRT, your principal residence and a vacation home, which could include a boat if used as a home. You can also create fractional interest QPRTs with a spouse or other co-owner.

- **Charitable Remainer Annuity Trust** (CRT). A CRT is a split interest trust in which the grantor receives an annuity from the CRT for a term of years, and a charity (or charities) receives the remainder at the end of the trust's term. The value of the remainder is calculated using the §7520 rate at the time the grantor creates the trust, and the grantor is allowed an income tax charitable deduction.

  CRTs must pass a minimum 5% remainder test, however, so the higher the §7520 rate, the higher the value of the remainder charitable interest and the more likely that the CRT will pass the IRS test. CRTs must also make a minimum annual payment to the grantor. If the lifetime payout to the grantor is too long, as with young grantors, it can be hard to pass the minimum payout test.

3. **Evaluate Your Credit Card Spending**

   Credit cards are handy tools to have at your disposal, but with many lines of credit – card or other small personal loans – it's easy to lose track of the details. Details you'll want to keep top of mind are:

   - Your variable interest rates and APR if you're carrying a balance on your cards
   - Current credit card offerings and if they align with your goals
   - Your credit score, which is an influential factor in helping you get better interest rates, should you choose to pursue new lines or refinancing

     If you need to focus on paying off debt or improving your credit score, focus on your small debts then focus on high-interest debts. Some methods to tackle debt may include a small personal loan or a zero-rate balance transfer to another credit card. Many credit cards offer deals that lock in the zero-rate transfer for anywhere from 12 to 21 months. This will insulate you for almost 2 years and allow you time to let the economy recover from elevated inflation without paying a premium on your ballooning credit card debt in the meanwhile.

Tax Planning Considering the Inflation Reduction Act (IRA)

The IRA didn't have any specific tax provisions that targeted individual income taxpayers; however, it is prudent to keep the new law in mind when considering your tax planning for 2023.

1. **Estate Tax Exemption – 2026 Sunset**

   The lead up to the IRA included a lot of talk about changes to the estate tax laws, none of which were included in the final Act. With the inaction on estate tax exemption from the IRA, we remain in the same situation as before – that the TCJA will expire at the end of 2025, thereby removing half of the estate tax exemption amount. If your net worth exceeds $6 million or thereabouts, which is what the exemption would be in 2026 (the American Taxpayer Relief Act – or ATRA – of 2012 value plus inflation), then engaging in wealth transfer planning today to shore up some of extra gifting value now would be prudent.

2. **Income Tax Brackets – 2026 Sunset**

   In addition to the loss of the extra estate exemption, the sunset of the TCJA would also include the loss of the favorable changes to the individual taxpayer income tax brackets which widened the dollar ranges of each bracket and lowered the top rate from 39.6% to 37%. Without additional action from Congress, we would go back to the previous law's brackets. Although we are a few years off from this sunset, if you have the ability to recognize income early, it may be worth having a discussion with your planner about the impact the change in tax brackets could have on the taxes you may pay versus if you wait to take action.

   For example, if Lucy Taxpayer, a single filer, earns $150,000 in compensation in 2022, she would be in the 24% tax bracket. However, according to the ATRA rules which would be back in place once TCJA sunsets, her income would put her in the 28% tax bracket. By accelerating some of her income now, Lucy can take advantage of the 4% leverage.

   (Source: www.taxpolicycenter.org "How did the Tax Cuts and Jobs Act change personal taxes?")

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3. **IRS Enforcement**

   The Inflation Reduction Act also increased funding for the IRS to the tune of $80 billion. While this is not a specific tax provision, it is likely to have an impact on many individual taxpayers. The IRS will spend those funds on improved technology and increased staff to enable them to select and pursue better audit targets, pursue failure to disclose assets, pursue employers who fail to deposit payroll taxes, and report foreign bank accounts. Being compliant with reporting and tax payment rules will likely reduce your overall tax burden for the future.

4. **Clean Energy Credits**

   The IRA contained several favorable tax credits for individuals. Being aware of these could work in your favor. If you plan to make any of these types of changes you could receive a monetary benefit as well.

   - A 10-year extension of the "nonbusiness energy property credit" which allows homeowners a 30% tax credit for energy-efficient skylights, insulation, exterior doors and windows (up to $1,200), as well as energy-efficient water heaters, heat pumps, and biomass stoves and boilers (up to $2,000 a year).

   - A "residential clean energy credit" which is a 30% tax credit for the installation of solar panels or other equipment for renewable energy sources.

   - Existing tax credits for buying a new (up to $7,500) or used (up to $4,000) electric or clean vehicle, including hydrogen fuel cell cars, are extended for 10 years until December 2032. The tax credit can be taken as a discount at the time of purchase. There are limits excluding high-priced luxury cars, however the 200,000-car cap for manufacturers has been removed allowing it to apply to Toyotas, Teslas and General Motors, etc. There are some requirements to meet regarding the source of batteries and income thresholds.

   - Two home-related rebate programs are available as point-of-sale programs starting in 2023, but require states to apply for and administer the programs:

     - The HOMES rebate program offers up to $8,000 for people who cut their home energy via efficiency upgrades, such as insulation or HVAC installations.

     - The "high efficiency electric home rebate program" offers up to $14,000 in rebates when households buy efficient electric appliances. Both programs will have requirements and possible income requirements. Keeping an eye on them and being aware of eligibility could help you save a few dollars if you are in the market for any of these upgrades.

       (Source: www.kiplinger.com, "Save more on green home improvements under the inflation reduction act", 8/19/2022)

5. **Student Debt Forgiveness**

   Lastly, although it was done through Executive Action and not the IRA, the Biden Administration forgave $10,000 (and up to $20,000 for Pell Grant recipients) worth of federal student loan debt for borrowers who earn less than $125,000 annually. Typically, cancellation of indebtedness results in reportable income, but that is not the case federally in this instance. However, do not assume that is universally the case for all 50 states. Some states such as Mississippi, Minnesota, Wisconsin, Arkansas, and North Carolina have laws in place to tax debt forgiveness which may negate the benefit for some. Check with your CPA to determine if your state has such laws in place.

   (Source: www.pbs.org "Some states have laws to tax student loan debt forgiven by Biden's plan". 9/4/2022)

Retirement Planning Under the Potential for Recession

Perhaps one of the greatest challenges of being an investor is keeping a level head during turbulent times. As our Chief Investment Officer, Brent Ciliano, frequently says, "it's time in the market, not timing the market." That time in the market coupled with a solid financial plan can help ensure you meet your financial and lifestyle goals, all while navigating a volatile market. In addition to an established financial plan, there are other financial activities you can do to shore yourself up against risks. Here are some actions to consider:

1. **Check Your Withdrawal Rate**

   A common rule of thumb that many use to measure how much they can withdraw from their retirement savings is the 4% rule.* Generally, you withdraw 4% from your retirement savings in year one and in subsequent years, you increase the dollar amount of the distribution by the previous year's inflation rate. For example, with $1.5 million, in year one you would withdraw

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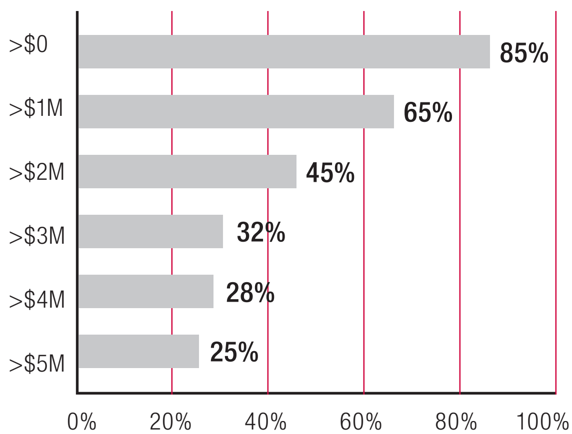
$60,000. At a more typically 2% inflation, in year two you would withdraw $61,200. However, at the rate of 9% inflation, this formula would be upended, and you'd withdraw $65,400. Taking out large distributions during a downturn in the market or during early years of your retirement means your retirement account won't get a chance to recover when the market and inflation returns to normal levels.

The 4% rule is good in theory but has been shown to be poor when put to practical usage. It's better to be flexible with your withdrawals rates by contracting in times of volatility or poor performance and increasing in times of higher returns. The ebb and flow of your distribution reflex will increase the likelihood of your retirement lasting all the way through your lifetime.

Historical ending wealth at 4% initial withdrawal rate (1928-2021)
65 rolling 30-year periods



(Source: JP Morgan, Guide to Retirement Planning 2022, 40 equity, 60 bond portfolio)

A more prudent course during a time of lowered market values and high inflation may be to adjust your financial plan and consider lowering your withdrawal rates to 3%. This would reduce your chances of running out of money in the latter years of your retirement. If you are in the early years of your retirement, you still have options to make up the difference such as earning a side income, renting a second home, or cutting your expenses. Just that one percent change in withdrawal rates could have a significant impact on sustainability over a projected period.

2. Potential Recession Effects

In addition to having an impact on your portfolio's performance, recessionary indicators can have tangible impact on your income through underemployment or unemployment. While it's not always possible to prevent a lay-off from happening, you can try to cushion yourself financially by taking some precautions:

- **Emergency Fund.** Have at least six months of liquid funds on hand for non-discretionary expenses (ex. Mortgage and car payments). You don't necessarily need to keep your full emergency fund in a low-interest savings account, either. Instead, consider obtaining a secured line against investments or an equity line against real estate, and let the underlying asset continue to grow while you use the loan. If you can lock such a line in now at a lower interest rate, that's even better.
- **Revisit Your Budget.** As we mentioned earlier, look at the details of your transactions. Evaluate where there's high interest debt to pay off, where subscriptions can be minimized or consolidated, and where other unnecessary spending might be happening.
- **Check Your Vices.** In times of economic, political, and global turmoil, be mindful of how, if at all, stress triggers your spending habits. Once you're aware, you can take steps to improve them. Replace expensive coping mechanisms such as shopping sprees or expensive trips with free options to release your stress such as a walk outside, a video call to a loved one or making a home-cooked meal.
- **Investment Accounts – Diversify, Review Asset Allocation and Rebalance.** One of the greatest risks when investing isn't necessarily the market's downturn, it's your portfolio's mix of assets that causes your exposure. Make sure you have an adequate mix of assets and that they are allocated according to your goals and risks. This differs for everyone and requires the advice and attention of a financial planner and portfolio strategist for guidance. Moreover, once you've attained the correct asset allocation, continue to rebalance so that your portfolio doesn't drift out of course over time as you continue to make contributions, or it appreciates.
- **Delay Social Security.** Once you reach age 62, you are eligible to file for Social Security benefits, but most people know if you wait until full retirement age (FRA), your benefits will increase. FRA is 66 for people born between 1943 and 1954, and 67 for people born in or after 1960. Fewer people know if you wait until age 70, you will get an even greater benefit.

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During periods of high inflation, waiting to age 70 to claim your Social Security benefit makes even more sense because Social Security benefits are adjusted annually for the cost of living. The cost-of-living adjustment for 2023 is projected to be a whopping 8.8%, an adjustment we haven't seen since 1981. (Source: Kiplinger, "What is the Social Security COLA?" 09/16/2022) By waiting to claim, those cost-of-living increases will compound the amount in benefits that you will ultimately receive at age 70. Moreover, you receive an 8% retirement credit for every year between FRA and age 70.

If you wait to claim, you'll have to make up the difference from your investment account or your qualified retirement accounts. Better yet, continue to work for an extra year or two if you are able. If you are married and your spouse earned less than you, they could claim before FRA and you both could live on that payout, while your Social Security benefit grows until your FRA or age 70.

- **Continue Making Contributions.** When times are tough it is tempting to delay saving for retirement. However, it's important not to get derailed by procrastination or short-sightedness and forget about your long-term goals. Delaying saving for retirement can end up costing you far more in the future than a short-term recession's effects.

  Be disciplined about setting aside a fixed contribution every month and invest it for your future. For example, if Sam starts contributing $200 a month every month from age 25, at 6.25% interest, she will have $420,300 at age 65. By comparison, if Jaden keeps delaying saving for retirement – he thinks he's too young, has student debt obligations or other priorities – and waits until he is 35 to start contributing $200 a month earning 6.25%, he'll have $210,000 when he's ready to retire at 65. That 10-year delay for Jaden resulted in almost 2/3 less in retirement savings than Sam, with all other factors being equal. Sam's advantage occurred not just because she started saving earlier and consistently, but also her reinvested assets compounded over time due to appreciation turning into principal. By letting procrastination get the better of him, Jaden lost out on both benefits – time value of money and compounding appreciation.

Conclusion

For the last few years, we have given you guides with tips and advice around weathering tough external circumstances, any one of which would be difficult. After three years, several stressors are starting to pancake our financial lives in layers. It's hard to know how long COVID will linger, or the high inflationary period, market volatility, war in Ukraine, political unrest, and slowed economic growth may last. However, the key takeaways from this guide and the preceding two are:

1. **Keep a level head.** Making emotional or rash decisions are likely to lead to a poor result.
2. **Focus on what is within your control.** While you can't control market volatility or inflation, there are planning actions you can take to shore up your situation or that of your parents or children.
3. **First Citizens Partner is your all-around partner.** We have a team of people and resources who are dedicated to helping you in fair weather and foul weather. Give us a call and we'll guide you through this storm and prepare you for the next.

*The 4% rule was developed by Bill Bengen. www.thinkadvisor.com "Father of 4% Rule Urges Caution, Cash as Market Risk Rises". 5/9/2022.