GREENLEAF TRUST

Perspectives

A Greenleaf Trust Newsletter

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William D. Johnston
Chairman, Greenleaf Trust

And the Award Goes To... 4

Primer on the European Natural Gas Crisis 5

Estate Planning with Roth IRA Conversions 10

Rising Interest in Terminating Pension Plans 13

Planning Strategies for a Rising Rate Environment 15

Proposed Regulations for Inherited IRAs Bring Unwelcome Surprises 18

Economic Commentary

All of us experience the realization that the hands of the clock spin at greater velocity every year. The fade of winter is briefly replaced by budding tulips before the fireworks for the Fourth of July light up the summer sky. I truly love college football and can't yet imagine that we are in the ninth week of the season and that the K-Wings will soon drop the puck again to launch their 2022-2023 quest for a championship. The number of times I say to myself, "Where does the time go?" increases every year.

In 2023 at Greenleaf Trust, we will celebrate our 25th anniversary! An entrepreneurial idea that began with seven people on South Street now includes 175 team members in six cities in Michigan and one city in the state of Delaware. Depending upon how the market closes on any one particular day, we are now responsible for managing the wealth and fiduciary management needs of 1200 clients and nearly 23,000 participants in employer-sponsored retirement plans totaling around $15 billion. Sarah Johansson, our Senior Vice President and Director of Marketing, has some special plans for a 25th anniversary celebration. More to follow later on those plans.

Essential to the perpetuity needs of sustaining great business and workplace cultures is the need for succession planning that embraces our current and future leaders as well as our board of directors. As a Michigan and Delaware chartered bank, we function in a highly regulated environment and are required to achieve fiduciary standards of the highest order as specified by state and federal laws. To achieve the expected level of performance, we have assembled a wonderful board of directors who practice fiduciary governance and business guidance at a world-class level, and we remain grateful to them for their governance, advocacy, dedication and collective wisdom.

I am honored to announce to you that at our regularly scheduled October board of directors meeting, the board unanimously approved the candidacy of James L. Liggins, Jr., Esq. as a member of our Greenleaf Financial Holding Company, Greenleaf Trust of Michigan, and Greenleaf Trust of Delaware board of directors.

Economic Commentary, continued

James Liggins Jr. is a Senior Counsel at Warner Norcross and Judd and works from the Kalamazoo office in the Warner building at 180 Water Street. Prior to joining Warner, he was an attorney with Miller Canfield. He earned his B.A. from the University of Michigan and his J.D. from Michigan State University College of Law where he received the George N. Bashara Jr. Distinguished Alumni Award.

James currently serves on the Bronson Healthcare Group Board of Directors where he chairs the medical quality oversight committee. He is a member of the Michigan, Illinois and Indiana Bar. Further, James is appointed to the Michigan Bar State Board of Ethics and Judicial Qualifications Committee. Demonstrating community commitment, James is also a member of Southwest Michigan First Board of Directors and serves on the Michigan Center for Civic Education. Locally, James has served as a director for the Douglas Community Center and United Way of Kalamazoo, Battle Creek where he chaired the 2018 Annual Fund effort. James continues in his role as advisor and coordinator for the Kalamazoo Mock Trial team, which has won many high school state and national titles under his leadership. Not surprising was James' nomination and recognition as one of Michigan's Super Lawyer Rising Stars.

“… we have assembled a wonderful board of directors who practice fiduciary governance and business guidance at a world-class level, and we remain grateful to them for their governance, advocacy, dedication and collective wisdom.”

On behalf of our clients, team members, and current board of directors, we thank james for accepting the role of corporate director and look forward to working with him for many years to come. We anticipate continuing our journey of succession planning by adding an additional director to our collective board in 2023. Our current board of directors include William D. Johnston, Chairman; Ronda E. Stryker, Vice Chair; Ronald N. Kilgore, Secretary; Ronald A. Elenbaas, Barbara L. James, Michael F. Odar, Dr. Kay M. Palan, Sydney E. Parfet, David M. Thoms, and James L. Liggins, Jr.

By the time that this communication reaches you, our midterm elections will have been decided. Sanguine, by definition, is the ability to be optimistic that all will be fine in the midst of a difficult environment. I have to admit that it is difficult for me to be sanguine in anticipation of the November 8 results. Those that know me understand that I love economics, history and politics; I have loved them all my life. Academically and intellectually I have been asked to explain and teach the causation and effects of a variety of economic, historical and political events over the course of my career. The research and reading to inform myself has always been stimulating and challenging. It has been truly joyful to own that as part of my role. It has never seemed laborious or work-like, but rather is something that I have been compelled to do.

A recent poll of a major publication revealed that 40% of the population

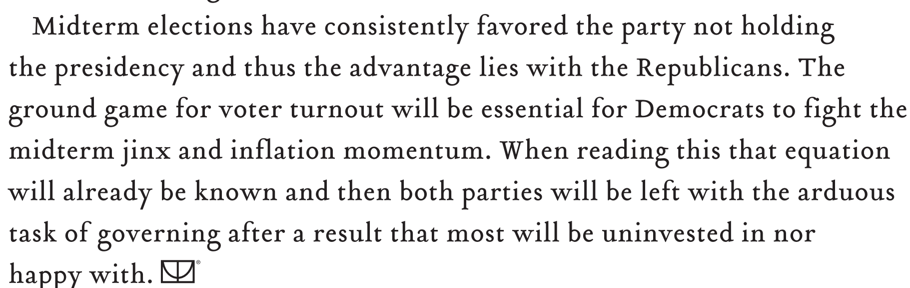
felt that there was a possibility that the United States could face a civil war in the next decade. The messages in political advertisements aired on television, leaflets and social media seem to me to be particularly targeted at fear rather than solutions or ideas. Interviews of candidates in any forum are simply regurgitations of talking points of national party politics. What relevance does blaming an opponent for inflation or immigration issues for a local school board or township commissioner position have? The thirst to achieve the perceived power of the elected positions seems to have eroded the normal reasons for serving the community and electorate. 54% of those queried in a USA Today poll felt that government is too powerful — yet parties, candidates, political action groups and donors are spending billions of dollars to be a part of what a majority say is too powerful.

It is clear through most polls that the majority of the electorate are unhappy. The list of the most important issues are clear to most. Democrats are focused upon reproductive choice, voter rights and environmental solution measures. Republicans are focused on inflation, immigration, election security and crime.

Democrats have stuck to a strategy that mirrors national polls on abortion rights, voting rights and the environment. In each of those specific areas the majority of people polled align with the Democrat's position at the state and national office level.

The vast majority of Republicans polled continue to feel aligned with their party's position on inflation, border security, crime and election security.

The two issues most likely to sway an increasingly smaller number of independent voters to either Democrat or Republican candidates are likely to be abortion rights or inflation.



Midterm elections have consistently favored the party not holding the presidency and thus the advantage lies with the Republicans. The ground game for voter turnout will be essential for Democrats to fight the midterm jinx and inflation momentum. When reading this that equation will already be known and then both parties will be left with the arduous task of governing after a result that most will be uninvested in nor happy with.

"The two issues most likely to sway an increasingly smaller number of independent voters to either Democrat or Republican candidates are likely to be abortion rights or inflation."

Michael F. Odar, CFA®
President and
Chief Executive Officer

And the Award Goes To…

Receiving an award can be quite gratifying especially if it validates your hard work on something you are passionate about. We are passionate about and work hard on our culture. The culture at Greenleaf Trust is an expression of our core values and a big part of what differentiates us in the marketplace.

Beginning in 2011, Greenleaf Trust began participating in multiple workplace culture surveys that measure our human capital practices and rank us relative to best practices and best companies. We thought we had created something unique but wanted to make sure and actually measure. It was particularly important to us that the surveys we participated in included the candid thoughts of our entire team, not just one person or leadership. Over the last 11 years, we have learned a lot about ourselves through these surveys and in the spirit of continuous improvement used that knowledge to nurture and strengthen our culture. This is extremely important as we continue to grow in numbers of teammates and expand our geographical footprint.

In 2022, we have been delighted and proud to be the recipient of several workplace culture awards including the following:

- West Michigan's Best and Brightest Iconic Award Winner
- Nation's Best and Brightest Brilliance Award
- Best and Brightest Companies to Work For Elite Winner for Employee Achievement and Recognition
- Inc. Best Workplaces List
- Crain's 100 Cool Places to Work – #6 overall, #1 in medium sized companies
- Certified Great Place to Work
- West Michigan's Best and Brightest Company to Work For
- Michigan's Best and Brightest in Wellness winner
- Metropolitan Detroit's Best and Brightest Company to Work For
- Best and Brightest Company to Work For in the Nation

These awards not only validate the hard work we put into our culture but have also helped us attract new talent. Winning a few of these awards over consecutive years stands out to potential new hires. They know we are committed to excellence and investments in them.

We like to think that these awards serve as a reflection of our passion about our corporate culture, in which dynamic, talented teammates embrace a mindset of integrity, teamwork, continuous improvement, service, and putting clients' interests first.

"Over the last 11 years, we have learned a lot about ourselves through these [workplace culture] surveys…"

Primer on the European Natural Gas Crisis

Christopher D. Burns, CFA®, CPA, CFP®
Vice President
Investment Strategist
Senior Fixed Income Analyst

Russia and Ukraine are significant producers of crude oil and natural gas commodities essential to the energy industry. The Russian invasion of Ukraine has caused significant disruptions in these energy sources, particularly for Europe. With winter around the corner, now is an appropriate time to provide a primer on the situation. This article will focus on the outlook for natural gas in Europe by providing background, a timeline of events, a summary of responses, and potential market and economic implications going forward.

Background

Focusing on sources of energy is not typical for most US consumers. We flip the light switch, or set the thermostat, and the light or heat comes on. So, here are some relevant facts that will help readers understand Europe's dilemma.

- Crude oil is a global commodity. It is relatively easy to transport, including over land by trucks.
    - ◊ This means most global purchasers of crude oil pay roughly the same amount, whether they are located in Europe or North America or elsewhere.
    - ◊ Replacing disrupted crude oil supply is achievable through crude oil tankers.
    - ◊ The primary use of oil is for transportation (i.e. gasoline).
- Natural gas is more of a regional commodity. Over land transportation is typically done by pipeline. This means that regional prices can diverge significantly.
    - ◊ Technological advances have made transporting liquified natural gas (LNG) more economical.
    - ◊ It is now possible, but is more difficult and expensive, to replace disrupted natural gas supply in many parts of the world through importing & regasification.
    - ◊ The primary uses of natural gas are to generate electricity and for heat.
- Europe is a significant importer of energy. In 2020, 58% of EU energy consumption was imported.
- Before the invasion, Russia and Ukraine were significant suppliers of crude oil and natural gas to Europe. Russia supplied 28% of imported crude oil and 45% of imported natural gas to Europe.
- Although the Eurozone has a common currency and the European Union has free movement of goods and people within member states, each government is responsible for its own energy policy.
- There are significant differences between European countries in terms

"Focusing on sources of energy is not typical for most US consumers. We flip the light switch, or set the thermostat, and the light or heat comes on."

Primer on the European Natural Gas Crisis, continued

of their reliance on energy from Russia, and their access to alternative sources of energy.

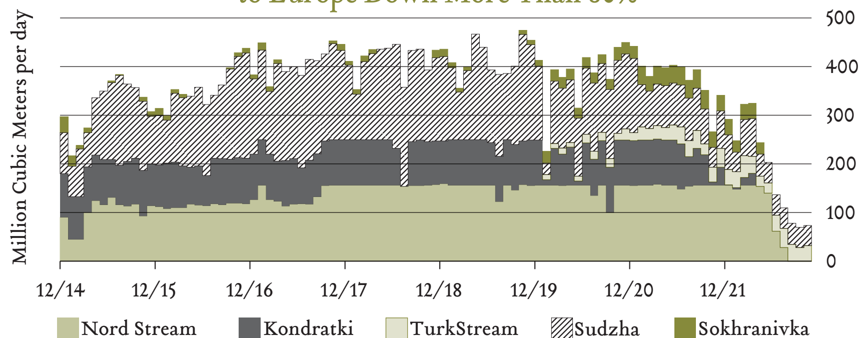
Timeline

This is a highly dynamic and complex situation. This article is being written on October 21 and by the time you read it, circumstances may have changed. Let's review the timeline of the evolving European natural gas crisis.

- February 21, Putin signs decrees recognizing independence of territories in Donetsk & Luhansk.
- February 22, German Chancellor suspends certification of the Nord Stream 2 gas pipeline from Russia.
- February 24, Russia invades Ukraine.
- February 26, the US, EU, UK, Canada, France, Germany & Italy take joint action to remove some Russian banks from the SWIFT messaging system and impose other sanctions.
- March 8, US bans import of Russian oil, LNG, and coal.
- Rest of March, G7 countries apply escalating sanctions on Russia & Russian oligarchs.
- March 31, Putin signs a decree forcing gas payments to be made in rubles.
- April 27, Russian energy company Gazprom cuts off natural gas exports to Poland and Bulgaria over their refusal to pay in rubles.
- May 21, Gazprom cuts off natural gas exports to Finland for failing to pay in rubles.
- July 27, Russian natural gas exports through Nord Stream 1 are reduced to 20% of capacity.
- September 2, G7 ministers agree on a price cap for Russian crude oil and petroleum products.
- September 2, Russia suspends natural gas shipments to Europe through the Nord Stream 1 pipeline.
- September 26, explosions damage the Nord Stream 1 pipeline under the Baltic Sea, effectively halting Russian natural gas exports to Europe, except some limited supply through Ukraine.

> "Let's review the timeline of the evolving European natural gas crisis."

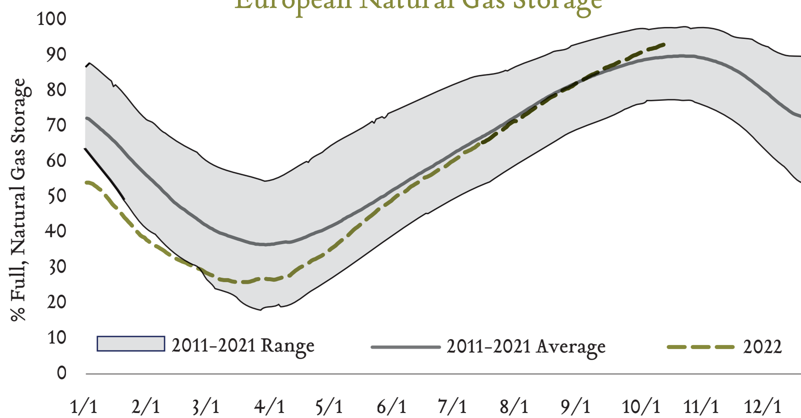
Russian & Ukranian Natural Gas Flows to Europe Down More Than 80%



Summary of Responses

The loss of a major energy supplier has caused dramatic price spikes in natural gas in Europe. In August, as Russia cut its exports through Nord Stream 1 to near zero, benchmark natural gas prices hit more than 20 times their 2016–2020 average. Imagine paying 20 times your typical monthly heating bill and you can appreciate the scale of the shock hitting Europe.

Prices remain extremely elevated, 6.5 times the historical average, but have eased recently due to the first major response from affected European countries: building natural gas storage to survive the winter months. They've done this by importing more energy from Norway, and from LNG markets like the United States and Africa.



As of this writing, these efforts have been relatively successful. Natural gas storage sits at around 93% of capacity, above the average of 89% for this time of year. At these levels of storage, Europe may be able to handle an average winter heating season without resorting to blackouts or energy rationing. If the winter is colder-than-average in Europe, or in regions that compete with Europe for LNG imports, maintaining adequate supply could become a multi-year problem.

"The loss of a major energy supplier has caused dramatic price spikes in natural gas in Europe... Imagine paying 20 times your typical monthly heating bill and you can appreciate the scale of the shock hitting Europe."

Primer on the European Natural Gas Crisis, continued

In addition to building up storage, affected governments have enacted fiscal support to blunt the impact of higher energy prices on businesses and consumers. For example, on September 29, Germany announced a 200 billion euro plan to subsidize gas costs, allowing consumers to pay 0.12 euros per kilowatt hour for the first 80% of the amount of energy they used in 2021. Across Europe, around 670 billion euros in fiscal support have been allocated to protect citizens and businesses from higher energy prices.

	Funding (Bn Euro)	% of GDP
Germany	264.2	7.4%
United Kingdom	97.0	3.5%
France	71.6	2.9%
Italy	62.6	3.5%
Netherlands	45.3	5.3%
Spain	38.5	3.2%
Poland	12.4	2.2%
Greece	10.5	5.7%
Other	65.8	1.6%
Total	667.9	3.8%

"The first and most direct impact of this energy shock has been to inflation. Several European countries are now dealing with double-digit inflation..."

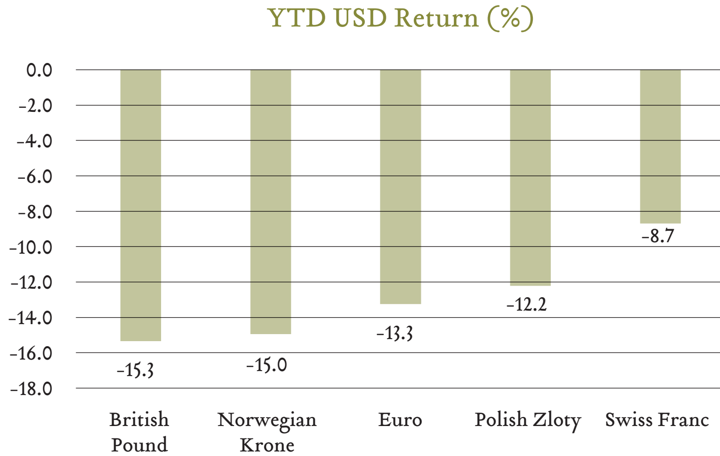
Finally, governments have also stepped in with subsidies, and in some cases, nationalization of businesses involved in the production of energy. Germany, for example, nationalized Uniper, buying it from Finland's Fortum, at a cost of around 29 billion euros. Uniper is an electric utility company and had previously been a large importer of Russian natural gas. The estimated value of credit lines, loans and bailouts total another 180 billion euros. Combined, this support is nearly equal to the amount of borrowing undertaken by the EU to navigate the COVID-19 pandemic.

Potential Economic and Market Implications

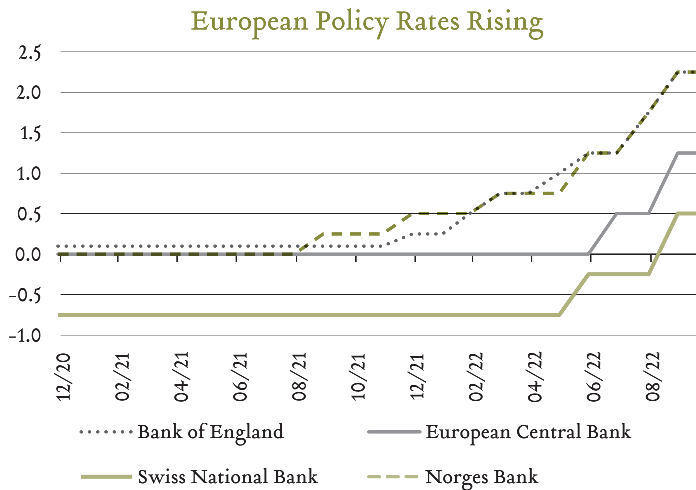
The first and most direct impact of this energy shock has been to inflation. Several European countries are now dealing with double-digit inflation, and accelerating expectations for inflation next year.

	CPI (YOY %)	2023 Consensus	YTD Change in Consensus
Eurozone	9.9%	5.5%	4.0%
Germany	10.0%	6.3%	4.6%
United Kingdom	10.1%	6.2%	4.1%
France	5.6%	4.5%	3.1%
Italy	8.9%	5.2%	4.0%
Spain	8.9%	4.5%	3.1%
Netherlands	14.5%	5.3%	3.6%
Switzerland	3.3%	2.0%	1.4%

The second major impact, arguably, has been in the currency markets. The need for additional deficit spending has contributed to a depreciation of many European currencies against the US Dollar.



Following these high levels of inflation, central banks in Europe have been moving to more restrictive monetary policy stances.



The combination of higher interest rates and higher energy costs is likely to push some European economies into recession, if they are not already there.

The final impact worth mentioning is on the prices of natural gas in other regions. LNG export markets will be key to resupplying Europe. Any disruptions to the export market could leave European governments facing difficult choices around blackouts and energy rationing. This new source of global demand will keep natural gas prices elevated in countries like the United States as well, where natural gas prices hit 10-year highs in May and August this year. It will likely be a multi-year project to rebalance the energy markets to cope with the absence of Russian supply.

"This new source of global demand will keep natural gas prices elevated in countries like the United States as well, where natural gas prices hit 10-year highs..."

Primer on the European Natural Gas Crisis, continued

Conclusion

The Russian invasion of Ukraine continues to impact the economic and investment landscape. Europe is navigating a natural gas crisis that has disrupted their economies and required significant fiscal support. The region is entering the colder winter months with strong levels of storage and a mild winter could leave them in a positive position in 2023. However, the energy markets remain a key source of risk and are likely to remain volatile in the short-term. We will continue to monitor the situation and provide updates as warranted. Thank you for the opportunity to serve on your behalf.

Sources:
Bloomberg
Reuters
Bruegel
Eurostat
Gas Infrastructure Europe
Peterson Institute for International Economics

Estate Planning with Roth IRA Conversions

George F. Bearup, J.D.
Senior Legal Trust Advisor

Often an individual will say that they are too old to engage in a Roth IRA conversion. Their fear is that the tax-free benefits of owning a Roth IRA with a shortened life expectancy will be outweighed by the up-front income tax cost that comes with the Roth conversion.

The reality is that an individual is never too old to convert their traditional IRA to a Roth IRA, despite the 'trade-off' of incurring an immediate income tax on the conversion to the Roth IRA's tax-free income. Such an individual, regardless of their age, might be more motivated to consider a Roth conversion if they view their Roth IRA as an important part of their comprehensive estate plan, a plan which they make to benefit their children and grandchildren and not for themselves.

Some of the benefits that are associated with the inheritance of a Roth IRA include:

1) A Roth conversion today eliminates the income tax bill the beneficiary will otherwise pay later when a traditional IRA is inherited. In effect, the converting IRA owner pays the income taxes, not the beneficiary of the Roth IRA. The payment of the income tax on the conversion is the equivalent of an advance gift: "I have paid your future income taxes."

2) If a traditional IRA is inherited, the beneficiary normally must take taxable distributions from that traditional IRA over 10 years. With the recently proposed SECURE Act Regulations, if the traditional IRA owner was over the age of 72 at the time of his/her death, then their beneficiary must take the taxable distributions over the next 10 years after the account owner's death.
   Instead, if a Roth IRA is inherited, the Roth IRA owner is treated as having died before attaining age 72. This means that the beneficiary who inherits a Roth IRA is not required to take annual distributions from the inherited Roth IRA. This means that the Roth IRA beneficiary can accumulate the income generated inside the Roth IRA, income tax-free, for the 10 years that follow the Roth IRA owner's death. Ten years of tax-free income is a nice asset to inherit.
3) If the IRA owner feels that the IRA should be paid to a trust instead of outright to their children or grandchildren as beneficiaries, a Roth IRA is a much better asset to direct to that trust rather than a traditional IRA. A traditional IRA that is paid to an irrevocable trust results in taxable income paid to the trust; an irrevocable trust much more quickly reaches the highest marginal federal income tax bracket than an individual. Accordingly, if the taxable income from the traditional IRA paid to the trust is accumulated inside the trust, it will be taxed at the 37% marginal federal income tax bracket once the trust's accumulated income exceeds $11,000. If a Roth IRA is made payable to the trust, there will be no bunching of income inside the trust, since distributions from Roth IRAs are all income tax-free.
4) The income taxes that traditional IRA owner pays on the conversion of their IRA to a Roth IRA will obviously deplete the size of their gross estate, i.e. the dollars used to pay the income tax liability on the conversion will disappear from their estate. If the IRA owner is concerned about federal estate tax liability [remember the currently large gift and estate tax exemption of $12.06 million is scheduled to be cut in half beginning in 2026] then the payment of the income tax liability now could reduce the potential size of the IRA owner's taxable estate at a later date.

As with any estate planning strategy, there are also some obvious cautionary remarks that need to be considered before making the decision to convert a traditional IRA to a Roth IRA.

A) A Roth IRA conversion will increase the account owner's ordinary income for the year of the conversion. This one-time increase in reported taxable income could potentially cause the IRA owner to

"... an individual, regardless of their age, might... view their Roth IRA as an important part of their comprehensive estate plan..."

lose valuable income tax credits and deductions, or possibly affect their eligibility to receive some governmental benefits that are means-based.

B) That additional increase in the account owner's reported taxable income in the year of the Roth IRA conversion could result in the taxation of the account owner's Social Security.

C) That additional increase in the account owner's reported taxable income in the year of the Roth IRA conversion could result in the increase of premiums paid for Medicare Part B and Part D premiums.

D) Since income taxes will have to be paid on the Roth IRA conversion, the account owner may have to liquidate other assets and incur a capital gain in order to create the liquidity needed to pay the income tax liability associated with the Roth conversion. It is much better to have cash on-hand to pay the tax liability caused by the conversion.

E) Traditional IRA owners age 72 and older also need to understand that their annual required minimum distribution (RMD) is not eligible for a Roth conversion. The first money that comes out of a traditional IRA is the owner's RMD for the calendar year when they are age 72. That means that the owner's RMD for the calendar year must be paid out first before the Roth IRA conversion can be completed. However, after the Roth conversion, there will be no more RMDs the account owner must take.

F) Finally, with any Roth IRA, the Roth account must be opened and held for at least five years before the income that is generated by the Roth IRA can be distributed to the Roth owner without any income tax. However, the funds rolled over from the traditional IRA to the converted Roth IRA (on which the account owner just paid the income tax liability) are always distributed from the Roth IRA tax-free, and those funds will be the first to the be distributed from the Roth IRA.

A Roth IRA always makes sense for those individuals who are concerned about future income taxes and income tax rate increases. While an older traditional IRA owner may believe that he or she does not have a long time to reap the benefits of a Roth IRA (tax-free income, no RMDs) they should at least factor into their decision-making process the potential estate planning benefits that their children and grandchildren will derive if they inherit a Roth IRA.

"A Roth IRA always makes sense for those individuals who are concerned about future income taxes and income tax rate increases."

Rising Interest in Terminating Pension Plans

Chris A. Middleton, CTFA
Executive Vice President
Director of Retirement Plan Division

Although the majority of private sector qualified retirement plans are now defined contribution (DC) type plans (i.e. 401(k), 403(b), profit sharing etc.), there are still some legacy defined benefit (DB) pension plans being maintained by employers. It has long been known that these pension plans can become a runaway train of costs and corporate liabilities that can threaten and even sink a company. In an effort to contain the ongoing pension costs and to ensure long term financial health, around ¾ of the corporate pension plans have been "frozen" so no new benefits can be accrued by employees. Outright pension termination is a more involved and costly endeavor that few companies have been able to afford, especially in the low interest rate environment of the recent years. But as Bob Dylan would say, "The Times They are A-Changin'."

$13.1 trillion of the $16.8 trillion assets currently in pension plans exist to benefit state, local, and federal government workers. The remaining 18% of pension assets are maintained by private sector companies that obviously have to operate with different fiscal accountabilities. The private sector response to limit the financial strain DB plans can apply to the balance sheet has been twofold. The first has been driving the adoption of DC plans as the main vehicle for employee saving and retirement preparation. Savings in these 401(k) type plans have exploded over the recent decades. Private sector retirement plan assets now represent $9.4 trillion or 87% of all DC plans, with government employers contributing the remaining $1.4 trillion.

DB plan termination has been the other arrow in the quiver. Beyond the relatively common pension freezing actions, the rapidly increasing interest rates are elevating the attention around outright plan termination. To avoid any misconceptions, the words freezing and termination do not indicate that participants are robbed of any benefits they have already accrued. ERISA law has strict anti-cutback rules to ensure that accrued benefits can never be taken away from participants. The Pension Benefit Guarantee Corporation (PBGC) also exists to ensure and guarantee that private sector workers are covered in the case of corporate bankruptcy. Rather, employers can stop future accruals (freezing) and/or expedite the financial payouts required to close up the plan instead of waiting for all participants to pass away (termination).

"There are many technical steps and notices required to initiate plan termination, but this article focuses on some of the financial aspects."

There are many technical steps and notices required to initiate plan termination, but this article focuses on some of the financial aspects. Every year pensions require an actuarial audit assessing their assets and liabilities

"...the burgeoning annual maintenance costs [of defined benefit] plans have left many private sector employers on unstable ground."

to arrive at the plan's funding rate. If the plan assets are less than the promised liabilities, the plan is deemed to be "underfunded" and vice versa. Due to several factors, such as life expectancy increases, investment returns, benefit discount rates, and perceived trapped costs, it is fairly rare for smaller companies to consistently maintain a pension plan in a fully or overfunded status. In order to terminate a plan, the employer has to be willing and able to fully fund all the termination liabilities.

Termination costs are different depending on participant elections between a lump sum payout or a future annuity payout. Regardless, a key factor in determining the current cost to payout future benefits is the assumed interest (discount) rate. The higher the discount rate, the lower current benefit (e.g. lump sum) amount. In 2022 alone, the spiking discount rate has reduced the calculated DB liabilities by ~20%. Of course, the recent stock and bond market declines have counterbalanced the mathematical gain from the discount rate for the time being. If the investment markets mount a comeback while interest rates remain elevated, small employers may consider a DB plan termination opportunity that may have been out of reach for quite some time.

Qualified retirement plans exist to attract, retain, and retire employees. DB plans have been one approach to help American workers on their retirement journey, but the burgeoning annual maintenance costs over the years have left many private sector employers on unstable ground. On the heels of rapid interest rate hikes, pension plan termination may become a more attractive option for many employers, allowing them to redirect expenses to 401(k) plans and other employee benefit-related programs.

Planning Strategies for a Rising Rate Environment

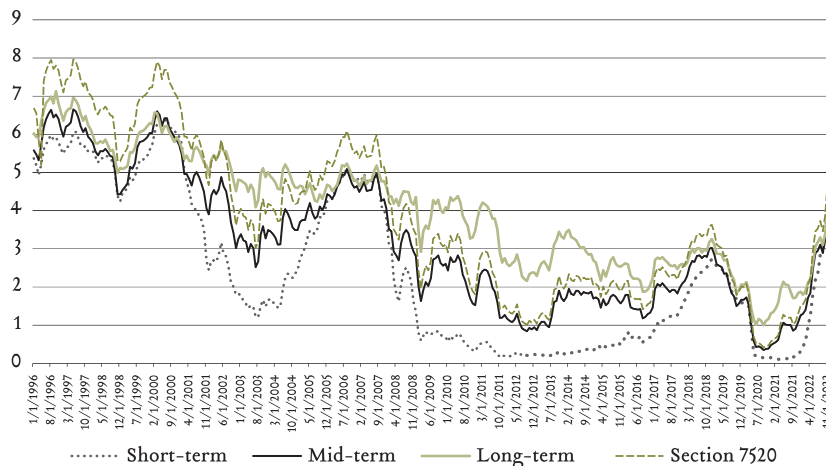
James R. Curry, CFP®, CPWA®
Vice President
Assistant Director of
Wealth Management

Over the past decade, we have become accustomed to a low interest rate environment which has favored certain estate planning techniques and wealth transfer strategies. A number of these strategies use interest rates which are published monthly by the Internal Revenue Service (IRS); the Applicable Federal Rate (AFR) reflects the minimum interest rate that the IRS allows for private loans in order to avoid triggering potential tax consequences, and the §7520 Interest Rate is 120% of the applicable federal midterm rate (compounded annually), traditionally referred to as the "hurdle rate," and is used to value long-term or future property interests.

Interest rates fell to historic lows in 2020 and 2021 due to the Federal Reserve reducing short-term rates in response to the economic contraction caused by the COVID-19 pandemic; however, rates have risen significantly in 2022 as the Federal Reserve attempts to fight inflation. From a historical perspective, the November long-term AFR is in line with historical averages calculated from 1996; however, November's short-term and mid-term AFRs are well above historical averages; 4.1% vs 2.4% and 3.97% vs 3.18%, respectively. Below is a chart which represents the Applicable Federal Rates and §7520 rate since 1996.

> "As Applicable Federal Rates have risen to their highest point in approximately 10 years, this article will revisit a couple of the planning strategies presented for a higher interest rate environment..."

Applicable Federal Rates (AFRs)
January 1996 – November 2022



In late 2019, Dan Baker published an article in the *Perspectives* newsletter related to planning in low and high interest rate environments. As Applicable Federal Rates have risen to their highest point in approximately 10 years, this article will revisit a couple of the planning strategies presented for a higher interest rate environment as well as present opportunities that may still exist in a rising interest rate environment.

Planning Strategies for a Rising Rate Environment, continued

Estate Planning Strategies for Higher Interest Rates

Certain estate planning strategies are more favorable with higher interest rates as the higher the rate, the more benefit the strategy may provide. Two strategies which provide greater benefit as rates rise are Charitable Remainder Annuity Trusts (CRATs) and Qualified Personal Residence Trusts (QPRTs):

Charitable Remainder Annuity Trust (CRAT)

The purpose of a CRAT is to provide income to a current beneficiary during his or her lifetime or for a specified term of years, with the remaining balance as a gift to a tax-exempt charity or charities (as recognized by the IRS). The funding of the CRAT reduces the value of the grantor's estate while providing income and estate tax benefits to the grantor.

The current individual beneficiary receives a fixed amount (annuity) for a specified term of years or for the beneficiary's lifetime. The income beneficiary pays income tax on the distributions from the trust, based on a tiered schedule. The annuity must be at least 5% of the initial gift, but less than 50% of the initial gift. The present value of the charitable remainder must be at least 10% of the value of the initial gift and the remainder beneficiary (a charity or charities) receives the remaining value of the trust outright.

> "Certain estate planning strategies are more favorable with higher interest rates..."

The benefits of this strategy in a higher interest rate environment are a larger charitable deduction due to the assumptions for more rapid growth and the potential to fund a CRAT for a younger beneficiary and still meet the remainder interest criteria (10% of the value of the initial gift). Below is a visual representation for establishing a charitable remainder trust.

A Charitable Remainder Trust (CRT) is an irrevocable trust that can provide a specified distribution at least annually unless a net-income provision is used to one or more beneficiaries for life or a fixed term up to 20 years. Upon the death of the beneficiary, or at the end of the term, the remainder of the trust passes to a qualified charitable organization.[1]

IS A CHARITABLE REMAINDER TRUST RIGHT FOR ME?

- Do you want to give to a charity and retain some level of income from the gifted assets?
- For tax purposes, is the timing right for a large charitable gift but you still want or need some cash flow?
- Do you want to provide income to one or more beneficiaries during their lifetime, but pass any remaining assets to a charity?

MECHANICS

Step One: Grantor transfers assets to the CRT. Grantor receives an income tax deduction for the charitable contribution.

Step Two: Grantor or other non-charitable beneficiary/beneficiaries receives annual income and pays income tax.

Step Three: Upon death of the last income beneficiary, a charity receives the balance of the assets.

1) Several techniques exist to allow for flexibility in determining the charitable remaindermen. As an example, a non-charitable beneficiary may be able to appoint, by will, the charitable remaindermen (Rev. Rul. 76-7, 1976-1 C.B. 179). Alternatively, a donor advised fund or private foundation could be the remainder beneficiary and the flexibility of those charitable giving structures could be utilized.

Qualified Personal Residence Trust (QPRT)

The purpose of a QPRT is to reduce the size of your taxable estate through the transfer of a residence to trust beneficiaries over a set period of time while maintaining the right to live in the residence (rent free over the set period of time and rented at fair market value following the expiration of the term).

The initial transfer of the property to the QPRT is a taxable gift of the remainder interest which is calculated using the §7520 Interest Rate. Assuming the grantor lives past the set period of time, the grantor is able to pay fair market rent to continue living in the property which further reduces the value of their estate. The primary benefit of this strategy in a higher interest rate environment is as the §7520 Interest Rate increases, the amount of the taxable gift decreases.

Estate Planning Strategy for Most Interest Rate Environments

While certain planning strategies are more favorable with higher interest rates, some strategies that are favored in low interest rate environments may work well with higher interest rates as well; however, the benefits may not be as great. These strategies often involve lending and provide a "freeze" to the value of assets which are loaned.

"…some strategies that are favored in low interest rate environments may work well with higher interest rates as well;…"

Intra-family Loans

Intra-family loans provide the opportunity to loan funds to family members at the relevant AFR based on the term of the loan. This strategy works best in low interest rate environments as the appreciation of the asset that the loan is used to purchase is able to more easily outperform the interest rate on the loan. However, in high interest rate environments, the loan may also allow the borrower to be able to purchase property at a much lower interest rate than through traditional bank financing. For example, let's view the total interest paid on a $400,000 30-year fixed mortgage using the November 2022 long-term AFR, 3.92%, and a 30-year fixed rate mortgage, 7.00%. If the borrower were to use traditional bank financing, the total interest paid over the life of the loan would be approximately $558,000 versus the total interest paid over the life of the intra-family loan using the long-term AFR rate, approximately $281,000. The primary benefit of this strategy in a higher interest rate environment is to allow for purchases to be more affordable while freezing the value of the assets for the family member loaning the money.

Summary

Estate planning strategies and wealth transfer opportunities exist in all interest rate environments. We recommend consistently reviewing your goals with your team of advisors in order to design strategies that fit into your overall comprehensive wealth management plan, are tailored to your unique needs and benefit from the current financial landscape.

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Director of Personal Trust and Fiduciary Officer

Proposed Regulations for Inherited IRAs Bring Unwelcome Surprises

When Congress enacted the SECURE Act in 2019, one of the noteworthy changes related to the period over which beneficiaries were required to take IRA distributions. Before the SECURE Act, beneficiaries of inherited IRAs could "stretch" the required minimum distributions (RMDs) over their entire life expectancies. The stretch period could be decades for younger beneficiaries, meaning they could take smaller distributions and defer taxes while the accounts grew. However, in an effort to accelerate tax collection, the SECURE Act eliminated the rules that allowed stretch IRAs for many beneficiaries. For IRA owners or defined contribution plan participants who die in 2020 or later, the law now generally requires that the entire balance of the account be distributed within 10 years of death. Unfortunately, the IRS has muddied the waters with conflicting guidance. In 2021, the IRS published guidance that a beneficiary is allowed, ***but not required***, to take distributions prior to the 10-year deadline. The IRS recently reversed this stance with a proposal that would force certain beneficiaries of IRAs to take ***annual*** RMDs.

"Before the SECURE Act, beneficiaries of inherited IRAs could "stretch" the required minimum distributions (RMDs) over their entire life expectancies."

The IRS's proposed regulations focused on Internal Revenue Code 401(a)(9)(B)(i) and concluded that the beneficiary of an IRA owner who died after the owner's required beginning date must take annual RMDs beginning in the first calendar year after the calendar year of the IRA owner's death. The SECURE Act added a section requiring that the account balance of the inherited IRA must be fully distributed by the 10th calendar year after the calendar year of the IRA owner's death. [Internal Revenue Code 401(a)(9)(B)(ii).] Thus, in order to satisfy both of those requirements, the proposed regulations provide that when the IRA owner dies after their required beginning date with a designated beneficiary who is not an eligible designated beneficiary, (i) annual RMDs must continue to be taken after the IRA owner's death, and (ii) a full distribution of the inherited IRA is required by the end of the 10th calendar year following the IRA owner's death.

In plain English, there will be annual RMDs based on the age of the designated beneficiary of the inherited IRA in years 1 through 9 following the IRA owner's death, and a complete distribution of the inherited IRA in the 10th year.

EXAMPLE: Doug dies on September 20, 2022. Doug died after age 72, so Doug's IRA was in-pay status, and he was subject to the RMD requirement. Doug named his daughter Flo as the beneficiary of his IRA. Payments from Doug's IRA to Flo are subject to the SECURE Act's 10-year rule. Flo must take annual required minimum distributions in each of the 9 years

that follow the year of Doug's death, based upon what would have applied under the pre-SECURE Act rules. All remaining assets in the inherited IRA must be distributed to Flo by December 31, 2032.

The only exceptions are for "eligible designated beneficiaries" who include the following:

1) A spouse
2) A minor child (the Proposed Regulations define as under age 21)
3) A disabled person
4) A chronically ill person
5) A beneficiary who is less than 10 years younger than the IRA owner (typically a sibling)

Those who inherit IRAs from individuals who have not yet reached their required beginning date at the time of death are also required to take RMDs for years 1-9 with the full amount being distributed by year 10.

On October 7, 2022, the IRS published its Notice 2022-53 which announced that it will not impose penalties on a designated beneficiary who failed to take specified RMDs for 2021 and 2022 that were required under the provisions of the 2019 SECURE Act. The IRS noted that a number of commentators voiced strong objections to this interpretation of the law, and many designated beneficiaries who inherited IRA accounts had not taken any distributions in 2021. Since the IRS did not release its proposed regulations until February 24, 2022, it was too late for many designated beneficiaries to take timely required distributions for 2021. The IRS still has not made the proposed regulations final, but is expected to at some point in late 2022 or early 2023.

- Accordingly, the provisions of the proposed regulations will apply no earlier than 2023: *"To the extent a taxpayer did not take a specified RMD, the IRS will not assert that an excise tax is due under IRC 4974. If a taxpayer has already paid an excise tax for a missed RMD in 2022 that constitutes a specified RMD, that taxpayer may request a refund of that excise tax."*
- The Notice also provides relief to defined contribution retirement plans that did not make a specified RMD to a designated beneficiary: *"A defined contribution plan that failed to make a specified RMD will not be treated as having failed to satisfy Section 401(a)(9) merely because it did not make that distribution."*

The good news is that those designated beneficiaries who failed to take an RMD in 2021 (or 2022) based upon prior guidance will not be punished by the imposition of a penalty for their failure to take an RMD. The bad news is that the IRS is sticking with its interpretation of the tax code and is expected to make the proposed regulations final requiring annual RMDs for most beneficiaries from an inherited IRA.

"The IRS recently reversed this stance with a proposal that would force certain beneficiaries of IRAs to take *annual* RMDs."

Stock Market Pulse

Index	10/31/2022	Total Return Since 12/31/2021
S&P 1500	886.33	-17.37%
Dow Jones Industrials	32,732.95	-8.42%
NASDAQ	10,988.15	-29.31%
S&P 500	3,871.98	-17.72%
S&P 400	2,433.05	-13.29%
S&P 600	1,195.57	-13.69%
NYSE Composite	14,747.03	-12.26%
Dow Jones Utilities	913.44	-4.49%
Barclays Aggregate Bond	1,985.01	-15.72%

P/E Multiples	10/31/2022
S&P 1500	18.4x
Dow Jones Industrials	18.7x
NASDAQ	47.5x
S&P 500	18.8x
S&P 400	14.4x
S&P 600	14.1x

Key Rates

Fed Funds Rate	3.00% to 3.25%
T Bill 90 Days	3.96%
T Bond 30 Yr	4.16%
Prime Rate	6.25%

Current Valuations

Index	Aggregate	P/E	Div. Yield
S&P 1500	886.33	18.4x	1.72%
S&P 500	3,871.98	18.8x	1.71%
Dow Jones Industrials	32,732.95	18.7x	2.06%
Dow Jones Utilities	913.44	16.9x	3.59%

Spread Between 30 Year Government Yields and Market Dividend Yields: 2.44%

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