Today's markets and tomorrow's taxes

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TRANSCRIPT

SPEAKERS:

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Nick Beis: Hey. Welcome everyone to our wealth webinar series. My name is Nick Beis. I'm a member of the advanced planning team here at Fidelity. As an advanced planner, it's my job to help educate clients on wealth planning strategies, including things like estate planning, the use of trusts, lifetime gifting, and charitable giving strategies. Today we brought together professionals in several different areas: investment management, financial planning, and government affairs to give everyone on the call today an update on market conditions, kind of where we stand as we're going into year-end, and also talk about the changing landscape—the changing tax landscape, that we'll be looking at and talk about some of the ways that what's going on in Washington might end up impacting your planning—not only your financial planning, but also your estate planning.

Today, I'm joined by two of my colleagues. Lars Schuster is an institutional portfolio manager with Strategic Advisers. That name Strategic Advisers might sound familiar; they're the folks that help manage our managed accounts here at Fidelity. And Alice Joe. Alice is with the government affairs in Washington, D.C. Lars is going to be providing us with a market update and Alice is going to be providing some additional insights on Biden's tax plan and the tax bill that's currently working its way through Congress. Together as a group, we're going to be having a conversation about some of the things you might want to consider if you believe that changing market conditions or these tax policy changes might impact your overall plan.

Before we jump into the content today and the conversation we're going to be having, I do want to remind everyone in our audience today that the topics that we're going to be discussing are fairly complex. And today's conversation is really more of a high-level nonpartisan sort of educational conversation on these topics. If we're concerned that these are going to impact our own plans, we really do want to be having conversations with our financial advisor, our CPA, our attorney, to see how this is going to impact ourselves and our family and our planning individually. It really does have to be a tailored plan for each individual.

So, hoping this will kind of give you some background and sort of maybe jump-start some conversations, but we do want to remind everyone that Fidelity can't give specific tax or legal advice on these topics. So, that being said, I know a lot of folks in our audience, they're very interested in hearing about these potential tax changes. But Lars, I thought we might kick it off by starting with a market update and then we can take it from there.

Lars Schuster: Yeah, I'd be happy to. Thanks, Nick, and good afternoon or good morning, everyone, wherever you may be. Happy fall. The world is a big place and I only have a limited time here, so I may not hit on all the topics that may be of interest to you. My remarks are really just some of the bigger themes. But we just think about the market at a very big-picture level, as you can see looking back over the last year or so, stocks globally have moved higher, particularly in that grey section which is just the 2021 period.

And when you really look at the returns on the left side to the middle of this chart, stock returns were likely driven by the optimism for growth given reopening, development of vaccines, the beginning of vaccinations. And as this happened, bond interest rates rose, which weighed on bond returns. I would say since then, stock prices appear to be driven by profits growing at an exceptional pace, really supported by a robust consumer demand for goods and services. And more recently, though, we've seen some choppiness in the markets and there are certain areas of the world, though, like developed international stocks, including those in Europe and Japan, that have done actually pretty well. And maybe some of that just because they're behind the U.S. in terms of reopening.

In fact, if you just look really recent, like in the last few weeks or so, as U.S. stocks have just been down just a little bit, what we've seen is stocks in Japan are actually up. So, when we look at that bottom line, that black line, the bond returns, they've had a bit better return more recently as interest rates have fallen since early spring. And some of this is probably a reflection that the COVID reopening recovery was not going to be as robust in the near term as originally believed.

Now, I will say that there are lots of other different types of investments and asset classes that are not on here. Things like real estate investment trusts, commodities, high-yield bonds. And all these areas have done well given the higher prices for things like raw materials and other entities. Overall, most of the returns on this page, though, are really consistent with an early-cycle environment. Some of the choppiness we've seen more recently has really been consistent with midcycle expansion.

So, a good segue here for the next slide, which is really a stylistic visual of economies in recovering from a downturn moving into expansion and then an eventual slowdown. This is something we call the business cycle. It can take years to play out. And there's a couple of reasons why we follow the business cycle. One is it's long and slow moving. It provides us at Strategic Advisers an investment framework to think about how we want to manage our clients' well-diversified accounts to really help them keep them appropriately invested to their goals when there are wiggles in the market from headline-driven events, not unlike what we've seen over the last few weeks.

The second reason is because there's a strong connection to investment markets. And that's because there's really three underlying cycles that make up the business cycle. It's made up of profits or profit cycle or corporations right now have, as I noted before, an exceptional pace of growth in profits. There's a credit cycle, so think about this availability of credit. Banks are very well capitalized, there's very low interest rates, and the demand for potentially borrowing from both businesses and consumers is there.

The third is actually inventories. And so, you think about inventories, which are very, very lean. I think we've all gone out shopping and probably seen that things are well behind in terms of being available. But they are being replenished, and that tends to be a positive for the economy and markets. So, despite the Delta variant—and I know that's been a big question on people's minds is the impact of the Delta variant—things are okay. In fact, we're in this expansion phase. So, the way I would look at it is the economy in its growth is just delayed a bit, but not derailed.

So, in well-diversified accounts that we manage for clients relative to a mix of stocks and bonds for each client, we've actually had a little bit more in stocks or equities. But that tilt more recently has shifted from more in U.S. to actually developed international. And as you can see from some of the balls on this graphic, it largely is because some of these developed international economies and their countries there, their companies in those countries, they are a bit behind the U.S. in terms of growth and they're still some of reopening type of acceleration that's present.

We've also had investments in real estate investment trusts and commodities because we think they can benefit from higher prices or inflation. And with the bond spectrum, we have very diversified bond positions for clients ranging from high-quality bonds like U.S. Treasuries as well as municipals where appropriate, to high-yield and corporate bonds that may benefit from healthy corporate balance sheets, as well as rising profits.

Now, I will say, this characterization of midcycle, it is really though characterized by slower pace of growth compared to where we have been. So, you think about that chart I showed earlier on stock returns, that is kind of party central time. When stocks are in this recovery environment, that's when they tend to do their best. So, an early cycle, many things go up together, the market begins to really price a lot of hope and optimism in, and that lifts a lot of companies. When you get to midcycle, you tend to see more differentiation.

In other words, the market really begins to recognize those companies that are or can continue to grow corporate earnings. It's a good environment, though, for investing in our opinion. It typically is positive returns for stocks. But another defining characteristic of midcycle expansion is that you tend to see similar corrections. You tend to have more market ups and downs that happen with more frequency. So, what might create some of that volatility here in the near term? Perhaps it's the path of COVID and its impact on supply chain disruptions as well as services, but also Federal Reserve policy and the impacts of inflation.

So, let's delve into one of those. Let's move to the next slide and think about inflation here for a minute. And this is a long-term time frame over the last 10 years, but when we think about just recent months or quarters, the unusually strong consumer demand for goods and services and these supply chain disruptions have really led to higher prices for many goods and services. Particularly when you compare that to the depressed prices we saw during the pandemic about 16 months or so ago.

Yet the Federal Reserve and many bond portfolio managers that we speak to believe that as many supply chain disruptions will eventually ease and consumer spending, when that normalizes, these price pressures may fade in the coming quarters. This is one reason why the Federal Reserve is likely to take its time in raising interest rates. The other reason why they may take their time is employment. They appear laser-focused on keeping interest rates low until we see some more progress on the employment front. Now, the exact timing of when warmer inflation will ease is really hard to nail down because of the continued presence of COVID.

What I can say is that the bond market, it remains skeptical of persistently higher inflation scenarios, and that's what we're really showing on this chart. It's something called inflation swaps; it means nothing more than a reflection of investor views on inflation looking out five years. And recently, if you look over on the far right of the chart, it's rolled over a bit, particularly moving modestly lower from recent peaks. I think in the end, warmer inflation is likely to be sticking around a bit longer, and it wouldn't be surprising to me to see prices be somewhat higher than what we've seen in the last 10 years. But at Strategic Advisers, we don't believe this is a 1970-style inflation scenario.

Nevertheless, in management of our clients' well-diversified accounts, we have the flexibility to respond; to own various stocks, certain types of bonds, like Treasury inflation-protected securities, real estate investment trusts, commodities. These are investment opportunities that may benefit from higher prices in certain goods and services. And so, as I finish out this market update section with the last slide, I think it is important to recognize that as investors, we tend to weigh bad news and risks more than good news.

So, I want to finish on some good news because there is good news out here for investors. And one of them is looking at earnings. And the earnings outlook is quite good. Now, these numbers that you see on your screen here across U.S., developed international areas, emerging markets, these are all well above long-term averages. And over time, it's our belief that corporate earnings are an important driver for stock prices, particularly when you think about in the international space. You have some more reopening, lower valuations when compared to the U.S., and in this environment, we think that active managers backed by robust research can really find some of those investment opportunities out there.

But again, in midcycle, it tends to be a lot of differentiation between stocks. The tide just doesn't lift all boats in this manner like what we experienced over the last year. Of course, there are other things to think about, and I know that's what we're going to get here to today, and that's to think about maybe what's going on in Washington and how that may weigh on investors' mindsets. So, Nick, I'll pass it back to you for a little discussion here on what's going on in Washington.

NICK: Sounds good, Lars. And no, great update. A lot of good information. I think a lot of my clients were very keen to hear about how inflation was factoring into things. And you're right, always good to end on good news—or the opportunity—so always a good place to start there. And I guess a good place to start there because now we'll be kind of shifting gears, as you said, to talk about what's going on in Washington.

I know, you know, last year, the end of last year, was a record time for planning. We had so many interactions with clients in the branch network talking about planning in anticipation, frankly, of the things that we're going to be talking about today. So, after the election and before year-end, clients were concerned about higher income taxes, lower state tax exemptions, and possible changes impacting wealth transfer strategies, and now here we are.

Some of those potential concerns might be becoming a reality depending on what happens with the bill that's working its way through Congress. Back in April we saw the Biden administration's green book that sort of laid out the administration's ideas of what an ideal tax reform bill would look like, and now we're sort of seeing the real thing with the language coming out last Monday. And I know all the members of my team and the advisors that I support, we've all been kind of poring over it, trying to figure out, okay, you know, how is this going to impact our clients, what conversations do we need to be having before year-end, and really just trying to rack our brains about what this means for planning going forward.

And so, I thought we'd take this in a couple different steps, talk maybe about some of the biggest potential changes that'll be impacting individual investors and the families that we work with. And so, Alice, I thought we might start off talking about capital gain, kind of what's on the table there, what could we potentially expect if this bill makes some progress.

Alice Joe: I'm happy to jump into that, Nick. You know, as you mentioned earlier this year, we saw a proposal come from the White House and President Biden on some proposed tax changes. Those really are designed to target corporations and, you know, some of the wealthy to pay for spending in its overall package. Where he came out earlier this year was a proposal to match the long-term capital gains and dividends rate to his proposed income tax rate of 39.6 for individuals.

Now, what really matters today is, as you mentioned, what's actually moving through Congress, because any significant changes to taxes is going to have to get done through legislation and Congress. So, last week the Ways and Means Committee introduced their proposal and market through committee which included a capital gains dividend increase from 20 percent to 25 percent. So, it didn't match that 39.6 rate that we had heard from the Biden administration. Now, that is only going to apply to those that are in the top tax bracket, and they changed that too. So, individuals that are making 400,000 dollars or more and 450,000 or more for married couples, that's where it would apply.

So, if you look at this chart, we also have a, you know, slight green shading there. That represents the additional 3.8 percent of the net investment income tax, which is currently applicable to those individuals, you know, earning 200,000 dollars or more. So, for a total potentially of up to 28.8 percent in investment income tax there. Now, the reason why they settled on 28.8 percent is the fact that, you know, there's a tipping point between 28 and 30 percent, where investment behavior starts to change. And so, the Joint Tax Committee estimated that, you know, if it goes beyond that, then the government's going to start losing revenue. So, that's why we topped out at 28.8 percent.

The one thing to note here is unlike some of the other tax proposals in the bill, this one is actually retroactive. So, it's going to be effective as of September 14th. So, if you made a trade as of last Tuesday and forward, it will be subject to this new capital gains rate if you made a trade. So, that's one thing to keep in mind there. And while we're on the topic of capital gains, I also just want to flag one other slight change related to capital losses.

So, I think many people are familiar with the wash-sale rule, which says that, you know, if you incur capital loss from the sale of a stock or security, but you buy again within 30 days, you can't write that up for tax purposes. So, what they've done on this bill is they've also extended that to commodities and foreign currency as well as digital assets. So, if you're trading bitcoin or options on the euro or something like that, the wash-sale rule will now also apply to you.

NICK: Okay. Good information there, good to know. And it sounds like maybe not as dire as we thought a little bit earlier this year when it comes to cap gains. Still, I'm sure a lot of folks on the call, not super thrilled about the increase to 25 percent. I know I spoke with a client earlier this week, we had actually met almost exactly a year ago and she had been considering at the time accelerating recognition of capital gain. Because after the election, her crystal ball told her that capital gain rates would be going up.

She had thought about this acceleration strategy and decided ultimately to hold off. Decided she had a good long-term plan. She didn't want to do anything aggressive at that point. And now, after hearing that the change to capital gain rates could be retroactive, she's kind of kicking herself and wondering if she missed out on an opportunity here. And for clients that might be feeling that way, Lars, do you have any thoughts from an investing standpoint?

LARS: Yeah, sure, Nick. You know, from a tax-sensitive investment point of view, you know, what do you do with this information that you just gave your story. Should I act now? Boy, should I have done it before, should I sell investments with appreciated gains? I think the first thing for a lot of folks is to think about what Alice noted, which is one, this isn't a done deal, and two, it does appear that an increase in certain taxes may only impact a small population of investors. So, you really need to understand how this impacts your personal situation.

Nevertheless, in management of client accounts where taxes matter, we believe that an investor's time horizon or their goal is a very important consideration. And for many of our clients, they have longer-term goals that are 5, 10, 15 years or more in the future. And to me, it may be more prudent to defer taxes to a much later date. And so, why is this? It comes down to some math, because the compounding of gains as we believe that stocks and other risk assets over time have a trending move upward, that may provide a better outcome many years down the road versus selling and resetting your cost basis now.

A second item is that considers that taxes change. Just look back over the last 10 years: we saw taxes changes go up and down during 2012-, 2017-year periods. It's likely that over the next 10 years or so, we could see additional tax policy shifts. And then finally, what I would say is keep in mind that in our experiences we've seen, some investors accelerate gains to minimize some tax impact only to unknowingly push themselves into the next tax bracket, which further exacerbates higher taxes, which is a situation they were attempting to avoid.

So, look, every situation is different. There is no one-size-fits-all strategy. The key here is for clients to really develop a thoughtful investment strategy that is aligned with their goals and to revisit their plan regularly to ensure it is consistent with their overall investment objectives. And one way I've always kind of thought about this is a phrase that we've said internally at Strategic Advisers, which is, "try not to let the tax tail wag the investment dog."

NICK: No, I think that's a great reminder, Lars, and I like that one, the tax tail, don't let it wag the investment dog. And, you know, related to that, then, I'm hearing from clients that are thinking that, you know, maybe the market is kind of topped out at this point and could some of these potential tax changes, maybe this is the signal that it's time to take a break, kind of cash out and get our chips off the table. Any thoughts on that?

LARS: Yeah, I can certainly appreciate that thinking given how strong the market's done over the last 16, 18 months or so. Some refer to it as profit taking, others refer to it around this perception that the market is at a top. Look, the markets have done very well. And it gives some people just a reason to sell when you start talking about taxes maybe potentially moving higher. But in our view, the economy and markets may be in the beginning of another expansion.

And importantly, the midcycle phase as I addressed earlier, it's the longest and broadest phase of the business cycle. It historically has coincided with a positive backdrop for riskier growth assets like stocks. I also noted earlier that corporate profits are projected to rise, interest rates are very low, and inventories are very lean. In other words, should consumer demand continue to be robust, backed by some excess savings that have really been built up by consumers over the last year or so, it can maybe provide a push to manufacturers to hire and replenish those empty shelves and goods. This doesn't mean that markets may not rise or fall in the coming months.

Again, I talked about volatility, that's quite normal. However, a market correction of five or 10 percent doesn't necessarily portend a 30-percent decline. A decline of that magnitude is usually associated with falling corporate earnings, not rising ones. That's why any volatility that we may see in the short term, we kind of think about that as an opportunity to rebalance accounts, which effectively means selling investments that have held up and buying those that have declined more recently.

And again, maybe for where accounts where taxes matter, we can actually pinpoint areas of client portfolios where we can potentially sell some recently struggling investments and use those as tax assets to potentially offset future gains. So, what really matters in my mind across all this is not whether or not the market may be at a top, but really any selling decision really should be connected to your goal. Stay focused on your goal, that's the most prudent thing to do in my mind.

NICK: And I think that's a really good reminder, and I think it underlines why it's so important to be having an open dialogue with our financial advisor, right? Because a lot of the changes that we want to make are probably small and incremental in nature, and we need good information about what's happening with the market in order to be able to do that. And so, just a great reminder that, you know, the financial advisor, that's what they're there for, right, to be having these ongoing conversations and to be talking through how things might be impacting our individual plans. So, good stuff there.

I know a lot of the attendees on the call today listening in on our conversation, I know they're very, very excited about our next topic. Who wouldn't be? And that is potential income tax changes. I know that's something that has definitely been on the minds of clients that I have been supporting here and, you know, now with this tax bill language coming out, those conversations are becoming pretty serious at this point. You know, at year-end, we're always looking at things like Roth conversion and income tax planning and things like that. And what I've been seeing is more and more clients trying to kind of balance the income tax planning along with other estate planning goals.

For example, I spoke to a client the other day who was considering a Roth conversion strategy, but the money he was going to need to pay the income taxes was money he was hoping to use for potentially a further gifting strategy that he had been doing to his daughter. And so, we kind of have to balance what we think, you know, for each individual situation what's going to be the best benefit. And so, I think to start that analysis we really need to know, you know, what is potentially on the table, what could the potential downsides be of not getting out in front of these proposed tax changes?

And I was hoping, Alice, you could walk us through a little bit what's on the table here, what's being proposed in Congress, and what does the timing of this look like? How long do clients have to make adjustments or address some of these income tax changes?

ALICE: Absolutely. So, on the individual income tax side, you know, there's two big changes here. One is that the tax rate as mentioned earlier for the top tax bracket gets bumped back up to 39.6 from where it is today at 37 percent. So, you go back to where we were back in 2017.

The other thing they changed was the threshold. So, you know, anybody that's making 400,000 dollars on the individual side, 425,000 for head of households, and then 450 for married couples will now be subject to that top tax bracket. So, starting in 2022, so January 1st of next year, instead of reaching the top tax bracket at 524,000 and change for an individual, you'll now be subject to that top tax rate when it hits 400,000 dollars. And then for married couples, you know, that threshold would've been 646,000, but now it's at 450,000. So, it's almost 200,000 dollars lower now to hit that top tax bracket.

The one thing I did want to mention is that the bill also includes a three-percent surtax on the modified adjusted gross income that's in excess of five million dollars. So, this applies across the board for individuals, head of household, married filing joint, and surviving spouses. The only difference is if you're married filing separately, then the threshold there is two and a half million dollars.

So, and since we're on the topic of individuals, and I know you mentioned Roth conversions too, Nick, the one thing I did want to flag is that there are some changes on the retirement side. Whether you have an IRA or a workplace retirement plan like a 401(k), there's definitely some changes coming. So, what we're seeing is a limitation in terms of the aggregated assets that you can hold in retirement plans. So, whether it's your 401(k), 403(b), or your IRAs, Roth or not, you can only now hold up to 10 million dollars in the retirement accounts on an aggregated basis. So, if you exceed that 10 million dollars, then you're going to have to take a distribution every year of 50 percent of that excess until you get down to that 10-million-dollar cap. So, a big change here, and a huge impact to a lot of our customers and clients as you can imagine.

There's also a change to Roth conversions too. So, starting next year, so starting in 2022, you will no longer be allowed to convert any kind of after-tax contributions to a qualified plan or IRA and then convert that to Roth. That is banned across the board; doesn't matter what your income is. That applies to everybody. And then for those who are in the highest tax bracket making 400,000 or more or 450 for those married, beginning in 2032, so 10 years out from now, you won't be able to convert pretax dollars that you've put into a retirement plan or IRA into a Roth account. So, they do give you a little time to phase out there, and the idea there is that, you know, over the 10-year period perhaps you will go ahead and convert, they'll get the tax revenue for that and that goes towards paying for some of the other programs in the bill.

And I know you also asked more specifically on timing of this entire bill. You know, we're still somewhat early in the process even though the Ways and Means Committee did their job last week, the reconciliation is not just the tax piece; there's a ton of other pieces, so, the Budget Committee and the House right now is putting that all together. It's got to go through the Rules Committee.

Speaker Pelosi had set a September 27th deadline to pass the bipartisan infrastructure bill, which is the hard infrastructure bill that covers roads and bridges and broadband and some other things. She had planned to have this bill pass the House floor to coincide with that bipartisan infrastructure bill. But that's really just five days away from now, and I'm pretty sure she's going to miss that deadline. Because what's going to have to happen in between is, you know, they're going to have to preconference a lot of stuff with the Senate, because I think the thin margins both in the House and Senate are causing a lot of issues there. So, this may run into October and possibly into November for them to actually come to an agreement and pass the bill.

NICK: Good to know. So, still quite a bit up in the air. And that's the tricky part, I think, for a lot of the clients that I've been meeting with recently is they're looking for an answer. They're looking for an answer to the question, and I think right now there's just a lot of uncertainty and, each client has to make the decisions that they think are best for their individual situation.

And so, to that end what we would really suggest is that we get out in front of this as soon as possible and start having conversations with financial advisors, tax professionals, even estate planning attorneys as soon as we can to start getting a sense of how these potential changes might impact the long-term planning that we've done so far. And the reason we might want to start doing that now is that these aren't decisions that can be made overnight.

As we've talked about, whether it's investment planning or estate planning, it's very individualized. And, you know, for example, that conversation I was having with the client about Roth conversion versus continued gifting, we probably spent more than an hour talking about his family situation. And frankly, I think we probably raised more questions than we answered. And he sort of left with a lot of homework to do, to talk to his CPA, to talk to his attorney. And we've kind of agreed to reconvene here in a few weeks and, you know, see what new information we have, what he's learned from his other professionals. So, I think the key is just getting out ahead of it, starting to have these conversations.

Now, what I'd also like to say is, you know, this isn't all doom and gloom, right? If we've been working on a long-term plan, we expect change. You know, it's a cliché, but change is the only constant. And so, if we have a good long-term plan, a solid plan, you know, these changes might not be great depending on our situation, but we can definitely make those adjustments to recognize them and build them into our plan going forward.

Also, we don't want to overlook some of the common ways of dealing with income taxes, managing those income taxes over time, retirement plan contributions, contributions to health savings accounts, maximizing the deductions that are available, and accelerating income recognition into 2021, if possible, are all still things to be considered. They still hold true in 2021 just as they did in 2020.

And charitable giving. For those on the line today that are charitably inclined, considering things like qualified charitable distributions, which are direct distributions from your retirement accounts to charity allowing you to avoid having to recognize the income on your return. For those that are 78-and-a-half years of age or older, it's a great option. Gifting highly appreciated positions to charity or even making use of things such as charitable remainder trusts. Again, using highly appreciated positions to fund a trust that creates an income stream for us. All of these are things that we can be considering to help manage these income tax liabilities.

So, definitely, again, good idea to start these conversations, start talking about how all of this will work together. Now, I know, too, when we're talking about, you know, we've been kind of focused on personal income tax issues and how they'll affect each of our own plans, but Lars, I know some clients in our audience are especially very concerned about how the tax policy changes here might impact the overall market. I was wondering if Strategic Advisers had any thoughts on that.

LARS: Yeah, Nick, and you kind of even said it, too, with, you know, the doom and gloom. Alice talked about not just the personal and the cap gains taxes, but also the corporate. And in my experience with investors and the markets over multiple decades, we all tend to extrapolate something happening to us personally to the broader market.

So, people think about tax increases as a market killer, but our historical research says something quite the opposite. And that's what we're showing here on the screen. Tax increases just don't happen in a vacuum; they're usually accompanied by some significant amount of spending. And so, political parties don't like to tax someone and not give something to others. And I think the market seemingly knows this about the potential tax impact.

So, what you're seeing here, personal, corporate, capital gains across your screen, these are those annual periods looking back about 70 years or so, when we've seen tax changes, what happened to stocks here in the U.S. during those periods. And as you can see, they're above that dotted green line. So, in other words, in years of tax increases, we've seen above-average returns. And what that really comes down to is, again, this idea that there's usually some spending offset. And so, when we've looked at some research and talked to various researchers outside of Fidelity that we have access to, the estimates are maybe around a five percent hit to corporate earnings when we think about corporate tax increases.

But that's not necessarily a gamechanger because you think about the offset for potential future stimulus. Alice just mentioned a couple—roads, bridges, broadband, but there are others. You combine that with economic growth then consumer spending, and I think that kind of makes it a maybe not such a gamechanger that some individuals want it or think it could be. So, again, in my opinion, I think the market understands all of this and is more focused on the impact of Delta variants, the direction of Federal Reserve policy. Those are things that are probably more top of mind.

NICK: Gotcha, gotcha. Good to know and good to have, I think, that broader focus, really. Well, so taking income taxes and putting those aside for a minute, I wanted to maybe switch gears just a little bit and talk about one of the areas that will be affected that we don't have maybe as much information on just yet. And this is the idea of estate planning. Obviously, very important to the group that I work with, the advanced planning team. This is kind of our day in and day out.

And, you know, we were expecting some changes. We knew they were on the horizon; we knew that when the Tax Cut and Jobs Act went into effect that the 11.7 million dollar per person exemption, federal estate tax exemption, wasn't going to be with us forever. But that felt like a tomorrow problem. Oh, that's going to happen in 2026 and, you know, we'll have time, we'll figure all of this out. And what we've been hearing is that, well, in fact that rollback to six million dollars might be happening a lot sooner than we thought.

And that's going to have a significant impact on legacy planning strategies. I think for a lot of families, the combined 23.4-million-dollar exemption for a married couple felt very comfortable. Very few families were going to be impacted by the estate tax at that point when we look at the broader population. But now that we're looking at these exemptions being cut essentially in half, things are going to get, I think, a little bit more complicated. And I know, you know, already we've been having this conversation here trying to squeeze this in before year-end. And so, that's definitely one thing we've been talking about.

The other thing that I know has been on everyone's mind is the potential loss of a step-up in cost basis. Essentially, the idea with the step-up in cost basis is that when we leave appreciated assets to our family at our passing, the federal government basically forgives the capital gain. They adjust the cost basis to the current fair market value and so when our family goes to sell those assets, they will have potentially no or very little capital gain to recognize assuming they sell it in a short period of time.

So, I know a lot of questions, a lot of concerns on these topics even though there might not be, as I said, as much known on the estate planning side of things. But I was hoping, Alice, you could give us at least an update on kind of where we stand right now, what's on tap when it comes to these topics, and particularly what's going on with the step-up in cost basis.

ALICE: Yeah, absolutely. So, yeah, earlier this year there was a lot of buzz that Congress could potentially eliminate the stepped-up basis as you had discussed just now. And in fact, it was actually included in President Biden's proposal back in April. You know, he recognized that, you know, a lot of small businesses and farms would be hit, and so they said we'll just do a carve out for that, right? And that'll just solve the problem there. Fortunately, that's actually been taken off the table. That was not included in the bill that went through the Ways and Means Committee last week. So, that's a positive there.

On the negative side, though, they did go back and decide to reduce the estate and gift tax exemption amount. So, what they're doing is they're accelerating the sun setting of that to the end of this year instead of the end of 2025. So, beginning next year as you mentioned, that exemption amount for individuals would go back up to somewhere in the six-million-dollar range.

NICK: Yeah, and I think for a lot of the clients that I support, that rollback in the exemption is really creating a sense of urgency. And if that's going to happen by year-end, we really need to be having conversations about whether, you know, it's time to start accelerating a gifting strategy, do we want to further fund trusts that we've already established. We want also to look, too, at how some of the other changes that are packed into the bill might impact more complex trust planning strategies that clients have been relying on.

So, again, I know I'm starting to sound like a broken record here and I apologize, but it really is important and critical that we start having these conversations right now with our financial advisor, our CPA, and our attorney about how this might impact our plan and to keep in mind that a lot of these strategies are very interrelated. If we kind of pull on one lever, you know, if we decide to do that Roth conversion, well that might mean less gifting.

But if we give up on that Roth conversion, it might mean higher income to be recognized in future years, which might mean we're being forced to liquidate our Roth faster than we expected. So, these are all potential changes, all of this, you know, is still subject to change, but we do want to be having these conversations. And I think, if at all possible, we want to be bringing these different professionals together and really having a collaborative conversation about what planning we might want to do.

The other thing to keep in mind is calendars will fill up quickly. I know I received a calendar invite for mid-November the other day, and I was kind of thinking, you know, that's crazy. That's a long time away. And when I looked at the work that needed to be done and what was happening, I was like, you know, November's going to be here before we know it. And, you know, it's going to be the same for my former colleagues, my estate planning attorney colleagues; they're going to be dealing with those calendar issues as well. So, again, a little bit of urgency here.

Now, I know when you say, Alice, that the step-up in cost basis was going to be with us and we're not seeing a change in the bill right now, I could feel through the internet, through the Wi-Fi, through the Zoom here, I could feel our audience kind of breathing a collective sigh of relief. But, you know, what I'm concerned about is clients that I talked to that have sort of diversification paralysis almost where they have these highly concentrated positions in securities typically where they've had really good luck, they've had really good success, it's done really, really well for them over the years.

And they're feeling as well, you know what, I don't want to recognize the capital gain. I want to rely on that step-up to cost basis, I want to see if my family can avoid some of those capital gains taxes. And I get really concerned for those clients just because I think they might be doing themselves a disservice. And, I wonder, Lars, you had mentioned earlier that tax tail wagging the dog, I was wondering if you had any thoughts about kind of that sit and hold, waiting for that potential step up in the future?

LARS: Yeah, you know, Nick, maybe just to trump that phrase with another phrase, you know, one that I've always kind of thought about is, risk trumps taxes. Especially when you're thinking about, you know, meeting future financial goals, you know, it can sound maybe boring, trite for some, but diversification can help smooth out investment experience. And, you know, this notion of big outsize gains from concentration could also mean big losses. So, I think it's a balancing act. And my only thing that I would probably say on that is when you get micro-focused on one issue, and maybe that issue is taxes, like you said, it can paralyze you from making prudent investment decisions. So, maybe just kind of consider risk trumps taxes on top of don't let the tax tail wag the investment dog.

NICK: Good. Definitely good advice, keeping an eye on sort of the end goal, right? What is it that we're looking to achieve for our own retirement success? And to that end, too, we also, I know, have conversations with clients about what can we do with these highly appreciated positions. And there are definitely some options, some things to take into account. A couple things that come to mind, charitable remainder trust—using highly appreciated positions to fund a trust and help kind of ease the tax burden by spreading it out over time, and it's a great option for those families that are charitably inclined.

We can also use bunching strategies with charitable giving accounts to make large charitable gifts using appreciated securities and then bill those out to charity over the years. And then even something as simple as gifting low basis stock to family that might just happen to be in a lower tax bracket. And when they go to sell it, they're going to recognize less in capital gains tax. And, you know, maybe that doesn't help our individual retirement situation, but if our goal has started to shift and we're focusing more on legacy, maybe that's a way to look at it, kind of that multi-generational planning for sure.

ALICE: So, Nick, can I just jump in here real quick? Because I know you're talking about planning and thinking ahead. One thing I just want to remind everyone is that, you know, this legislative process is actually still super, super fluid. And the process has already started and potentially we could have a vote in the House next week, but you've got to look at the politics of this, too, right, in terms of whether a bill can pass.

And if you look at the House, the margins there are really thin because Democrats can really only lose three votes on the Democratic side. And then in the Senate, it's a 50/50 split so, you know, any one senator, especially in the Democratic side, could hold up that bill. Conversely, in the House when you generally, unless you're in leadership, you don't have as much power. But now we're starting to see some of the moderates and even the progressives, you know, form little groups and coalitions and start to drive it one direction or another.

And, you know, with respect to this bill, you know, we've got sort of a little bit of a circular firing squad among the moderates and the progressives in the Democratic Party that's really slowing this bill down some. So, there's going to be a long way to go, but, you know, for example, we've got a number of members in the House that are demanding some changes to the SALT deduction limitation that was put into place in 2017. You've got others in the Senate on the progressive side that are saying hey, we've got to implement a mark-to-market for billionaires or some stock buybacks. So, there's just a lot of competing interest there, and it's just going to be interesting to see how this plays out.

And then on top of that, you know, you've got two moderates in the Senate, one from Arizona, Kyrsten Sinema, and then Joe Manchin from West Virginia, have come out and said, hey, 3.5 trillion dollars is a lot of money. We spent, you know, trillions over the past 18 months already, maybe we should take a pause and see where we are. You know, let inflation come back down a little bit, get people back to work and then consider it a litter bit later. So, there's a lot of dynamics at play. I think this bill could potentially move pretty fast, but I think it also could get really complicated with the dynamics that I just described, and this could drag out in Congress for a while. So, basically bottom line is stay nimble.

NICK: I think that's great advice, Alice. And I think it also highlights the need to just kind of keep the open dialogue, right? Keep thinking about it and keeping an eye on potential changes. And for all of our clients that have been listening in today, just to remember that, you know, all of these changes will impact every client a little bit differently depending on their individual situation, their planning goals, and risk tolerance. And, you know, again, broken record time, but we've got to be having these conversations early. We have to tie in the CPA, we have to tie in the financial advisor and the attorney. So, important to get out in front of this.

And for those of you who've joined us today, first of all, I'd like to say thank you very much and of course thank you to Lars and Alice for joining me in the conversation. And for our audience members, you know, you might be leaving today's webinar, you know, maybe you fall into one of a few categories. Maybe you think, you know what, I listened to everything, I listened to the market update, what's happening with taxes, Nick's rambling about estate planning, and I feel really good. I feel like I've done some good planning, it's a long-term solid plan, I've been in touch with my financial advisor, I feel like we're in a really good spot.

Or you might be saying, you know, boy, this is going to affect me more than I thought, these potential changes. I really, you know, might need to be doing some quick year-end planning here getting out in front of this, I need to make an appointment with somebody, I need to start this process. Or you might be sitting there saying, you know what, I'm just as confused as I was before. I'm not sure how all of this is going to impact me or my family, where do I go from here?

And I would say no matter where you sit on that spectrum, whether you're feeling really good about it, you're really concerned, or you're just confused, doesn't matter. We're here to have that conversation, and we're here to help you through it. And I'll tell you that even those of us that kind of deal in this day to day, we ourselves aren't doing this in a vacuum. We're not just sitting in a room by ourselves saying, okay, here's what the strategy's going to be or here's how I think this is going to impact things.

We're all kind of leaning on each other. We all have different areas of expertise; we all have different resources we can pool. And I know even within the advanced planning team that I am a part of, even just yesterday we were having a really in-depth conversation about how this might impact our clients and kind of throwing hypotheticals and different ideas past one another to get our input.

You know, really as a client here at Fidelity, take advantage of all of that. Get in touch and, you know, take advantage of the resources that you have available to you through your financial advisor here. Really encourage it so we can have that conversation about whatever's on your mind really going into 2022. I'd also say, too, I'd like to remind everybody if you'd like to explore more of our thought leadership around these various topics, investing, taxes, estate planning, please check out insights from Fidelity Wealth Management on Fidelity.com. A lot of really good information there.

So again, thank you so much everybody, really appreciate it. Again, Lars and Alice, thanks. I think clients of mine that attended today are really going to see a lot of value, so much appreciated. Thanks, everyone.

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