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Trust UPDATE

CITIZENS BANK
A Bank Built For You

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Inflation and your portfolio

The July news from the Department of Labor was sobering. The consumer price index for the 12 months ending in June 2022 rose by 9.1%, the largest increase in over 40 years. Inflation has become widespread across the entire economy.

- The 10.4% increase in food prices was the largest since February 1981.
- A 59.9% increase in gasoline prices was the largest since March 1980.
- Overall energy prices rose 41.6%, the largest since April 1980, including a 70.4% boost to home heating oil which consumers have not yet felt—but they will if it is a cold winter.

The graph below has more detail. Wages have advanced as the pandemic has eased, but inflation has grown even faster. Real average hourly earnings have fallen 3.6% in the last twelve months, *The Wall Street Journal* reports, and average weekly earnings are down 4.4% because there has been a reduction of hours in the average workweek.

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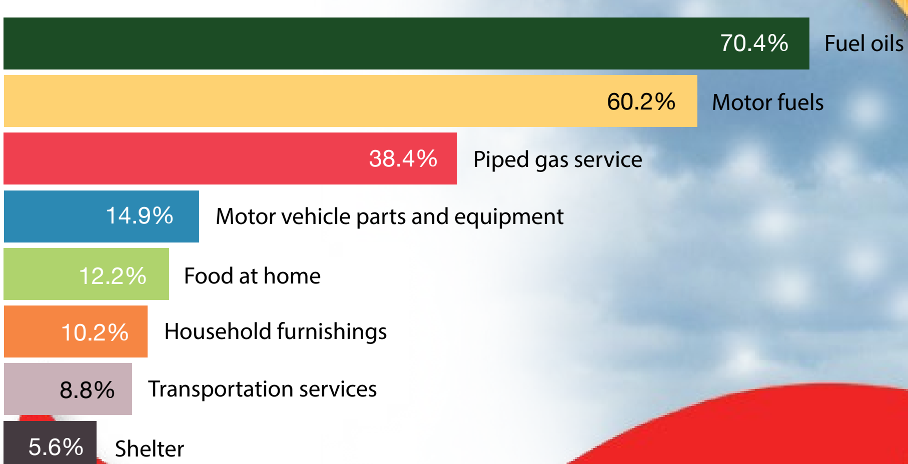
12-month percent changes, June 2022



Source: Department of Labor

Hypothetical retirees. When Sam and Janet retired in January 2010 their household expenses ran to $50,000 per year. Using the inflation calculator provided by the Department of Labor (https://www.bls.gov/data/inflation_calculator.htm), ten years later they needed $59,526 to have the same buying power. By June of 2022, they needed $68,373. In other words, they've experienced almost as much inflation in the last two years as in the first ten of their retirement!

Past as prologue

In 1980 and 1981, the last time inflation was this serious, Paul Volcker was Chairman of the Federal Reserve. In March 1980, the federal funds interest rate at which banks lent to each other was 19.85%, according to the St. Louis Federal Reserve Bank economic data. In February 1981, it was 15.53%, down from the 22.0% reached in December 1980.

As of the end of June 2022, the federal funds rate was only 1.58%. Many additional interest rate hikes seem likely, given this history.

Investors have difficult choices. As interest rates rise, the values of existing bonds fall—that's not investor sentiment, it's just how the bond math works. Bonds with the longest maturities tend to fall the most. But stocks are not an easy alternative, as shown by the declines in the stock indices this year. Sam and Janet may have been protected from inflation during the first ten years of their retirement because, although there were down periods, on the whole the value of stocks rose more than inflation. Now, as inflation has taken off, the value of stocks is down at the worst possible moment.

Fear of recession is one factor that is depressing stock prices. Those high interest rates of the Volcker years triggered two recessions in quick succession—those downturns were the price for taming sustained inflation.

CPI-linked returns

Since 1997, the U.S. government has provided investors with a convenient tool for building inflation protection into their portfolios. That tool is Treasury Inflation-Protected Securities, or TIPS. These securities are issued several times during the year in maturities of five, ten and 20 years. The principal value of the TIPS is adjusted annually for inflation, and that, in turn, affects the interest payments. (See "TIPS explained" at right for more on the mechanics of these securities.)

The coupon payments from TIPS are subject to ordinary income tax. One of the drawbacks of TIPS is that the principal adjustment is subject to ordinary income tax as well, in the year that it is made, though there is no cash distribution to draw the tax payment from. For example, if the value of a $10,000 bond is raised to $10,250 to account for 2.5% inflation, that $250 adjustment is fully taxable. Because this situation can create a cash flow problem for meeting the tax obligation, often TIPS are recommended for tax-deferred accounts, such as IRAs.

In the event of deflation, the value of TIPS will decline. However, the redemption will be at face value, and the dividend can't fall below zero, so there is a deflation hedge built in as well.

TIPS are traded on the secondary market. Their price fluctuates with changes in interest rates as well as changes in the inflation rate. Such volatility indicates that they are best suited for longer-term time horizons,

TIPS explained

Assume that a TIPS is purchased with a face value of $10,000 and a dividend rate set at 2%. Assume as well, for the sake of this illustration, that inflation runs at a constant 2.5% annual rate. Finally, assume that the 2% dividend is paid in two coupons each year, of 1% each.

The first coupon would pay $100 (half of the 2% dividend times the $10,000 face value).

After a year, the value of the bond would rise to $10,250, given the 2.5% inflation adjustment. Accordingly, the interest payment would rise to $102.50.

After ten years of 2.5% inflation, the value of the bond would rise to $12,800, bringing the coupon payment to $128.

However, if there is one thing that we know for certain, it is that inflation will not stay at a constant rate for ten years.

This example is for illustrative purposes only, and the return is not indicative of any actual investment. Actual investments may differ substantially.

What they said about INFLATION

Inflation is one form of taxation that can be imposed without legislation.
—Milton Friedman

Inflation is when you pay fifteen dollars for the ten-dollar haircut you used to get for five dollars when you had hair.
—Sam Ewing

Inflation is when sitting on your nest egg doesn't give you anything to crow about.
—Anonymous

The arithmetic makes it plain that inflation is a far more devastating tax than anything that has been enacted by our legislature. The inflation tax has a fantastic ability to simply consume capital.
—Warren Buffett

reinforcing the idea that they are a good choice for IRAs.

Some investment funds include TIPS among their holdings, and some funds specialize in TIPS. Funds can provide for diversification of maturities and easy reinvestment choices. On the other hand, funds do not have a maturity date, and so can have risks not present when TIPS are owned outright.

Can we tell you more?

TIPS are not the only inflation-fighter to consider for one's portfolio. Dividend-paying stocks or commodities are alternatives favored by some investors, for example.

If you would like a second opinion about your portfolio management strategies, we would be pleased to share our expertise with you. Just call on us! ☐

Tax shares

On June 28, the nonpartisan Congressional Joint Committee on Taxation released an overview of the federal tax system (https://www.jct.gov/publications/2022/jcx-14-2022/). The appendices were the most interesting part of the report.

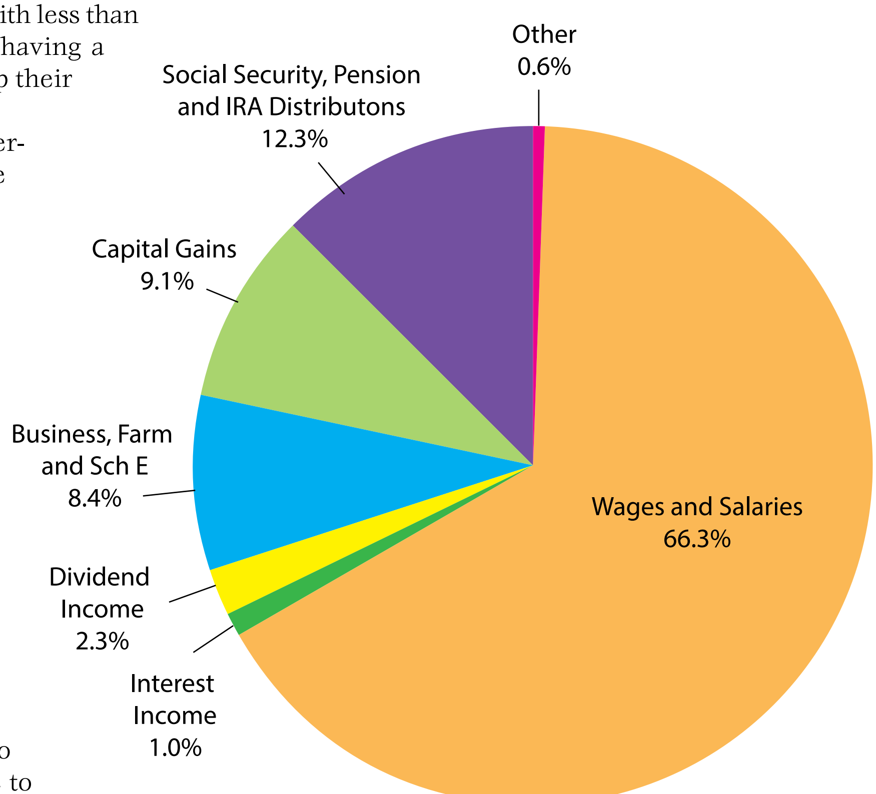
For example, in 2021 estate and gift tax collections reached $27 billion, the highest that figure has been since 2008 ($28 billion). Although that may sound like a lot of money, it was only 0.7% of total federal collections, barely a rounding error. Estate and gift taxes have always been the smallest federal revenue stream. In 1972 they were 2.6% of total federal revenue, and the share has never been higher. Since 2009 it has never exceeded 1.0%.

Income taxes are mostly paid by the very rich. The top 1.5% of taxpayers, some 2,752 total, accounted for 51.8% of all federal income tax paid. Those with less than $50,000 in income scored in the report as having a negative income tax rate, because as a group their tax credits exceeded their liabilities.

But income taxes are only 54.2% of federal tax receipts, and the next biggest share (30.3%) comes from social insurance taxes. The burden for these taxes is quite different. Here the top 1.5% pay only 9.5% of the total. Those earning $100,000 to $200,000 provide nearly a third of social insurance tax payments. Expanding the group to include those from $50,000 to $200,000 accounts for 54.6% of such tax payments.

In 2010 the income tax accounted for only 41.5% of federal tax receipts, and social insurance 40.0%. Since then the government has increased its dependence on income taxes while holding social insurance taxes steady, so that now there is more than a 20-point gap in their relative shares. Corporate taxes began the century at 10.2% of federal receipts, fell to 7.6% as the dot-com bubble burst, then rose to 14.4% in 2006 before falling down to 6.6% in the Great Recession. The current share of 9.2% is about average for this century. Federal taxes as a percentage of gross domestic product came to 18.1% in 2021, a recovery from the 16.3% in the pandemic year of 2020. The long-term average since 1952 for federal taxation has been 17.3%, so current taxation levels are above average. The high water mark of 20.0% was set in 2000, just before the internet bubble collapsed.

The report also projected the sources of income for individual taxpayers for 2022. Interestingly, distributions from pensions, IRAs, and Social Security benefits will be larger than total realized capital gains, and nearly equal to capital gains plus dividends plus interest. See the graph below for details. ☐



Source: Joint Committee on Taxation (JCX 14-2022)

More time to claim a tax benefit

For Americans who die in 2022, the amount exempt from the federal estate tax is generally $12,060,000. Each partner in a marriage has an exemption, so a married couple could have a total exemption of $24,120,000 should they both die this year. What's more, this tax benefit is now portable, that is, any part of the exemption not used at the death of a spouse may be inherited by the survivor, to be used in future years.

Simplified example. Married couple John and Mary are worth $20 million. When John dies in 2022, he leaves his entire estate to Mary outright. That transfer is shielded from the estate tax by the marital deduction, so John has used none of the federal exemption amount. Mary inherits his Deceased Spousal Unused Exclusion (DSUE) of $12,060,000, which her estate may use in future years to reduce her estate tax liability. Or she could use it to avoid gift taxes on large lifetime property transfers.

But there is a catch: One has to ask for the DSUE to receive it—it's not automatic. There's only one way to claim the DSUE, and that is by filing an estate tax return for the first spouse to die, even though no tax will be due.

This point has been frequently overlooked. When the oversight is later discovered, some estates have asked the IRS via a private letter ruling for permission to file a very late estate tax return so as to claim the DSUE. The IRS has taken a very taxpayer-friendly posture on this question. For estates smaller than the filing threshold ($12,060,000 in 2022) the Service has granted the extension of time. With larger estates, the tax code does not give the IRS the same flexibility.

So many people were filing these private ruling requests that in 2017 the IRS announced that smaller estates that asked for the extension within two years of death would automatically get a favorable response, and did not need to go to the expense of a private ruling. However, that change did not make a big enough dent in the flood of requests. Recently the IRS extended the deadline to five years following the death of the spouse. The estate tax return must say on page 1:

"FILED PURSUANT TO REV. PROC. 2022-32 TO ELECT PORTABILITY UNDER §2010(c)(5)(A)."

Why have so many estates realized belatedly that they have this issue? The fact that stock prices were, until this year, appreciating very nicely may have grown some estates into taxable territory, triggering the need for a DSUE. Also, the amount exempt from federal estate tax is scheduled to fall roughly in half in 2026 under current law. That change will not affect a DSUE secured in an earlier year. ☐