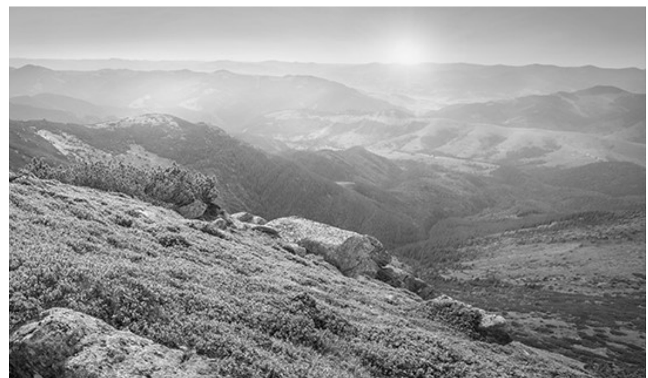
2021 Year-End Planning Guide

2021 has proven – if you hadn't already learned from 2020 – that it's impossible to predict the future. While the fight against COVID-19 seemed like it would wrap up this spring, the delta variant sent us into another deadly surge by summer's end. In addition, high inflation rates, an inconsistent market, hiring difficulties, increasing real estate values, and continued debate over the current administration's proposed infrastructure and tax legislation has led to a mixed bag of economic conditions.

As we wait for final legislation from Congress, several changing economic conditions will color the path of your financial planning going forward. Let's identify and focus on those conditions while considering some strategies that work best in such environments.

Based on what we know today, we will likely find ourselves, at least in the short-term, in an economic environment with the following characteristics:

- Increasing Income Taxes
- Market Volatility
- Increasing Inflation and Low Interest Rates



Planning for Higher Taxes on Individuals

In our document, Budget and Treasury Green Book for 2022, we provided an overview of some of the proposals made in the Biden Administration's Made in America Tax Plan and the American Families Plan.

Although some version of the proposals will likely pass, tax increases are set to occur through inaction. Many of the corporate tax changes in the Tax Cuts and Jobs Act of 2017 (TCJA) were permanent, but the provisions affecting individuals are scheduled to expire on December 31, 2025.

But before taking any action, please meet with your First Citizens Consultant as well as your tax and legal advisors for a customized strategy.

Proposed Tax Legislation for Individual Taxes

The bills coursing through Congress are extensive. Some of the broader proposed tax increases include:

- **Capital Gains and Qualified Dividends.** Long-term capital gains and qualified dividends of taxpayers with adjusted gross income of more than $1 million ($500,000 for married filing separately) would be taxed as ordinary income. This could result in a top rate of 43.4% when the 3.8% net investment income tax is included.
- **Ordinary Income**. Proposed legislation would increase the top marginal individual income tax rate from 37% to 39.6%.
- **Like-Kind Exchanges**. Congress may limit the deferral of gain from like-kind property exchanges of real estate. Gains in excess of $500,000 for each taxpayer, or $1 million for married filing joint taxpayers, would be taxed in the year of the like-kind property exchange.
- **Inherited Assets**. Realizing a capital gain upon death or gift of appreciated assets may change with proposed legislation. Death would be treated as a recognition event, and there would be no more step-up in basis of assets transferred at death. In addition, gains on unrealized appreciation of property would be realized every 90 years, targeting assets held in dynasty trusts.
- **Corporate Tax Rates**. TCJA instituted a flat tax of 21% for all C corporations, but new legislation would likely increase that rate. Bills have varied the exact percentage from 25% to 28%.

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Strategies to Consider for Higher Individual Taxes

Even though the infrastructure and spending legislation is not yet final, let's consider strategies for a rising income tax environment. Consider implementing these strategies before year-end to help minimize your tax liability and shore up your long-term financial wellness.

1. **Adjust Asset Allocation for Taxes**. Taxes can erode a portfolio's investment returns. A portfolio's asset allocation is its mix of cash, bonds, stocks and other investment classes;

   You should consider taxes as a factor in asset allocation when working with your strategist. Overall, net investment return is still the factor that matters most. Leaning too heavily on tax consequences could result in missing earning opportunities.

2. **Contribute to Tax-Efficient Accounts**. Certain vehicles like IRAs, 401ks, similar qualified plans, and life insurance have tax-deferred or tax-free aspects to their tax treatment. In an environment where income taxes are increasing, it makes sense to invest new monies in such tax-efficient accounts to help reduce current and/or future taxes. Traditional IRA or 401k accounts may be tax deductible when you contribute. However, your total annual contribution to any qualified account whether traditional or Roth, is subject to a dollar limit. Your deductible portion is also subject to limits based upon your active participation in an employer-provided retirement plan.

   Although qualified plans will remain a preferred vehicle for retirement savings, proposed legislation for tax-efficient accounts has provisions that affect retirement accountholders with large balances (+$10 million) and certain income thresholds. Some of those proposals include:

   - **Conversion Limitations**.
     - Eliminating the ability to process a conversion based on taxable income for:
       - Singles with income of $400K or more
       - Married Jointly with income of $450K or more
       - Head of Household with income of $425K or more.
     - Prohibiting employee after-tax contributions to a qualified plan.
     - Prohibiting the conversion of after-tax contributions in an IRA.
   - **Contribution Prohibitions**.
     - Prohibiting contributions to a Roth/Traditional IRA if the value of all IRAs and retirement plans combined exceeds $10 million.
   - **Large Qualified Plan Balances**.
     - If combined Roth/Traditional IRAs and Defined Contribution Plan balances exceed $10 million at year end, required minimum distributions (RMD) are required the following year to remove half of the amount exceeding $10 million (50% rule).
     - If combined plan balances exceed $20 million, RMDs are required the following year for amounts over $20 million (100% rule). Alternatively, you could distribute the balance in Roth IRAs and designated Roth in Defined Contribution plans, and then the 50% rule applies to continue decreasing the total balance to under $10 million.

   Given the above proposals, tax-saving strategies in a rising income tax environment now should be considered with a "proceed with caution" warning. The proposals highlighted above target Mega-Roth and Backdoor Roth strategies. Their availability, if legislation passes, will require a visit with your tax advisor.

3. **Tax Loss Harvesting**. Tax loss harvesting is a common strategy recommended in most year-end guides and will be even more prevalent with rising income tax rates. A few things to keep in mind:

   - Tax loss harvesting isn't permanent tax avoidance but rather a tax-deferral. The proceeds will be reinvested and eventually taxed at a profit.
   - Tax harvesting can occur throughout the year as opportunities arise, not just in December.

   Investors can "harvest" losses on capital assets to offset reportable gains on other capital assets. You can offset up to $3000 of ordinary income if you have that amount of personal capital losses. Harvesting requires selling securities at a loss or less than cost basis. Market volatility combined with increasing taxes, raises the possibility that the activity of harvesting capital losses can or should be done when the opportunity arises such as during market swings. As with any investing strategy, there are rules to keep in mind – namely the wash sale rules, which prevent you from repurchasing a similar security within 30 days of selling at a loss.

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Some other factors to consider when tax loss harvesting:

- The ratio of loss generated to your net capital gains.
- Your tax return as a whole - does capital loss harvesting makes sense with all the other income, losses, and deductions that you must recognize?
- When replacing the security, how will the new cost basis and holding period fit into your total portfolio management strategy?
- Does timing of the harvesting affect dividend distributions and/or transaction fees?

One last thing to keep in mind when harvesting losses: the trade date — not the settlement date — determines the holding period for most transactions. This will determine whether an asset qualifies as long-term.

4. **Tax-Efficient Charitable Gifting**. Assets that do not receive a step-up in basis at death are the most tax-efficient choice to give to charity. Right now, those are qualified plan assets. However, that could change for upper middle class or mass-affluent estates. Legislation proposals would limit the step-up in basis for estates exceeding $1 million ($2 million for joint filers) and the current capital gains exclusion of $250,000/$500,000 for primary residences.

   - **Qualified charitable distributions (QCDs).** QCDs allow individuals who are at least age 70½ and have traditional and/or inherited IRAs to distribute up to $100,000 per year directly from their IRA to a 501(c)(3) nonprofit with no federal income tax consequences. Gifts to grant-making foundations, donor advised funds, or charitable gift annuities are not included. A QCD can help a taxpayer avoid being pushed into a higher income tax bracket and prevent phaseouts of other tax deductions due to RMDs. QCD could also reduce the value of your IRA, thereby potentially reducing the size of your RMDs.

   If you plan to take both a RMD and make a QCD, consider making the QCD first if a RMD is required for the year ("first money out" rule).

Planning for Market Volatility and Low Interest Rates

Market volatility is common and a normal part of the investing process. While this year has continued to be a bull market, it has seen its share of ups and downs, which are likely to continue. We coach our investors to remain calm and level-headed during volatile market days.

Strategies to consider with Market Volatility and Low Interest Rates

If the markets do go through periods of increased ups and downs there are some actions to consider:

1. **Financial Plan**. Revisit your goals in your financial plan, especially your time horizon. We often find that even with short-term volatility, the long-term prospects for success of your plan remain largely the same. You may need to make small adjustments such as reviewing your monthly budget and having an adequate emergency fund.

   This is also a good time to revisit the impact of the SECURE Act on your qualified accounts, especially if you are considering working beyond age 70½. The SECURE Act was signed into law on December 20, 2019 and was the largest piece of retirement legislation in over a decade. Its impact and understanding were blunted by the onset of the pandemic a few months after its effective date. Some of the significant changes that may be helpful to remember, especially in an increasing income tax environment, include:

   - **Required Minimum Distribution at Age 72**. The SECURE Act raises the RMD age from 70½ to 72. This increase affects individuals born after June 30, 1949. Such individuals do not have to take their first RMD until April following the year in which they turn 72.
   - **Maximum Age for IRA Contributions**. The SECURE Act repealed the upper age limit preventing contributions to traditional IRAs by an individual over age 70½. As long as an individual has earned income, he or she can make contributions to a traditional IRA regardless of their age. The rules regarding whether the contribution will be tax deductible have not changed. As a result of the SECURE Act, deductible traditional IRA contributions made beginning at age 70½ may reduce your QCD amount.

2. **Line of Credit**. Consider obtaining a line of credit in the event unexpected expenses occur or you want to make a large purchase during a market downturn. Having a line of credit available secured against your investments also helps avoid having to pay capital gains taxes to create liquidity.

   With a line of credit, you may not need to have the full six months of emergency funds on hand since the line can serve immediate liquid needs if necessary, while allowing what would otherwise be underinvested funds to remain fully

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invested and take advantage of a continued bull market. The low interest rate environment we are currently in will allow you to obtain a line at historically low levels while maintaining the arbitrage of investing in a historically high market.

3. **Diversification**. If market drops are difficult for you to stomach, discuss your allocation with your financial consultant. You may need to adjust your portfolio into lower risk investments to dull the effects of a potential correction.

4. **Refinance Debt**. Interest rates continue to be low, so refinancing debt remains a good strategy for this situation. Changing the length of your mortgage cannot only lower your payment, but it can also improve your credit rating and take the pressure of your monthly budget. In addition, with rising home values, refinancing can allow you to take some equity out of your home for other purposes. When deciding to refinance, be aware of the closing costs and how long you need to stay in the home to make the new loan more financially beneficial than the old loan. Keep in mind that the average homeowner moves or refinances every seven years.

5. **Conversions from Traditional to Roth IRA**. Depending on your situation and concerns, it may be a good time to consider converting a traditional IRA to a Roth IRA. A Roth IRA can include tax-free income distributions for you and your heirs. Roth IRAs do not have Required Minimum Distributions during your lifetime (or your spouse's, if rolled over).

   Following the 5-year waiting period, the amount converted to a Roth IRA can be distributed tax-free without the 10% additional tax penalty for early or pre-59½ distributions. The likelihood of higher income taxes in the near future makes these benefits more valuable. A financial planner can conduct an analysis to compare the benefits of holding or converting, and identify the crossover point. A conversion works best if you have funds outside of the converting IRA to pay the income taxes due upon conversion.

   Keep in mind, the SECURE Act of 2020 eliminated the ability to recharacterize a conversion if you change your mind. The modeling analysis helps gather all the beneficial information before making the change. The SECURE Act also impacts beneficiaries inheriting a Roth IRA; depending upon their category, beneficiaries must receive funds from the ROTH IRA account via distributions within 10 years.

6. **Intra-family Loans**. In a continued low interest rate environment, intra-family loans may be a strategy to move assets to the next generation at lowered transfer tax rates.

   Utilizing strategies such as an installment sale to a grantor trust allows you to move a highly appreciating asset and/or high-yield asset such as rental real estate to a grantor trust in exchange for an installment note. That sale transaction is not recognized for income tax purposes due to the grantor status of the trust, and the note can be set at the currently very low applicable federal rates.

   The asset is the trust which is recognized as being outside of your estate for estate and gift tax purposes. While there are more requirements and complexities to the strategy, a low interest rate environment is typically an ideal time to consider setting up a grantor trust, especially with the prospect of lowered estate tax exemption, repeal of the step-up in basis, and an increase in capital gains taxes on the horizon.

Planning for High Inflation

For an in-depth look at inflation impacts on the market and the economy, be sure to check out our Making Sense webinar series, featuring CIO, Brent Ciliano, and Manager of Institutional Portfolio Strategy, Phillip Neuhart.

Inflation is defined as an increase in prices and a fall in the purchasing value of money. Usually when our planning team creates financial plans, we default to an increase of 2% in inflation or cost of living each year. Prices have been much higher recently due to the COVID pandemic and the shortages, labor stops and starts and economic shocks that have fallen out in its aftermath. The cost-of-living adjustment for Social Security in 2022 is predicted to be 5 to 6 percent, the highest since 2008.
(www.aarp.org Social Security COLA 2022: How Much Will Benefits Increase?)

Moreover, inflation fears have invaded Wall Street. The number of American corporations mentioning the term "inflation" during earnings calls with analysts for second quarter results hit a 10-year high, according to data compiled by FactSet, in a survey of transcripts. The 12-month increase in core consumer prices in the U.S., excluding volatile food and energy, was at 5.4% in July, the highest since 2008. That rate slipped to 5.3% in August, the first time the rate has slowed since October 2020, however the cost of groceries, cars and restaurants are still rising due to increased demand and supply-chain bottlenecks. Consumer prices have risen this year at the fastest pace in three decades.
(www.marketwatch.com S&P 500 Companies have inflation on the brain, as 'inflation' mentions on earnings calls hit 10-year high, by Mark DeCambre Sept 17 2021).

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While it's likely inflation will level off in the near future, some steps you can take to protect yourself against a high inflation environment are outlined below.

1. **Financial Plan – Review Cash Flow**. As we mentioned with high volatility and low interest rates, if you expect high inflation, it's time to reconsider your financial plan. Now may be the time to evaluate your spending categories to determine where you can downsize, simplify, and cut out entirely, especially if prices are high. As you rerun your plan, it's important to factor in projected price increases for food and health care.

2. **Social Security**. If you defer claiming Social Security until age 70, you will obtain the highest payment possible. Deferral helps protect you against rising prices because Social Security has automatic cost-of-living adjustments built in. It is an exceptional government-based lifetime inflation-adjusted source of income, and savvy planning can help you squeeze the most out of it.

   Deferring to age 70 will result in a monthly benefit that is ¾ greater than if you claimed at age 62, a strategy that's particularly well-suited for a low interest rate environment. This tactic works best if you have a normal life expectancy. If you have health conditions that impact your longevity, then you may consider filing at the full retirement age or earlier.

3. **Review Your Insurance**. Some insurance products can help protect against inflation as well. There are a couple of add-ons that some insurance carriers offer as an option that help protect your policy against inflation.

   - **Indexing**. This allows you to link your policy premiums with a figure tied to inflation, such as the Retail Price Index or the Average Earnings Index. Thus, your policy stays on pace with the economy as inflation occurs and the cash value maintains over the long-term. The Indexation option is usually only offered at the onset or application of the policy. Once the policy starts, the option may close.

   - **Inflation Rider**. For an additional cost, some policies come with an inflation rider. The rider would add extra protection against inflation by providing a monthly benefit that increases each year to offset the economic change or reduction in the purchasing power of the dollar. Typically, this is a rider offered for long-term care policies, but can sometimes be found with a life insurance policy or annuity.

Conclusion

In times of uncertainty, your greatest asset is having a solid financial plan that helps flatten the ups and downs. While we wait for final legislation from Congress, we can help you adjust your portfolio using strategies that work well in this environment.

If you do not have a financial plan, our consultants and planners are here to help you get started. If you already have a thorough financial plan, it's likely a good time to review it with your team of advisors and financial consultants to consider the options in this guide.

As we near the end of 2021, make sure you've taken necessary steps to avoid potential tax erosion in your finances. To help in this process, we've constructed a Year-end Planning Schedule Checklist to help you stay organized. Reach out to the First Citizens Wealth Management team with questions and to get started.

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