WhittierTrust

2023 FINANCIAL OUTLOOK

It May Be Better Than You Think

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It's early 2023 and we've just come out of one of the toughest markets for financial assets in recent years. The broad U.S. stock market as measured by the S&P 500 Index was down about 18%, while the bond market as measured by the Bloomberg US Aggregate Index down over 12% (a historic record). It's likely that even a balanced portfolio of stocks and bonds ended the year 15% to 20% lower than it started! But it might not be all bad news for strategic investors.

There was a focus by the mainstream press at year-end concerning "tax loss harvesting" or selling assets at a loss to lock in an income tax advantage. Specifically, when an asset is sold for less than the investor paid, a capital loss is incurred. Under most circumstances, these losses can be used in future years to offset capital gains. It is a great technique to use in taxable accounts. Investors should be mindful of the wash sale rules which prohibit booking the loss if the identical security is purchased within 30 days of the sale. For investors wishing to maintain market exposure during the 30-day period, it is possible to buy an exchange traded fund (ETF) or index fund that mimics the stock market. Keep in mind that IRAs and other retirement accounts do not benefit from this strategy since investments inside the account are tax-deferred.

For individuals and families with significant wealth, there is another benefit to lower valuations across asset classes. It may be a good time to transfer assets to younger generations, particularly if you think the assets will increase in value again once economic fortunes shift. Tax loss harvesting focuses solely on income taxes, but what about the gift, estate and generation-skipping transfer taxes? With the lifetime gift and estate tax exclusion amount set at $12.92 million per person, admittedly this is not an issue that all families will face. However, for those who find themselves always looking for ways to lessen the tax burden of estate taxes upon death, a lousy year in the market may be an excellent opportunity. The current large lifetime exemption amount is scheduled to sunset at the end of 2025 back to something in the $6 to $7 million range. The IRS has announced that there will not be a "clawback" of gifts made in excess of that amount during this period when the amount is higher.

Let's take the example of an asset that is worth 20% less today than it was in January 2021, yet it is expected to grow again when conditions improve.

By gifting that asset to a younger generation family member today, less of the donor's lifetime exemption is used and any appreciation on the gift escapes gift tax. If the younger family member is too young to handle a gift right now (say it's a grandchild), the gift may be made to an irrevocable trust. That way it can be preserved for future use. One caveat to lifetime gifting is that the donee inherits the donor's income tax basis in the asset. So, if grandpa gives shares of Amazon and his basis is $60 per share, little Johnny (or his trust) will hold the stock with a cost basis of $60 per share. Contrast this to a gift upon death which results in a "step up" in basis to the date-of-death value. Since the top income tax bracket for individuals in high income tax states is often above the transfer tax rate of 40%, an analysis of the two types of taxes should be conducted prior to making a substantial gift. A lot will depend on the prospects for the asset's appreciation.

Of course, stocks and bonds aren't the only asset classes that suffered in 2022; real estate and private business entities may also have taken a hit. A critical component of gifting a non-marketable asset is obtaining a qualified appraisal and attaching it to the gift tax return. The IRS has specific rules about what goes into and who may perform a qualified appraisal. Many gift and estate tax audits are essentially battles over valuation, so it is a good idea to be prudent. Specialty assets like fine art involve an additional layer of complexity and must be handled by experienced appraisers of similar objects.

A good estate planning attorney and an accountant can advise donors on the best way to structure a gift of depreciated property. There are many techniques, each with its own pluses and minuses. The right choice will involve an analysis of the donor's tax situation and family situation as well as knowledge of prior gifts. This is not a DIY exercise—seeking expert advice is critical to success.

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