CRANBROOK

7 Year-End Charitable Strategies in a Time of Inflation and Uncertainty

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Do you remember any of the following?

- Lines at gas stations that often circled around an entire block
- Home mortgage rates in the double digits, as high as 16%
- Pins reading WIN (Whip Inflation Now) that were worn on very, very wide lapels

If so, then you lived through the 1970s and early 1980s when the United States experienced a prolonged period of double-digit inflation. Fortunately, high inflation rates have not been an issue for Americans to worry about for most of the past 40 years. Unfortunately, recent events have resulted in a rise in the rate of inflation; however, current inflation rates are not as high as those experienced in the 1970s.

As a result, inflation has reappeared as a topic of conversation in many circles and as a consideration for financial and tax planning. Even if you lived through the 1970s, you may not remember specific details about how inflation impacts your financial health.

Inflation will undoubtedly be a consideration as you engage in year-end tax planning this year. Several other domestic and global events have created additional economic uncertainty that will also impact your year-end tax planning.

This brochure will provide you with:

- A primer on inflation.
- Seven year-end planning strategies that you can employ in a period of higher inflation and economic uncertainty.

Inflation: A Quick Review

Inflation has many facets that are important to be aware of. Space does not permit an in-depth examination of the various economic theories and details of inflation; however, this article will provide you with a good basis on the topic that you can build upon through additional research and reading.

What is inflation?

Economists define inflation as the rate of decline in the value of a nation's currency and the resulting rise in the cost of goods and services. In layperson's terms, it is the loss of purchasing power of a dollar over time or the increase in the cost of products over time.

The financial media website Investopedia explains inflation through the change in the price of a cup of coffee. In 1970 a cup of coffee cost $0.25, and 49 years later that same cup of coffee cost $1.59.

Inflation is measured by a variety of indexes such as:

- **Consumer Price Index (CPI)** which measures the prices of a basket of goods that are purchased by individual consumers such as food, gasoline, and clothing
- **Personal Consumption Expenditures Index (PCE)** which measures items that people consume but do not pay for directly, such as health care that insurance and government programs partially pay for
- **Wholesale Price Index (WPI)** which measures the cost of materials that are in the production stage to eventually become consumer goods, such as the price of cotton or steel
- **Lesser Used Indexes Include the Consumer Price Index for All Urban Consumers (CPI-U)** which measures the buying habits of those living in urban areas and the Higher Education Price Index (HEPI) which measures the costs of attending college

"Shadow inflation" occurs when providers of goods and services reduce the amount of what they provide but do not lower the cost of the goods or services. For example, you have a recipe that calls for a 16 oz. can of beans but can find only 15½ oz. cans of beans in the store, which cost the same as the old 16 oz. cans did. Or you notice that the size of the pancakes you crave from your favorite breakfast shop are much smaller than they used to be, yet their cost remains the same. It is virtually impossible for economists to measure these subtle, consumer level changes. But they are an impact of inflation that each of us experiences.

What causes inflation?

There are three basic components that drive a country's inflation rate:

1. Production costs
2. Consumer demand
3. Governmental monetary policy

The rise in cost of raw materials used in production, including oil, can be the catalyst for higher inflation. For example, higher gas prices make it more expensive to deliver raw peanuts to a peanut butter factory, and a poor growing season results in less peanuts being available—which also leads to higher peanut prices. Those increases in the cost of production are passed along to the consumer in the form of increased cost for a jar of peanut butter.

Consumer demand for a particular good or service can exceed industry's ability to produce enough of that good to meet the demand. Under the basic economic law of supply and demand, when demand is greater than supply, the cost of the demanded good rises. For example, when the initial members of the Baby Boom generation entered their 50s, many of them turned to yard and garden work as a hobby. This placed increased demand on the supply of garden hoses. While it was easy to increase the production of rubber hoses, there were very few suppliers of the brass couplings for the ends of the hose. Demand for the brass couplings exceeded the manufacturers' ability to supply them. As a result, the cost of the brass couplings increased—resulting in an increase in the cost of a garden hose.

The Federal Reserve and the central bankers in other countries are responsible for controlling the size and rate of growth of the money supply. This is known as monetary policy. Increases in the nation's money supply are the foundations of inflation. The Fed's monetary policy goals are moderate long-term interest rates, price stability, and maximum employment. It then can "heat up" or "cool down" the economy from time to time to achieve these goals.

Is inflation bad?

As stated on the previous page, one of the three components of inflation is governmental monetary policy. A certain, minimal amount of inflation is necessary for the economy to thrive and expand over time. The Federal Reserve attempts to maintain an annual inflation rate of 2%. So, a small amount of inflation is good.

However, rapid increases in the price of goods and services are disruptive to the economy and to individual consumers and businesses. On the other hand, moderate inflation can be seen as both a benefit and a detriment. For example, moderate inflation is often considered good for borrowers of fixed-rate loans but bad for the lenders of those same loans.

Inflation presents what can best be described as a Goldilocks Paradox. Inflation that is too high is bad; inflation that is too low is bad; but inflation that is just right is good.

Why did inflation suddenly jump this year?

While COVID-19 is not solely responsible for this year's inflationary jump, the steps taken to fight the global pandemic have set the stage for it. Consider the three components of inflation and what has happened this year to each of them.

1. **Production Costs:** A near-universal response to the pandemic was to shut down workplaces or at least to slow them down. Factories produced less component materials and finished products, which resulted in less goods for purchase by consumers. Supply chains were interrupted because there were not enough workers to process the movement of goods through the system. The combination of these factors limited the supply of goods, which drove up their costs rapidly.

2. **Consumer Demand:** Most Americans spent a considerable amount of time "sheltering in place" during the pandemic. This resulted in near-record amounts of savings. In addition, the federal government provided stimulus checks to families. These factors provided consumers with a great deal of cash to spend. As a result, demand for many goods rose sharply (consider home exercise equipment and cooking supplies). This increased demand exceeded the supply of certain goods, which drove up prices.

3. **Governmental Monetary Policy:** The Federal Reserve employed a few strategies to keep the economy moving during the pandemic. For example, it employed the strategy of "quantitative easing," which is the purchase of large amounts of government and corporate bonds and sometimes publicly traded stocks. The intended outcome from this strategy is to increase the amount of money in circulation, which lowers interest rates for borrowers who use these funds to grow their businesses. This increased amount of money in the economy is another factor increasing inflation rates.

Are we returning to the inflation rates of the 1970s?

The short answer is "likely not." The fundamental causes of inflation in the 1970s were unique to that time. Among those causes were taking the U.S. dollar off of the gold standard, a series of wage and price freezes that had the net result of reducing the supply of goods, particularly meat, and two significant interruptions of oil exports from the Middle East to the U.S. (the OPEC oil embargo of 1973 and the Iranian revolution of 1979).

Most economists view the disruptions caused by the COVID pandemic that fueled this year's jump in inflation as transitory occurrences. In addition, factors such as an aging population and the increase of wealth and income disparity, which have helped keep inflation at the proper level for many years, have not changed.

One item to keep an eye on is consumer expectations. In the 1970s people expected a high level of inflation and demanded higher wages, which helped perpetuate the higher rates of inflation. Over the past 20 years, consumers have come to rely upon reasonably stable prices. This continuing belief can help quiet down the rate of inflation.

1 Take Advantage of Your Gains

One of the sectors that has helped fuel this year's higher inflation rate is residential real estate. Many parts of the country report a prolonged "seller's market" where new listings last only a matter of days before a buyer makes an offer. In addition, corporate speculators are contacting homeowners who are not selling and making extremely large cash offers.

Example: Bill and Ida are both aged 67 and are contemplating the next steps in their journey. They will be able to retire comfortably and look forward to remaining in their longtime home to pursue several of their hobbies. They purchased their home 30 years ago for $245,000, and they learned about a year ago that it was worth $375,000.

However, the recent run-up in the real estate market has them reconsidering their plans. "Can we afford not to take the $525,000 that our next-door neighbor just received?" "If we choose to stay, will we rue this decision in a few years?" "How will all of this impact our desire to use our home to make a significant gift to our favorite charity when we die?"

After consulting with their advisors, including a charitable gift planner from their favorite charity, Bill and Ida decide to use a charitable giving technique known as a retained life estate. Their attorney simply drafts a deed transferring their home to their favorite charity while reserving a life estate for both of their lives in their home. Bill and Ida are aware that they are responsible for the entirety of the maintenance and upkeep costs on their home as long as they live there. Upon their deaths, the title to the home will go to their favorite charity.

Given the rise in the value of their home, Bill and Ida will receive an income-tax charitable deduction based on that new, higher value as determined by a qualified appraisal. The IRS formula for calculating the deduction for a retained life estate gift determines that they will receive an income-tax deduction of $189,313, and they will avoid any capital-gain tax on the transfer. Due to the $250,000 capital-gain exclusion for the transfer of a primary residence, their capital gain is only $30,000. In their 32% income-tax and 15% capital-gain tax brackets, they will achieve a total tax savings of $65,080 for this gift.

Through this gift they will have achieved the goals of continuing to live in the cherished home, taking advantage of the sharp increase in its value, and guaranteeing a generous gift to their favorite charity.

2 Conquer "Psychic Bearishness"

From 2009 to 2020, the United States stock market achieved the longest-running bull market in its history resulting in total market growth in excess of 400%. The COVID pandemic halted this unprecedented bull market, but the market came roaring back—reaching its all-time high in January 2022. But the market has fallen back a bit from those record highs as of this writing.

Many investors tend to judge their portfolios against the highest point it attained. Anything below that is viewed as a potential loss, even if they still have a large amount of gain in their portfolio. This concept is called "psychic bearishness." You feel as if your portfolio is down, when, in fact, it is actually up.

Example: Dan invested $5,000 in Apple stock in 2012 at $40 per share. A mere ten years later his investment is valued at $92,000 due to market appreciation and stock splits, a 1,740% increase.

At its high in early 2022, Dan's Apple stock was valued at $182 per share. Its current value is $145. Dan is disappointed with the current value and worries that he has "lost" money. After deeper consideration, he overcomes his psychic bearishness by realizing that he has a $105 per share gain in his Apple stock and that it has done very well indeed.

Dan wishes to retain all of his Apple stock in his portfolio, and he wishes to make a generous gift to his favorite charity. He was considering writing a $25,000 check when his charity's gift-planning officer suggested that he give a few shares of Apple stock instead so that he could benefit from an additional tax break by avoiding capital-gain tax on the transfer.

Dan would implement this plan by donating $25,000 of Apple stock to his favorite charity and then use the cash he was intending to donate to the charity to purchase additional shares of Apple stock.

By doing this, Dan receives the following benefits:

- A $25,000 income-tax charitable deduction based on the value of the Apple stock on the date it was donated
- Avoiding the $105 per share capital-gain recognition on the stock transfer
- His income tax savings will be $8,000 at his 32% bracket, and his 15% capital-gain tax rate will save an additional $2,716 (15% of his $18,107 capital gain) for a total tax savings of $10,716. This makes the net cost of his gift only $14,284
- He replenishes his Apple stock and significantly increases his cost basis in the newly purchased shares, which will assist with other financial planning in the future
- He has the satisfaction of making a generous gift to his favorite charity and maximizing the tax benefits from it

3 Harvest Your Losses

Stocks of companies in various sectors react differently to changes in economic circumstances. The economic uncertainty brought on by the COVID pandemic caused stocks in certain sectors to fall in value, while other sectors saw values rise.

If you own stocks that have fallen in value below what you paid for them, you can employ a strategy known as "tax-loss harvesting" to create tax savings for yourself.

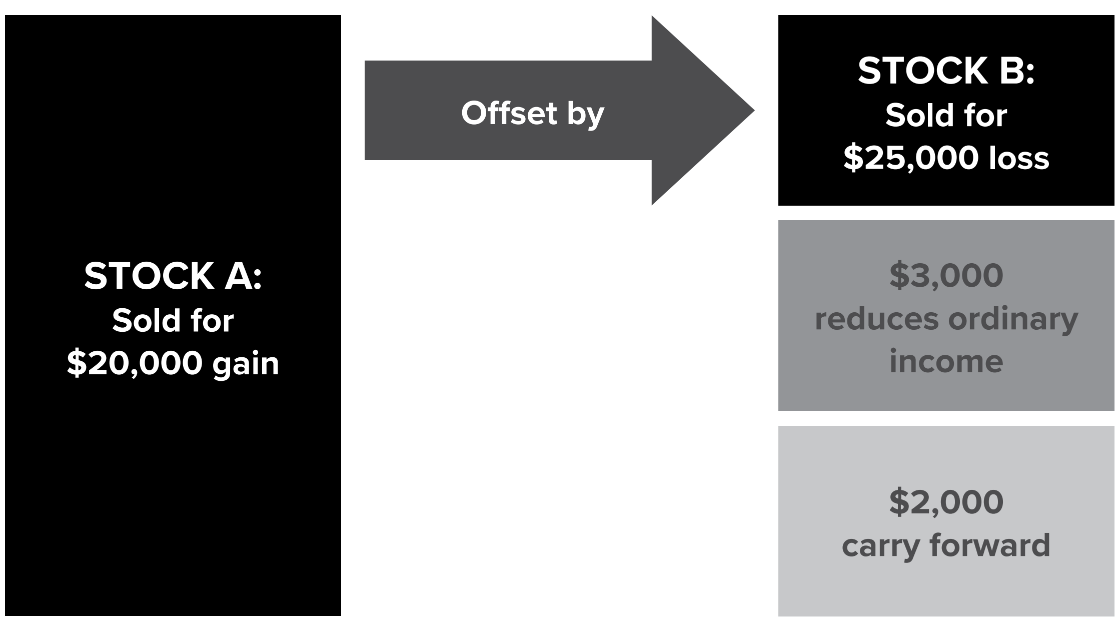
Example: Pamela is a very savvy investor. She holds a diversified portfolio of stocks and tracks it daily. As a result of the economic circumstances brought on by the pandemic, a portion of her tech stocks show a capital gain of $20,000 while a portion of her stocks in heavy industries show a $25,000 capital loss.

To harvest her loss, she sells both the tech stocks and the heavy industry stocks. Her $25,000 loss offsets her $20,000 gain, so she will not have to pay any capital-gain tax on the sale of the tech stocks. At her 15% capital-gain tax bracket, this saves her $3,000 in capital-gain tax.

Pamela receives an additional benefit from this transaction. Because her capital loss exceeded her capital gain, she is permitted to use the excess losses to offset up to $1,500 of her ordinary taxable income (married couples can offset up to $3,000 of ordinary income). At her 35% income-tax bracket, she can potentially save $525 of income tax.

Her total tax savings is then $3,525 ($3,000 capital gain + $525 ordinary income). In addition, she can carry forward the additional $2,000 of capital loss into next year to offset income on that year's tax return.

Pamela then reinvests both the proceeds of her stock sales and her tax savings into her diversified portfolio, being careful not to reinvest in any of the stocks she sold at a loss for 30 days to avoid the IRS wash-sale rule. The wash-sale rule states that if you sell a stock at a loss, you cannot purchase the same stock, or a substantially identical stock, within 30 days before or after the sale. If you violate this rule, you will not be able to recognize the loss on the sale.



4 Turn Your Savings Bonds and CDs into Income Producers

Many people hold U.S. savings bonds and certificates of deposit in their portfolios as a safety net because their returns are fixed and guaranteed. Their value does not decline when the stock market goes down.

While their principal value is fixed, they do not provide any spendable annual interest or dividends. Any interest earned is part of the amount returned when the holder cashes them in.

In an era of inflation, additional cash flow can be important to meet the rising costs of goods and services. There is a method for charitably inclined people to turn their U.S. savings bonds and certificates of deposit into income-producing assets.

Example: Judy has always maintained nearly a quarter of her portfolio in CDs and U.S. savings bonds as a safe, secure hedge against market instability and as an emergency fund. Neither of those instruments pays her any interest on an annual basis, and both earn minuscule amounts of interest that she will not realize until she cashes them in.

She would like to increase her income, and, at the age of 76, she has realized that she does not need as much of an emergency fund as she once thought. Judy has a $50,000 CD maturing soon. Rather than rolling it over into a new CD, she takes the proceeds and donates them to our organization in exchange for a charitable gift annuity. A charitable gift annuity is a contract under which a charitable organization, in exchange for cash or other property, agrees to pay a fixed sum of money for a period measured by one or two lives.

Judy will receive an income-tax charitable deduction of $26,843, and the gift annuity payment of 5.6% is about 3% more than what a new CD would return. In addition, her annual income goes from $-0- to $2,800, of which $1,963 will be tax-free. This income is guaranteed for her lifetime, and she will make a substantial gift to our organization.

She could achieve a similar outcome by cashing in one or more of her U.S. savings bonds and donating them to our organization in exchange for a charitable gift annuity. When cashing in U.S. savings bonds, Judy must remember that the accumulated interest that she earned on her savings bonds is subject to federal income tax when she redeems the savings bonds.

5 Take Advantage of Giving Options from Your IRA

Retirement-plan assets are one of largest assets in many people's estates. The historic gains in the stock market over the past decade have provided larger balances than people would have ever anticipated. Your IRA provides two tax-efficient ways for you to make charitable gifts.

Qualified Charitable Distribution: Some commentators call this the "IRA charitable rollover," but the official name is a "qualified charitable distribution" (QCD) from an IRA. This gift can be made from either a traditional or Roth IRA.

There are specific rules that you must follow in order for this to qualify. First, you must be aged 70½ or older at the time of the gift. Second, your IRA administrator must make the transfer directly to the charitable organization. Third, you can give up to $100,000 per year, and your spouse can also give up to $100,000 from his or her IRA. Finally, you can make a QCD only to a "public charity" such as a university, a hospital, your church, or other similar nonprofits. You cannot make a QCD to a private foundation, a donor-advised fund, or a charitable remainder trust or gift annuity.

It is quite simple to make a QCD. Ask your IRA administrator for their QCD form and any related procedures. Alert the charity to be on the lookout for this gift from your IRA administrator because some administrators do not put your name on the distribution check. If you have an IRA checking account, you can write a check to the charity and send it directly to them.

There are multiple benefits to you for making a QCD gift. The QCD is removed from your IRA without you claiming it as income. If you are 72 or older, your QCD gift can satisfy some or all of your required minimum distribution (RMD). If you are not required to take an RMD, you can still make a QCD gift. QCDs are the functional equivalent of a 100% charitable deduction whether or not you itemize your deductions. Please note that if you do itemize your deductions, you cannot take an additional charitable deduction for your QCD gift. Finally, QCD gifts can be directed to a specific program at your favorite charity.

Estate Gifts from Your IRA: It is easy to assume that your IRA is a good asset to give to your children and other loved ones. Unfortunately, that assumption is incorrect.

Your loved ones will be required to pay income tax on any amount they receive from your IRA following your death. Combining federal and state income-tax liabilities, your loved ones could end up with as little as 49 cents on the dollar. However, a charitable organization will not have to pay any of those taxes.

6 Utilize Your Cryptocurrency for Good

Cryptocurrency was introduced to the market in 2009. In a little more than a decade, the cryptocurrency market is valued in excess of $2 trillion.

Today it is almost impossible to turn on your television or look at something on the internet without being bombarded by commercials featuring a famous actor or athlete hawking one of the numerous cryptocurrency trading platforms. What was once viewed as foreign, and even dangerous, by traditional investors has become quite mainstream.

Legally, cryptocurrency is considered to be “property,” and the IRS has determined that it is to be treated like a capital asset—such as securities and real estate. As a result, capital-gain tax must be paid when cryptocurrency held longer than one year is sold for a profit.

Given the rise in value of the cryptocurrency market, many crypto investors are examining whether they can use their highly appreciated crypto holdings to fulfill their philanthropic goals. Some charities will accept cryptocurrencies directly, and several third-party foundations will accept cryptocurrencies on behalf of charities that do not accept them.

Example: Frank and Ellie decided to take the crypto plunge six years ago. They cautiously invested $5,000 into a cryptocurrency which purchased 7.6 crypto coins. Despite a roller coaster of valuation fluctuations over the years, today that investment is valued at approximately $228,000.

They would like to use some of this gain to make a generous contribution to their favorite charity. Unfortunately, their favorite charity does not have the infrastructure to accept gifts of cryptocurrencies. A gift-planning officer from the charity assisted Frank and Ellie in finding a charitable foundation that would accept the cryptocurrency on behalf of the charity. This charitable foundation will liquidate the cryptocurrency as soon as it receives it and then transfer the sales proceeds, minus a small fee, to the charity.

Like the charitable gift of any capital asset, Frank and Ellie’s crypto donation entitles them to an income-tax charitable deduction for the fair-market value of the cryptocurrency on the date of their gift. There is no IRS-accepted market to determine the value of the cryptocurrency, like there is for stocks and bonds.

Therefore, Frank and Ellie must obtain a qualified appraisal in order to determine the value of their gift.

The requirements to be a qualified appraiser in the eyes of the IRS are strict. As a result, there are currently very few qualified appraisers for cryptocurrency; but Frank and Ellie were able to find one with the assistance of their gift-planning officer and their financial advisor.

Despite these challenges, Frank and Ellie were quite pleased to make a substantial gift from their “wise” investment.

OPTION 1

OPTION 2

7 Follow Your Best Thinking

No matter the circumstances of the larger economy, some people are comfortable with risk and remain aggressive in their investment decisions while others are risk averse and make conservative choices for their portfolios. A third group is moderately risk tolerant and move their portfolios according to the state of the economy.

Whatever the level of your investment risk tolerance, charitably minded people have a giving option that will provide them with additional income within the boundaries of their individual risk tolerance. This option is called the charitable remainder trust (CRT). CRTs can be established in one of two varieties, the charitable remainder annuity trust (CRAT) or the charitable remainder unitrust (CRUT).

Example: Jack and Jacqueline are twins who were born 70 years ago. They both enjoyed successful careers, Jacqueline as a college professor and Jack as a high school mathematics teacher. While both have comfortable retirement incomes, they both are concerned about the impacts of higher inflation on their incomes and what they will be able to afford in the future.

When their mother died last year, her estate provided generous distributions to both of them. Jack and Jacqueline each wish to honor their parents for providing them with a solid family bond by creating a scholarship in their parents' names at their alma mater. Given their concern about the purchasing power of their retirement incomes in the future, the CRT appeals to them because it allows them to accomplish both their philanthropic goal and a financial goal.

They decide to each make a gift of $250,000 to fund matching one-life CRTs that will pay them annual income. Upon each of their death's, the principal of their CRT will go to their parents' alma mater to create the endowed scholarship fund.

Jack, being the more conservative of the two, chooses to fund a CRAT that will provide him with a fixed income for the rest of his life. The CRAT will pay him 5% of $250,000 ($12,500) each year for the rest of his life. His payments will not fluctuate. This provides Jack with the certainty that he desires as he looks forward to his future income.

Jacqueline has always been the more adventuresome of the two, never finding a challenge that was too big to take on. This attitude continues in her financial life, and she is willing to take reasonable risks with her investments. As a result, she chooses to create a CRUT with her gift. In year one, her CRUT will pay her 5% of $250,000 ($12,500), just like Jack's CRAT.

However, beginning with year two, her income is likely to fluctuate. The trustee of Jacqueline's CRUT must determine the value of the CRUT's assets on the first business day of January each year. She will then receive 5% of the new value for that year.

Let's suppose that the value of Jacqueline's CRUT rises to $260,000 in January of year two. Jacqueline will receive 5% of that amount ($13,000) for that year. Let's further suppose that the market produces poor returns during year two so that the value of her CRUT in January of year three is only $248,000. In year three, Jacqueline will receive 5% of that amount ($12,400).

Jacqueline has full faith and confidence that the market will be on a general rise over time so that her CRUT payments will continue to rise along with the market.

It is also important that Jack and Jacqueline work with a gift planner at their parents' alma mater to establish a fund with the parameters that they wish. This ensures that their charitable intentions can and will be put into place upon their deaths.

Here are the tax benefits to Jack and Jacqueline for establishing their CRTs:

	Jack CRAT	Jacqueline CRUT
Age	70	70
Gift amount	$250,000	$250,000
Charitable deduction	$118,483	$131,468
Capital-gain tax due if CRT is funded with appreciated property	$0	$0
Annual payment amount	5% fixed	5% payments vary with annual CRUT valuation

We Can Help You Navigate These Uncertain Times

The first step is often the most difficult in exploring whether any of these strategies fit within your estate, financial, and philanthropic plans.

We would be honored to assist you in taking that first step and to partner with your advisors to determine the best course of action. Please contact us if you would like to begin a no-obligation conversation.

Photo by Colton Graub CK'13

Kristin A. Hermann, J.D., CFRE
Cranbrook Educational Community
Office of Advancement
P.O. Box 801
Bloomfield Hills, MI 48303-0801
cranbrook.giftplans.org
cranbrook.edu