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May 2023

New investment realities

Steps to steady your portfolio

Today's economy seems packed with difficult problems. The severe hardship of economic closures during the pandemic was followed by widespread supply chain bottlenecks upon the reopening. The resulting price spikes were thought, at first, to be part of an inevitable transition back to normal, but that proved not to be the case. Inflation has been stubborn, and at times at levels not seen in more than a generation. The Federal Reserve has raised interest rates at the fastest clip in its history.

Unfortunately, raising interest rates inevitably reduces the market value of bonds. That's just how the math works. Those who can hold the bonds to maturity do not suffer any losses, but those who must liquidate early will have to recognize the value decline. That has weakened the underpinnings of many financial firms, and 2023 has already seen the second and third largest bank failures in U.S. history.

During the pandemic, the phenomenon of remote work took hold. At many firms, remote work has been fairly successful, and some employees have been reluctant to return to the commut-

ing grind. Bottom line, commercial vacancies have spiked in downtowns around the country. According to a recent *Wall Street Journal* article, a prestigious building in San Francisco that was valued at \$300 million in 2019 is looking for a buyer, but has lost most of its tenants. The projected selling price is in the \$60 million neighborhood—an 80% markdown.

San Francisco may be a special case, but there can be no doubt that commercial real estate values are under pressure.

Stocks and bonds have been on a roller-coaster ride during this volatile economy. After suffering a 4.38% loss in 2018, the large company stocks represented by the S&P 500 grew by 31.49% in 2019 and 28.71% in 2021 (including dividends), as the worst effects of the pandemic receded. But then inflation proved not to be transitional, and the Federal Reserve was forced to act. Stocks lost

18.11% in 2022, and long-term government bonds lost an eye-watering 26.08%! Here is more detail on the performance of the indices:

Recent total returns, stocks and bonds

Year	Large-cap stocks	Long-term government bonds
2018	-4.38%	-0.57%
2019	31.49%	12.16%
2020	18.40%	16.65%
2021	28.71%	-5.41%
2022	-18.11%	-26.08%

Source: M.A. Co.; Kroll 2023 SBBI Yearbook

Balancing act

To avoid the extremes of one asset class or another, one needs to employ an asset allocation strategy for smoothing portfolio performance.

Some of the riskiness of an investment portfolio can be mitigated in this fashion. Here are the returns of various mixes of stocks and bonds in the last five years.

Continued on next page



The question of balance

Year	70% stocks, 30% bonds	50% stocks, 50% bonds	30% stocks, 70% bonds
2018	-2.84%	-2.00%	-1.31%
2019	25.93%	22.09%	18.16%
2020	19.16%	19.04%	18.43%
2021	17.64%	10.67%	4.01%
2022	-20.27%	-21.83%	-23.47%

Source: M.A. Co.; Kroll 2023 SBBI Yearbook

As you can see, during this anomalous period, stocks and bonds have not counterbalanced each other, rather they have moved in parallel. But an asset allocation plan will employ many more than two asset classes. The historical performance of the asset classes is the starting point, then the degree to which the classes move in sync or not is determined mathematically. With these coefficients in hand, the portfolio may be optimized. That means expected performance may be maximized for a given level of acceptable investment risk. Alternatively, risk may be minimized for a target level of return.

We can help

Unbiased investment management is an integral part of our service as a trustee, but you don't need to fund a trust to be able to call upon our professional expertise. We manage investment portfolios for a fee for individuals and families in a wide variety of situations.

This month, why not schedule a meeting with us to learn more? □



Market volatility in retirement

As difficult as jumpy markets are for savers, they can be even more ominous for retirees. Imagine a soon-to-be retiree who has a \$500,000 portfolio from which he or she will need to draw \$25,000 annually. That's just 5%. How long will the money last? The answer depends on whether your retirement starts in a bull or bear market.

In a bull market, as the table below of hypothetical returns shows, the retirement money will continue to grow in the early years, despite the withdrawals. The fund is better cushioned for setbacks that occur later.

Retire in a bull market

Year	Return	Withdrawal	Value
			\$500,000
1	25%	\$25,000	\$600,000
2	18%	\$25,000	\$683,000
3	8%	\$25,000	\$712,640
4	12%	\$25,000	\$773,157
5	10%	\$25,000	\$825,472
6	3%	\$25,000	\$825,237
7	8%	\$25,000	\$866,256
8	-2%	\$25,000	\$823,930
9	-4%	\$25,000	\$765,973
10	-28%	\$25,000	\$526,501

Source: M.A. Co.

Although that loss of 28% in the tenth year was severe, it did not bring the fund below where it was when retirement started. But if we reverse the sequence of returns, the result is very different.

Retire in a bear market

Year	Return	Withdrawal	Value
			\$500,000
1	-28%	\$25,000	\$335,000
2	-4%	\$25,000	\$296,600
3	-2%	\$25,000	\$265,668
4	8%	\$25,000	\$261,921
5	3%	\$25,000	\$244,779
6	10%	\$25,000	\$244,257
7	12%	\$25,000	\$248,568
8	8%	\$25,000	\$243,453
9	18%	\$25,000	\$262,275
10	25%	\$25,000	\$302,844

Source: M.A. Co.

The strong returns have a smaller base upon which to build. Accordingly, when markets are doing poorly, one may need to delay retirement or reduce spending—or work with an investment consultant who can smooth the bumps in portfolio returns.

This simplified example ignores the effects of taxes and inflation on spendable income.

Are Social Security and Medicare really fair for most taxpayers? That is, how do the benefits reaped by retirees compare to the taxes they paid throughout their careers to secure those benefits?

An updated February research report from the Urban Institute explored the data from the Social Security Administration to address those questions. Researchers compared the total career FICA taxes paid to the discounted present value of Social Security and Medicare benefits for an average retirement. Their tables show how this relationship has changed over time and project how it will change in the future.

For example, a male who turned 65 in 2020 and who earned an average wage throughout his career, \$62,600 in 2022 dollars, will have paid \$344,000 in total Social Security taxes (adjusted for inflation). His first year Social Security benefit was \$23,100, and the total retirement benefit for an average retiree in this situation will come to \$358,000. Taxes paid represent about 96% of the value of the benefits.

For those who reached age 65 in 1980, the ratio was quite different. The average wage earner paid \$111,000 in lifetime taxes for a benefit worth \$262,000—taxes covered only 42% of the benefit. That ratio was not sustainable, and thus the necessity of the changes to Social Security taxes and benefits recommended by the Greenspan Commission (higher taxes and later ages for full retirement).



Social Security: Taxes versus benefits

Medicare is another story entirely. The average wage earner who was 65 in 2020 had lifetime Medicare taxes of \$91,000, while the actuarial value of his Medicare benefits net of premiums was \$250,000! Cumulative taxes covered only 36% of the projected benefit.

The picture for top taxpayers

For the highest income taxpayers, the picture is not quite so rosy. Someone who had maximum taxable earnings throughout a career would have paid, according

to the report, \$815,000 in taxes for a total retirement benefit worth \$576,000. The first year benefit would have been \$37,300. He would have paid well over double the total taxes for a roughly 50% increase in benefits, with his taxes at 141% of the benefits. His Medicare net benefit is the same \$250,000, but he paid \$218,000 in lifetime Medicare taxes.

The table below shows the total taxes and benefits for a married couple with two average incomes, reaching age 65 at various years. The table includes the ratio of benefits to taxes, which has held fairly steady over the years. Average couples receive benefits worth about 150% of their total tax payments.

However, the better the deal looks for retirees, the sooner the trust funds will run out of money. According to the 2023 annual report of the Social Security Board of Trustees, the surplus in the Social Security trust fund will be depleted by 2034. Medicare's trust fund could go dry even earlier. □

Projected Present Value of Lifetime Social Security and Medicare Benefits and Taxes

For married couples with two average earners (\$125,200 in 2022 dollars)

Year reaching age 65	Lifetime BENEFITS			Lifetime TAXES			Ratio of benefits to taxes
	Social Security	Medicare	Total	Social Security	Medicare	Total	
2000	\$621,000	\$352,000	\$973,000	\$487,000	\$93,000	\$580,000	1.68
2010	\$715,000	\$431,000	\$1,146,000	\$611,000	\$147,000	\$758,000	1.51
2020	\$757,000	\$536,000	\$1,293,000	\$688,000	\$183,000	\$871,000	1.48
2030	\$843,000	\$703,000	\$1,546,000	\$778,000	\$212,000	\$990,000	1.56

Source: Urban Institute, "Social Security & Medicare Lifetime Benefits and Taxes: 2022" (February 2023); M.A. Co.

No attorney-client privilege for an estate plan?

Chaim Lax was a real estate developer and diamond merchant in New York City. In October 2005, the IRS began an examination of Lax's income tax returns for 2002, 2003, and 2004. Lax died in 2008. In 2009, the IRS assessed some \$60 million in taxes and penalties due from Lax's estate, primarily income tax deficiencies.

Lax's heirs took steps in 2010 that they believed would help to shield some of the family assets from the IRS. Specifically, there was an assignment for the benefit of creditors transaction, which is a business liquidation proceeding under New York state law that is offered to insolvent debtors as an alternative to bankruptcy.

The IRS won a summary judgment against the estate for some \$55 million in March 2022. Next, the Service attempted to collect the tax from Lax's adult children, who are the co-executors of his estate. To facilitate that effort, the IRS sought all communications between the executors and their law firm concerning the 2010 corporate reorganization.

The District Court held that the IRS "demonstrated probable cause that a crime or fraud was attempted or committed and that the communications with the Porzio Firm were in furtherance of that crime or fraud." The attorney-client privilege protects communications about past wrongdoing, but it does not extend such protection to possible future crimes. The law firm was ordered to answer questions put to it by the IRS regarding the transaction.

Blogs and taxes

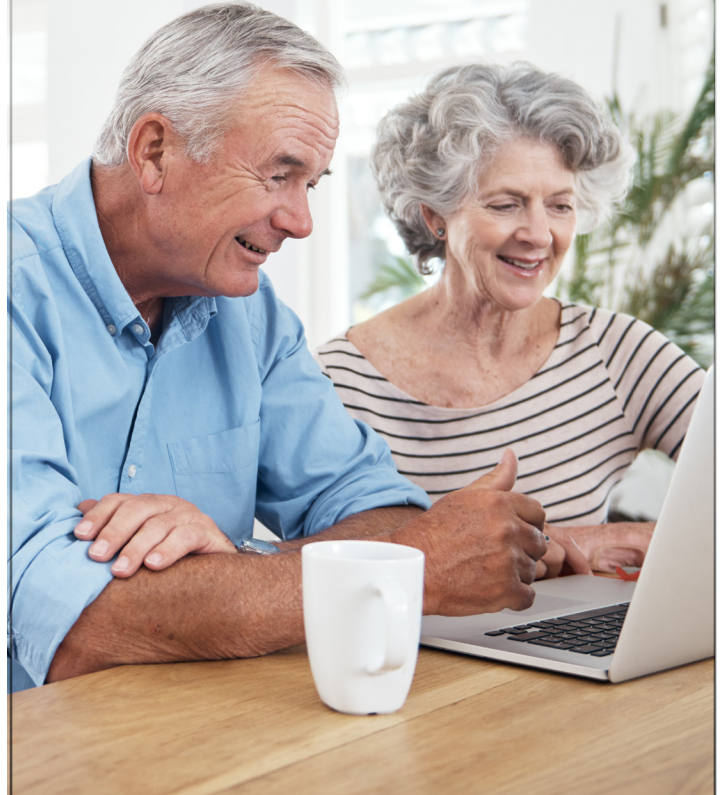
Sydney Thomas filed joint tax returns with her husband in tax years 2012, 2013, and 2014. Some of the taxes shown on those returns were never paid. Mr. Thomas died in 2016.

After her husband's death, Sydney petitioned for tax relief as an "innocent spouse." When the IRS denied that relief in 2020, Sydney turned to the Tax Court. The Tax Court reviews such cases taking into account the administrative record and any newly discovered evidence.

In the course of preparing for the Tax Court, the IRS discovered a series of Sydney's blog posts about her assets, lifestyle, businesses, and relationship with her husband. In the view of the Service, this evidence tended to undercut her claim for innocent spouse relief. Sydney asked the Tax Court to bar the introduction of the blog posts because they were not part of the administrative record and could have been discovered at any time.

The Court ruled for the IRS. There was no need for the IRS to search the internet for information about Sydney before she filed her suit in the Tax Court. Once her filing happened, the Service undertook that investigation, and what they found is newly discovered. □

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