The 2016 essential tax and wealth planning guide
Tax planning in a transforming world

Get started
Dear Reader,

As we prepare this guide for publication each year, we take into account recent and proposed tax policy and political changes as a matter of course. However, this year we are also considering several profoundly transformational trends with potential tax consequences that may impact our readers.

Continued globalization is a major trend. As more individuals and companies conduct business across borders around the world, they encounter an increasing array of tax issues that should be woven into their tax planning and compliance.

Tighter and more highly integrated regulations globally. Governments and standards organizations around the world are responding to increased globalization with a growing number of regulations and rules and stronger requirements for financial transparency from businesses and individuals — the alphabet soup includes FATCA (Foreign Account Tax Compliance Act), CRS (common reporting standards), and BEPS (OECD’s Base Erosion and Profit Shifting initiative), among many others. Increased information sharing and expanded enforcement cooperation between governments are strengthening the new regulations, tax transparency and reporting standards.

Social transformation. The US Supreme Court ruling on same-sex marriage, continuation of Obamacare, and the ongoing headline status of immigration reform—these are a few of the truly transformational changes that are reshaping life in the United States. Both businesses and individuals are already experiencing tax impacts of these changes, and more are coming.

Technological transformation. The continued rapid proliferation of mobile devices, cloud computing, and social media may seem unrelated to taxation, but the increasingly digital economy in which we live has felt ripple effects across the tax landscape — some overt, some quite subtle — of which both individuals and business leaders should be aware.

The 2016 essential tax and wealth planning guide offers many valuable considerations to assist in your tax planning as these trends unfold and your personal circumstances change. No one has a crystal ball, but with heightened awareness of change forces around you, you can be more informed and better prepared for the tax decisions you may face in the next year.

To find a member of the Deloitte Private Wealth practice who specializes in your area of interest, please contact us at PrivateWealth@deloitte.com.

Regards,

Julia Cloud
National Managing Partner
Private Wealth
Deloitte Tax LLP
Our contributors

We thank the following Deloitte Tax practitioners for their valuable contributions to this guide:

Craig Boyer
Karen Brodsky
Wendy Diamond
Debra Estrem
Eddie Gershman
Laura Howell-Smith
Craig Janes
Eric Johnson
Jeff Kummer
Pat Mehigan
Bina Patel
Doug Robb
Sarah Caplan
Stephen LaGarde
Moira Pollard
Jacqueline Romano
Micaela Saviano
Mike Schlect
Tracy Tinnemeyer
Molly Antell
Evan Beard
Meghan Kerns
Trisha McGrenera

Deloitte Private Wealth
Sustain, enhance, and protect your wealth

Deloitte Private Wealth focuses on the specialized needs of the ultra-affluent, including families with multi-generational wealth, entrepreneurs, and closely held business owners. In an era of complex tax laws, stringent regulations, and a turbulent investment environment, we are highly valued as trusted private wealth advisors with knowledge and experience, broad resources, and global scope.
The current legislative environment: Still waiting for tax reform

**Introduction**

Promising 2014 tax reform efforts stalled

**Status of key expired tax provisions**
- Senate developments
- House developments
- Prospects unclear

**Tax policy and the 2016 presidential elections**
- Rate lowering/base broadening tax reform
- Repeal-and-replace tax reform proposals
- Difficult policy decisions remain

**National retail sales tax**
- How it works
- Issues in rate setting
- Large and complicated rebate system
- Problem for states
- Other criticisms

**Flat tax**
- How it works
- Opposition to flat taxes

**Planning for today with a view of tomorrow**
- Continue to plan, work with what you know
- Adopt a view of the future and plan accordingly
- Be wary of quick answers and simple advice
- Watch for opportunities and know your risks
The current legislative environment

Introduction

When voters in last November’s midterm congressional elections opted to consolidate control of the House and Senate with the Republican party, they arguably gave the GOP a stronger hand in shaping tax policy — including, potentially, reform of the federal tax code — in the 114th Congress, which convened at the beginning of this year. But as 2015 unfolded and the 114th Congress got under way, it became clear that although a major impediment to the passage of tax reform had been removed, other significant obstacles remained.

Support for enactment of comprehensive tax reform was high, but differences between congressional Republicans and President Obama over key individual income tax issues — such as whether tax reform should be used to raise revenue and whether the tax code should be made more progressive — appeared insurmountable. By the spring, House Ways and Means Committee Chairman Paul Ryan, R-Wis., and Senate Finance Committee Chairman Orrin Hatch, R-Utah, were signaling that a comprehensive overhaul of the federal tax code likely would have wait until after 2017, when a new president is in the White House.

Representative Ryan and Senator Hatch subsequently began to explore the possibility of piecemeal tax reform that would focus on the business side of the code — an approach Ryan dubbed a “down payment” on tax reform; but that effort faltered due to concerns expressed by small business groups as to how passthrough entities and sole proprietorships would fare, relative to their corporate peers, under such an approach.

As Congress returned from its summer recess, Ways and Means Chairman Ryan was attempting to generate support for an international-only tax reform package that would be tied to must-pass legislation to extend funding and spending authority for the cash-strapped Highway Trust Fund. (Under the plan, one-time revenue from a “deemed repatriation” of previously untaxed foreign-source earnings of US multinationals would provide an infusion of cash for infrastructure spending.)

The notion of using deemed repatriation to fund the nation’s infrastructure has support from the White House and from lawmakers on both sides of the aisle in Congress; but as this publication goes to press, the success of Ryan’s effort remains unclear in the face of skepticism from some high-profile policymakers and the realities of a crowded legislative calendar in which Congress must confront other politically thorny issues such as legislation to fund the federal government for fiscal year 2016, lift the statutory debt limit, and address the dozens of temporary tax “extenders” provisions that expired at the end of last year.

This section examines how the upcoming presidential election has already begun to reshape discussions over tax reform and how taxpayers can prepare in the face of an uncertain political environment. It also looks at the divergent approaches to tax extenders legislation being taken in the House and Senate and how that debate could be resolved in the coming months.
As we look ahead to the presidential campaign dominating the political scene in 2016 and potentially setting the stage for tax reform efforts in the next administration, it is worth looking back to assess the key players and tax reform developments from 2014. The year had a promising beginning as then Ways and Means Committee Chairman Dave Camp R-Mich., released a comprehensive tax reform discussion draft proposal which called for lowering corporate and individual income tax rates and moving the United States toward a territorial system for taxing US-domiciled multinational corporations. To accomplish those objectives, the draft included a long list of base-broadening provisions that would have a significant impact on corporations, passthrough entities, individual taxpayers, and tax-exempt organizations.

On the Senate side, Ron Wyden D-Ore., ascended to become chairman of the Finance Committee with an established tax reform portfolio of his own. Along with Indiana Republican Sen. Dan Coats, Wyden had introduced comprehensive tax reform legislation in 2011 that generally would have:

• Lowered the corporate tax rate to 24% and compressed individual tax rates to three brackets of 15%, 25%, and 35%;
• Provided a temporary tax holiday for repatriated foreign income but eliminate deferral on foreign income;
• Repealed the individual alternative minimum tax (AMT);
• Created new retirement savings incentives;
• Eliminated numerous current-law credits, deductions, and exclusions.

As promising as these developments were, ultimately, the tax reform debate was derailed due to a number of factors. Chief among these was a change in leadership on the two taxwriting committees for the incoming 114th Congress. On the House side, Dave Camp retired from Congress at the end of 2014. Even if Camp had not retired, his tenure as head of the Ways and Means Committee was scheduled to end as House Republican rules impose term limits on committee chairmen.

The 2014 elections also resulted in Republicans winning control of the Senate for the 114th Congress. Thus, Republican Orrin Hatch took over as chairman of the Finance Committee and Senator Wyden became the panel’s ranking Democrat.

On the policy front, a White House that was not engaged in tax reform talks with congressional Republicans, coupled with the continued divide between the two political parties over how much revenue a reformed tax system should raise and whether a reformed tax system should increase the tax burden of upper-income taxpayers through a more progressive model, proved too much for tax reform supporters to overcome. Even if 2014 did not prove to be the year comprehensive tax reform was enacted, it is instructive to keep those reform efforts in mind as presidential candidates unveil tax plans that emulate many of the proposals included in the Camp discussion draft and the Wyden legislation.
The current legislative environment

Status of key expired tax provisions

Similar to last year, the House and Senate are on disparate tracks for addressing dozens of now-expired temporary tax deductions, credits, and incentives.

Senate developments
In the Senate, the Finance Committee has opted for a straightforward renewal of most of the tax extenders that expired at the end of 2014, with an eye toward giving Congress more time to evaluate each provision and determine whether it should be extended permanently or stricken from the code as part of tax reform. The Finance Committee extenders package was approved in July but has not yet come up for a vote on the Senate floor.

For individual taxpayers, the Finance Committee bill would extend these provisions through December 31, 2016 (retroactive to December 31, 2014):

- Credit for health insurance costs of eligible individuals;
- Deduction for state and local general sales taxes;
- Above-the-line deduction for qualified tuition and related expenses;
- Parity for exclusion from income for employer-provided mass transit and parking benefits;
- Deduction for certain expenses of elementary and secondary school teachers;
- Discharge of indebtedness on principal residence excluded from gross income of individuals; and
- Premiums for mortgage insurance deductible as qualified residence interest.

The Finance Committee bill also would extend the following charitable giving provisions for the same period:

- Tax-free distributions from individual retirement plans by individuals age 70½ and older for charitable purposes;
- Special rules for contributions of capital gain real property made for conservation purposes;
- Enhanced charitable deduction for contributions of food inventory;
- Modification of tax treatment of certain payments to controlling exempt organizations; and
- Basis adjustment to stock of S corporations making charitable contributions of property.

House developments
In the House, Republican leaders have opted to move permanent extensions of discrete extenders provisions rather than another broad temporary package as Congress has done in the past. This strategy — which former Rep. Dave Camp developed last year when he steered the Ways and Means Committee and which current Ways and Means Chairman Ryan has opted to follow this year — is intended to build the budget baseline to make tax reform a less expensive proposition for a future Congress. Specifically, building extenders into the budget baseline would make tax reform much easier because it would lower revenue targets and, in turn, give taxwriters more flexibility as they make decisions about what base broadeners would be necessary to achieve the desired level of rate reduction.
The current legislative environment

Status of key expired tax provisions

Earlier this year, the House approved permanent extensions of these charitable giving incentives:

- Tax-free distributions from individual retirement plans by individuals age 70½ and older for charitable purposes;
- Special rules for contributions of capital gain real property made for conservation purposes;
- Enhanced charitable deduction for food inventory contributions; and
- Basis adjustment to S corporation stocks making charitable contributions of property.

Prospects unclear

On a theoretical level, there is support in both chambers for making at least some of the current roster of extenders provisions permanent as a way to provide certainty to taxpayers. But because the House-approved measures are not offset, they have not garnered much support from congressional Democrats and have drawn veto threats from President Obama. Leaders in both congressional tax-writing committees have stated that they would prefer to avoid a repeat of last year’s extenders process, in which legislation did not reach the White House until late in December. But the prospect of yet another partisan stalemate over permanency and offsets has prompted most observers to believe that enactment of extenders legislation is unlikely until closer to the end of 2015.
As this publication goes to print, we are in the midst of one of the most wide-open presidential campaigns in decades. November 2, 2016, is still in the distant future, but the various approaches to tax reform being discussed by candidates today may shape the direction of tax policy in the next administration. While some candidates have unveiled key components of their tax reform visions, many of the details are necessarily absent—a testament to the fact that details are difficult to explain on the campaign trail and that legislative proposals can morph considerably on the road to enactment.

With comprehensive tax reform seemingly off the table in the near term given the current political environment, the debate over how to overhaul our tax system, whether current revenue collections by Treasury are sufficient, the appropriate level of progressivity for our tax system, and the extent to which changes to the tax code result in economic growth has become a dominant theme of the 2016 presidential campaign.

When it comes to overhauling the tax code, the presidential candidates have so far fallen into two camps. One camp favors a more traditional approach to tax reform—the type of rate-lowering and base-broadening exercise made famous by the 1986 Tax Reform Act which generally lowered tax rates but offset the cost through elimination or modification of certain tax benefits. The other camp argues that our current tax system is simply too outdated and complex to be fixed and should be replaced with something altogether different, such as a flat tax with a single rate of tax on income or a so-called "Fair Tax," which functions similarly to a national retail sales tax.

Rate lowering/base broadening tax reform

Broadly speaking, many candidates would like to reduce the number of individual income tax brackets from the current seven. Republican candidates also would reduce rates while Democratic candidates generally argue for keeping rates on upper-income individual taxpayers at their current levels and reducing the tax burden for middle- and lower-income taxpayers. To offset the cost of a rate reduction, candidates across the board look to limiting tax expenditures (defined as deductions, credits, exclusions, deferral of tax liabilities or preferential rates of tax). Specific proposals under consideration by various candidates include overall caps on itemized deductions, limits on the ability to deduct mortgage interest and state and local taxes, and changes to the preferential rates for investment income such as dividends and capital gain. Notably, Democratic and Republican candidates alike have indicated that they are not interested in limiting charitable deductions.

In addition to rates, other aspects of the tax code are being examined by candidates including the following:

- **Capital gains/dividends** — Depending on what party the candidate represents, proposals range from reducing the current-law top rate for capital gain and dividends to imposing a tiered holding period structure that favors holding investments for long periods of time before qualifying for preferential capital gain treatment. Other components like the current-law 3.8% tax on net investment income that was enacted under the Patient Protection and Affordable Care Act in 2010 would be repealed in some plans, but remain intact in others. The preferential tax rate of carried interest has garnered attention as several candidates—from both parties—have called for taxing income derived from carried interest at ordinary income tax levels.

- **Alternative Minimum Tax** — Originally, the AMT was designed to tax a small number of wealthy individuals who escaped owing significant regular income tax by using a variety of exclusions, deductions, and credits; but because it was not originally indexed for inflation, it subsequently grew to affect millions of unsuspecting upper-middle-class taxpayers. (The American Taxpayer Relief Act of 2012 permanently controls the growth of the AMT by indexing the AMT’s exemption amounts for inflation, thus ending what had become an annual ritual in Congress of approving temporary "patches.") Some candidates are calling for repeal of the AMT as part of their tax reform platforms.
The current legislative environment

Tax policy and the 2016 presidential elections

Repeal-and-replace tax reform proposals
Several candidates call for removing many of the vestiges of our current tax system and replacing them with a relatively simplified structure such as a flat tax or a national sales tax. A flat tax features the simplicity of imposing a single rate of tax on individual and business income, but opponents often cite its potentially regressive nature. A “Fair Tax” or national sales tax is conceptually a simple consumption-style tax; like the flat tax, however, it also sparks concerns about regressivity. (See additional discussion on flat taxes and the “Fair Tax” below).

Difficult policy decisions remain
Regardless of who resides in the White House beginning in 2017, there are a number of difficult tax policy choices that the next president and Congress will have to make as they contemplate reshaping our income tax system. Chief among these are:

• The long-standing question of how much revenue, if any, should be raised under tax reform (that is, whether reform be revenue neutral, whether it should lose revenue over time but potentially generate economic growth, or whether tax reform should produce more overall revenue).

• Whether tax reform should be used to address income inequality or whether the tax code is already sufficiently progressive and doesn’t need to be made more so.

• The transition rules that would be necessary to prevent tax reform from creating economic shockwaves.
The current legislative environment

National retail sales tax

How it works
A national retail sales tax would be imposed on the retail sale of any property or service (including rentals and financial intermediation services) to any retail purchaser. Intangible property and used property would not be subject to tax. Nonretail sales, such as sales for resale or sales for use in a business or investment, would not be taxed. The tax would be imposed on imports, but exports would be exempt. Certain limited items, such as payments for education, could be exempt. Wages would no longer be subject to tax. Under some proposals, the tax would be administered and collected primarily by existing state tax agencies.

Issues in rate setting
A retail sales tax is perhaps the most straightforward type of consumption tax, but its implementation may not be as simple. States that currently impose sales tax often exempt certain categories of items such as education, medicine, utilities and transportation. Additionally, the tax base in some states also excludes certain foods and clothing. Therefore, if the tax rate is set too low, it could be difficult to collect enough revenue to fund government services. However, if the rate is set too high, policymakers face the potential problem of regressivity — that is, lower-income individuals paying a disproportionately high percentage of their income on taxes (compared to more affluent taxpayers) because so much of their income is spent on consumer transactions.

Large and complicated rebate system
To protect lower-income individuals from experiencing a dramatic increase in tax burdens with the adoption of national retail sales tax, policymakers would likely contemplate a cash grant (rebate or "prebate") in the form of monthly cash payments to all US citizens and residents. One of the challenges to this approach, however, is the potentially high cost of a rebate system that could result in many taxpayers being dependent on monthly checks from the federal government for a substantial portion of their incomes. A national-level sales tax would also likely increase the size of government and possibly offset the simplification gains promised by the national retail sales tax.

Problem for states
Additionally, some state taxing authorities are concerned that ending the current federal income tax system in exchange for a national retail sales tax would have serious consequences for their jurisdictions. Not only would a national retail sales tax invade a revenue source historically reserved to the states, but the many states that collect individual income taxes would find it difficult, if not impossible, to maintain those systems in the absence of federal income tax information reporting requirements. And that fact could force states with no sales taxes to adopt them against their wishes.

Conversely, states with sales taxes could also face problems. States that have no income tax often rely on relatively high sales taxes to generate a major portion of their revenues. A national sales tax would put pressure on those states to lower their rates because of the additional burden imposed by the federal levy. (States that have income and sales taxes, or local option retail sales taxes would face the same problem.) States with relatively low rates would feel constrained in keeping a low rate for the same reason.

Other criticisms
Consumption taxes, such as a retail sales tax, are a hard sell politically at the national level. Like other taxes, consumption taxes are unpopular, but may be even more so because taxpayers would see them daily on almost every transaction. Because of this visibility, there is a widely held belief among lawmakers that voters will punish them at the polls for enacting one. Further, Democrats and Republicans alike have reservations about consumption taxes, although each party generally has a separate set of concerns. Some Democrats are bothered by the potential for regressivity under a consumption tax regime; some Republicans, for their part, worry that the revenue-raising capacity of a consumption tax could be used to grow government.
The current legislative environment

Flat tax

How it works
In its simplest form, a flat tax imposes a single rate of tax on individual and business income. Businesses, regardless of legal form, would be taxed on “gross active income” (gross receipts from the sale or exchange of property or services in the United States and from the export of property or services) less the cost of business inputs, amounts paid for wages and compensation, and contributions to pension accounts (excluding the employer’s portion of Social Security taxes). There would be no other deductions or business credits, such as for nonpension employee benefits, business interest, and state and local income taxes.

Business income derived from investment (as opposed to operations) would not be taxed. Capital expenditures to acquire real property utilized in a business would be immediately deductible.

Individuals would be taxed on their compensation for personal services, pension distributions, and unemployment compensation. Proposed flat taxes also typically include a substantial standard deduction for each dependent. Individual itemized deductions and present-law tax credits generally would be eliminated, although certain versions of the flat tax that have been proposed in the past would retain the Earned Income Tax Credit. Interest, dividends, capital gains, and other investment income would not be taxed. The individual AMT would be repealed.

Opposition to flat taxes
An argument against flat taxes is that replacing income taxes, the estate tax, and payroll taxes with a single tax rate would be too disruptive. Opponents have often argued that it would be difficult to achieve an equitable distribution of the income tax burden under a flat tax without also creating a federal rebate program for lower-income taxpayers to address regressivity concerns.
The current legislative environment

Planning for today with a view of tomorrow

Long-term planning is more effective when you develop your own personal view of our economy and the markets, the future of taxes and tax rates that you may experience, and federal spending priorities that may influence your financial and retirement needs. Although no one can predict the future, making a personal assessment of future possibility is vital to the planning process. In fact, you may want to test your plans under a range of possibilities. Having framed the debate in Washington over the future of tax and fiscal policy, this publication will examine several key areas where effective tax planning is paramount.

Continue to plan; work with what you know
Given that many policymakers are already looking ahead to the next administration beginning in 2017 as an opportunity for comprehensive tax reform, we believe significant tax changes could occur at some point in the future; but until that change comes, disciplined planning under present law produces real benefits.

Adopt a view of the future and plan accordingly
As this goes to press, Washington is fundamentally divided over the future direction of tax and spending policies, and the year ahead is likely to be consumed by presidential politics. The shape of potential changes to the tax code is likely to become clearer as a tax reform debate plays out against the backdrop of the 2016 elections. Fundamental reform that lowers top tax rates into the 25 to 28 percent range coupled with repeal of — or at least significant changes to — favorite tax expenditures is the topic of the day. However, there are significant obstacles to reform, so current law could prevail for some time.

Be wary of quick answers and simple advice
Tax legislation rarely concludes in the manner in which it starts. The US and global economies and our governmental processes are highly complex, as are the structures, instruments, and businesses to which a tax law must apply. Even simple tax proposals change during the legislative process. Before taking action in response to a potential change, you should completely analyze a proposed transaction and alternative outcomes.

Watch for opportunities and know your risks
The mere discussion of tax law changes and new taxes can influence markets. Continued uncertainty over the long-term outlook for the federal budget influences financial markets and the value of the dollar. As a taxpayer and an investor, you should work to be informed about significant tax and nontax reforms and position your portfolio in a manner consistent with your conclusions about how changes will affect investment opportunities.
Income tax: Planning is always important

Even on calm seas, a ship’s captain rarely relaxes. Instead, the captain focuses on potential dangers in nearby waters and scans the horizon for the next change in weather — all the while keeping the ship on course toward its destination. With interest-rate uncertainty ebbing and tax reform adrift, affluent individuals should take a similar approach to income tax planning today. Pay close attention to tax policy developments, especially tax deduction and credit extensions, and near-term federal, state and local tax-law changes. Prepare for the potential political storm around tax reform in an election year and after a new president takes office — reform could present new boundaries for income tax planning. And carefully attend to long-term tax approaches that will keep your financial ship on course.

In this section, we offer a range of tax planning considerations to help you address issues at various points out to your horizon, from recent developments in tax rates, the AMT, and healthcare taxes to charitable contributions, retirement savings and income, state income tax planning, and year-round tax planning. We also turn the spotlight to three particular areas that represent the leading edge of tax planning: the “financialization” of art, practical tax implications of private aircraft ownership, and the importance of being prepared for tax authority scrutiny and resulting tax controversy.

Learn more about:
Introduction

Income tax planning is always important. By implementing a long-term commitment to thoughtful tax planning, you can better navigate today’s increased rate environment. Think about planning considerations in terms of categories of income, and also in terms of categories of tax. This approach can provide a solid foundation on which to focus your planning options.

<table>
<thead>
<tr>
<th>Categories of income</th>
<th>Categories of tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment income</td>
<td>Income tax</td>
</tr>
<tr>
<td>Ordinary income</td>
<td>Alternative minimum tax (AMT)</td>
</tr>
<tr>
<td>Retirement savings</td>
<td>Healthcare taxes</td>
</tr>
<tr>
<td>Deductions</td>
<td>State Taxes</td>
</tr>
</tbody>
</table>

This guide is designed to provide information to assist you in both short and long-term tax planning. Of course, it goes without saying that you should focus your planning on your own specific fact pattern and objectives, as there is no one-size-fits-all approach. You should know that not all planning considerations are designed to save you taxes across the board — some planning considerations are designed to plan for income tax and AMT while others are designed to plan for healthcare taxes. In some instances, the considerations may save you on both fronts: alternatively, certain considerations decrease exposure to one tax but increase it for another. You should also know that all planning considerations may not apply to you, and that you should always consult a tax advisor.

By implementing a long-term commitment to thoughtful tax planning, you can better navigate today’s increased rate environment.
Income tax: Planning is always important

Tax rates

As the American Taxpayer Relief Act of 2012 (ATRA) permanently extended the majority of tax provisions that were originally enacted as part of the Bush-era tax cuts and the significant tax rate increases that were previously enacted in 2013, tax bills for low, middle, and high-income taxpayers will generally go unchanged from 2014 to 2015. For 2015, the top marginal tax rate is 39.6% for unmarried taxpayers with income over $413,200 and married taxpayers with income over $464,850. Tax rates continue to range from 10% to 39.6% and will remain in place permanently until further reform.

Overview of tax rates for individuals from 2014-2015

<table>
<thead>
<tr>
<th>Provision</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary income tax rates</td>
<td></td>
<td></td>
</tr>
<tr>
<td>39.6%</td>
<td>39.6%&lt;sup&gt;1&lt;/sup&gt;</td>
<td></td>
</tr>
<tr>
<td>35.0%</td>
<td>35.0%</td>
<td></td>
</tr>
<tr>
<td>33.0%</td>
<td>33.0%</td>
<td></td>
</tr>
<tr>
<td>28.0%</td>
<td>28.0%</td>
<td></td>
</tr>
<tr>
<td>25.0%</td>
<td>25.0%</td>
<td></td>
</tr>
<tr>
<td>15.0%</td>
<td>15.0%</td>
<td></td>
</tr>
<tr>
<td>10.0%</td>
<td>10.0%</td>
<td></td>
</tr>
<tr>
<td>Top rates for investment income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term capital gains top rate</td>
<td>20.0%</td>
<td>20.0%&lt;sup&gt;2&lt;/sup&gt;</td>
</tr>
<tr>
<td>Qualified dividends top rate</td>
<td>20.0%</td>
<td>20.0%</td>
</tr>
</tbody>
</table>

Marriage penalty relief

<table>
<thead>
<tr>
<th>Standard deduction</th>
<th>Deduction for married-joint filers is twice that of single taxpayers</th>
</tr>
</thead>
<tbody>
<tr>
<td>15 percent bracket</td>
<td>Bracket expanded to twice that for single taxpayers</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Provision</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>AMT exemption</td>
<td>$52,800 Single; $82,100 Married</td>
<td>$53,600 Single; $83,400 Married</td>
</tr>
<tr>
<td>Healthcare taxes enacted in Patient Protection and Affordable Care Act</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| Net investment income tax (NIIT) | 3.8% surtax on net investment income of single taxpayers with AGI over $200,000 ($250,000 for joint filers) | \begin{align*} \text{Single and joint filers with AGI above} & \$254,200 \text{ and } \$305,050, \text{ respectively (annually indexed for inflation)} \\
\text{Single and joint filers with AGI above} & \$258,250 \text{ and } \$309,900, \text{ respectively (annually indexed for inflation)} \end{align*} |
| Increase in Medicare hospital insurance (HI) tax wage base | 0.9% increase in employee portion of HI wage base of single taxpayers with AGI over $200,000 ($250,000 for joint filers) | |
Income tax: Planning is always important

Tax rates

Underpayment penalties

Federal law requires the payment of income taxes throughout the year as the income is earned. This obligation may be met through withholding, making quarterly estimated tax payments, or both. The penalty for underpayment is calculated as interest on the underpaid balance until it is paid, or until April 18, 2016, whichever occurs first.

For 2015, individuals will not be subject to an underpayment penalty if the balance due on their federal tax return (total tax liability for the year, less withholdings) is $1,000 or less. If the balance due is more than $1,000, the taxpayer will be subject to a penalty unless 2015 withholdings and estimated tax payments equal 90% of the 2015 tax liability, 100% of the 2014 tax liability (110% if 2014 AGI exceeds $150,000 for married taxpayers), or 90% of the 2015 tax liability based on quarterly annualized year-to-date income.

The table below illustrates the amount required to be paid (cumulatively) for 2015 taxes under each method by each date for calendar-year taxpayers.

<table>
<thead>
<tr>
<th>Cumulative amount of estimated taxes to be paid</th>
<th>Due date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current year’s tax or annualized income method</td>
<td>22.5%</td>
</tr>
<tr>
<td>Prior year’s tax — safe harbor for qualified individuals</td>
<td>22.5%</td>
</tr>
<tr>
<td>Prior year’s tax — safe harbor for AGI of $150,000 or less</td>
<td>25%</td>
</tr>
<tr>
<td>Prior year’s tax — safe harbor for AGI over $150,000</td>
<td>27.5%</td>
</tr>
</tbody>
</table>

Adjust withholding amounts to avoid penalties. Income tax withholdings are considered to be paid equally throughout the year, even if the withholdings are made near the end of the year. If you anticipate that you have underpaid your estimated taxes for 2015, consider adjusting withholdings for the remainder of the year to avoid penalties for underpayment of estimated taxes.

Account for supplemental wages. In certain circumstances, supplemental wages (e.g., bonuses, commissions, and overtime pay) may be subject to a flat 25% withholding rate. If this rate is different from your normal withholding rate, be sure to factor the different rate into your estimated tax calculations. Supplemental wages in excess of $1 million are subject to withholding at the highest marginal income tax rate in effect for the year they are paid.
Income tax: Planning is always important

**Tax rates**

**PLANNING TIP #3**

*Cure underpayments through indirect rollover distributions.*

If you anticipate being liable for underpayment penalties on estimated tax, you may consider taking an indirect rollover distribution from a traditional or Roth individual retirement account (IRA) account during the year of underpayment. If an indirect rollover of an IRA occurs, the trustee of the IRA is required to withhold 20% of the funds distributed as a prepayment of federal income tax unless you elect not to have federal taxes withheld on Form W-4P. You may also elect to have an additional amount withheld from the distribution by providing the trustee of the IRA with Form W-4P. By triggering sufficient withholding tax, you can “cure” prior underpayments of estimated tax and avoid or reduce penalties. As long as you redeposit the gross amount of the IRA distribution to another IRA within 60 days, no adverse tax consequences result from the rollover, provided you meet the once-per-year rollover limitation. Please note, beginning in 2015, you can make only one indirect rollover from an IRA to another IRA in any 12-month period, regardless of the number of IRAs you own. Trustee-to-trustee transfers between IRAs as well as rollovers from traditional to Roth IRAs (“conversions”) are not limited.

**Overpayment of estimated taxes**

Just as you should avoid underpaying estimated taxes and incurring a penalty, you also should avoid overpaying estimated taxes. Overpaying taxes is the equivalent of providing an interest-free loan to the government. You may receive a refund eventually, but you have lost the opportunity to have the money working for you.

**PLANNING TIP #4**

*Monitor and adjust withholdings throughout year.* If you anticipate that you have overpaid estimated taxes (or withholdings have been too high during the year), consider reducing withholdings during the remainder of the year to create an early refund. Certain restrictions apply with respect to the number of allowances you may claim, which will affect the minimum amount that can be withheld; therefore, check with your tax advisor before submitting a new W-4 to adjust your withholdings for 2015. Also, estimate withholding for 2016 and file a new W-4 with your employer, if necessary.

**Recognition of compensation income**

Depending on your situation, you may be able to time the receipt of commissions, bonuses, or billings between one year and another. Income recognition timing is not easy, however. You need to consider the time value of money, the impact that acceleration or deferral might have on various deductions, credits, your projected income tax rate in both years, and other nontax financial factors. There are several income recognition techniques you may consider. Again, you must be aware of tax rules that impose an additional income tax of 20% or more on certain impermissible changes in the timing of compensation payments.
Income tax: Planning is always important

Tax rates

To further complicate the impact of today’s increased tax rate environment, when timing income recognition, taxpayers should also consider the interplay with AMT and the PEP and Pease deduction limitations also discussed in this publication.

PLANNING TIP #5

Timing and character of compensation and bonuses. As discussed above, if you have the ability, consider delaying or recharacterizing compensation or bonuses where possible. For instance, analyze opportunities to make a Section 83(b) election on restricted stock to convert ordinary income to capital gains. Section 83(b) imposes ordinary income tax on property received as compensation for services as soon as the property becomes vested and transferable. If you receive the eligible property (such as restricted stock), within 30 days, you can elect to recognize immediately as income the value of the property received and convert all future appreciation to capital gains income, and convert all future dividends on the stock to dividends qualifying for the reduced rates. Keep in mind, however, that future capital gains and dividends may be subject to the 3.8% Net Investment Income Tax (NIIT). This should be considered carefully as this election cannot be undone in the event the stock does not appreciate or never vests. Careful planning is required to make sure you comply with the strict rules and are able to properly weigh the benefits against the risks, for example, the risk of forfeiture. Consult with your financial advisor before making this election.

PLANNING TIP #6

Consider NOL carryforwards. If you are generating a net operating loss (NOL), you should consider having your NOL carried forward to offset future ordinary income taxed at higher rates, rather than carried back to offset income taxed at lower rates. Careful modeling of this decision is critical and must focus on cash flow, as well as tax considerations. Note that one must affirmatively elect to carry forward an NOL. Without such an election, the NOL must be carried back.

PLANNING TIP #7

Consider deferring bonuses to 2016. Income is usually taxable to an individual in the year of receipt. In most cases, therefore, deferring income to 2016 will defer the associated ordinary and Medicare taxes. If you have the ability, consider delaying the receipt of an annual bonus until shortly after December 31st, or waiting until January to bill for services. Check with your tax advisor prior to engaging in this type of planning to confirm you are not running afoul of constructive-receipt rules, which treat income as received even though you do not have the cash in hand, or subjecting the income deferred to the very stringent Section 409A rules imposed on nonqualified deferred compensation. Also, check with your tax advisor to determine whether you are subject to AMT in either year, as this may affect your ability to benefit from such a deferral strategy.
Income tax: Planning is always important

Tax rates

Investment income
In addition to consulting your tax advisor about planning techniques specific to your situation, you should work with your investment advisor to determine whether it is better to invest funds in a taxable account or a tax-deferred account, and to consider your asset allocation and investment strategy in light of the impact of tax rates on portfolio income. Keep in mind that tax-exempt investment income, from municipal sources for example, is not affected by increased ordinary rates nor are they subject to the NIIT.

Long-term capital gains tax rates
The long-term capital gains tax rate is 20% for taxpayers in the top 39.6% bracket. The long-term capital gains rate for taxpayers in the 25%-35% tax brackets is 15% and for those taxpayers in the two lowest tax brackets, the long-term capital gains rate is 0%. In addition, capital gains may also be subject to the 3.8% NIIT. Gains from installment sales are taxed at the rate in effect on the date an installment payment is received.

2015 capital gains tax rate

<table>
<thead>
<tr>
<th>Taxable income</th>
<th>Description</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than threshold</td>
<td>$37,450 single; $74,900 for MFJ</td>
<td>0%</td>
</tr>
<tr>
<td>Over $37,450, but less than $413,200</td>
<td>for single: over $74,900, but less than $464,850 for MFJ</td>
<td>15%</td>
</tr>
<tr>
<td>Greater than threshold</td>
<td>$413,200 single; $464,850 for MFJ</td>
<td>20%</td>
</tr>
</tbody>
</table>

Certain sales of capital assets do not qualify for the lower capital gains rate. Collectibles remain subject to a 28% maximum rate. Unrecaptured Section 1250 gain on real estate is subject to a 25% maximum rate. Qualified small business stock is generally subject to the 50% exclusion and the remainder is taxed at 28%, subject to certain exceptions discussed in Planning Tip #12 — Sell a business through a stock sale.

Capital gains and capital losses
The decision to sell capital assets should be based on economic fundamentals, together with your investment goals; however, you should also consider the tax aspects. To illustrate, a taxpayer in the 39.6% tax bracket is subject to a 20% capital gains tax rate on assets held for more than one year; thus, a 19.6% rate differential exists between said long-term capital gains and short-term capital gains (which are taxed at ordinary income rates). Both long and short-term gain on almost all assets will be subject to the 3.8% tax. Special attention should be given to the holding periods of assets to take full advantage of the long-term capital gains rates available for assets held more than one year.

Holding period

When considering the following planning tips, you should also be mindful of how the 3.8% NIIT may affect your overall capital gain rate for 2015 and future years.
Tax controversy
Before federal and state tax examiners request, preparation is critical
You might not be able to avoid an examination, but you can benefit by being prepared

What can make you a more likely target?
Since 2009, the IRS has had a division dedicated to “Global High Wealth” taxpayers. And according to IRS statistics, higher-income taxpayers are indeed more likely to be examined. People who earn more than $10 million have almost a one in four chance of meeting the agency across that table every year. (This is more than 25 times the average rate across all incomes.)

Certain types of financial, personal, or business activity may also attract inquiries:
- Charitable donations and related substantiation
- Sales transactions — both third-party and intra-family
- Businesses with potential elements of personal enjoyment (small farms, wineries, horse breeding and racing, etc.)
- Gifting transactions
- Losses, including passive activity determinations
- Household employees and related employment tax considerations
- Use of private aircraft

What’s new?
- IDR enforcement. A 2014 IRS directive for certain taxpayers shortens the time frame for enforcement of failure to respond to Information Document Requests (IDRs) in a timely manner. Nevertheless examiners follow strict rules on how and when they issue may issue IDRs.
- AJAC tightens appeals. The Appeals Judicial Approach and Culture (AJAC) is meant to make the process of appealing an IRS audit more judicial and less an informal extension of the audit process. The intent is to protect taxpayers, which includes new rules to follow.
- Driven focus. There are larger numbers of examinations that target a specific, defined issue that may yield positive results. However, traditional exams with broad requests for information also continue to affect taxpayers.

How can you be ready?
IRS examinations have a defined lifecycle, and along the way there are multiple options for resolving controversy. Your readiness begins with understanding how the process works.

- Know your situation. Performing a risk assessment may help identify the specific areas upon which a potential IRS exam might focus. You may be able have more information and potential options when you analyze possible issues before an IDR has been issued.
- Confirm documentation. Is your auto or aircraft use taxable? Was that winery a business or a hobby? Small facts may impact significant tax issues.
- Don’t be a hero. Think hard before representing yourself before the IRS. A trained advisor can help you prepare, help you understand what kind of examination you face, and serve as an intermediary.
- Think big. The planning that goes into your discussion with the IRS should be part of a larger plan that ties estate and income tax planning into a single, coherent reality. The IRS will examine the timeline and background — you should too.
Income tax: Planning is always important

Tax rates

**PLANNING TIP #8**

Consider tax brackets when realizing capital gains. If you anticipate being in a lower tax bracket in 2016 and future years or expect significant amounts of capital losses in 2016, you may want to consider realizing capital gains in 2015, but deferring tax recognition until 2016. You can accomplish this by using such strategies as entering into an installment sales agreement (but not when selling marketable securities, as such gain is not deferrable) or implementing other investment techniques. Consult your tax advisor for planning techniques specific to your situation.

**PLANNING TIP #9**

Consider harvesting losses to offset short-term capital gains. If you have short-term capital gains (which are taxed at ordinary income tax rates), consider selling capital assets that will generate a capital loss in order to offset the short-term capital gain. Taxpayers are allowed to deduct up to $3,000 of net capital losses against ordinary income each year. Any net capital losses in excess of $3,000 are carried over to future years. While harvesting losses can make sense from a tax perspective, make sure you are not overlooking investment implications and transaction costs that could more than offset the tax gains. In some cases, the primary benefit of harvesting a tax loss is simply to offset the payment of capital gains tax.

**PLANNING TIP #10**

Consider the wash sale rules. Under the “wash sale” rules, if securities are sold at a loss and the same — or substantially the same — securities are purchased within 30 days before or after sale of the original securities, the loss cannot be recognized until the replacement securities are sold. These rules apply even if the purchased securities are in the seller’s IRA. There often is a satisfactory alternative, however. To realize the loss and maintain the ability to benefit from any market up-side, consider selling a stock or mutual fund to realize a loss and then replacing it in your portfolio with one having similar characteristics in the same industry or style group.

**PLANNING TIP #11**

Gift appreciated assets. Taxpayers interested in family wealth planning should consider gifting appreciated assets (or those that are expected to appreciate) to their children who are not subject to the kiddie tax and are in the lowest two tax brackets. Because taxpayers in the highest five tax brackets are taxed at 15% or 20% long-term capital gains rates versus a 0% rate for taxpayers in the lowest two tax brackets, you may realize an immediate tax savings. Combining utilization of the gift tax annual exclusion with a gift of appreciating assets can be a powerful wealth transfer planning tool. Keep in mind that the applicable age for applying the kiddie tax is children under age 19 or full-time students under age 24 (more details on the kiddie tax are discussed later in this section).
Income tax: Planning is always important

Tax rates

**PLANNING TIP #12**

Sell a business through a stock sale. If you are considering selling a business, you may attempt to structure the transaction as a sale of the company’s stock rather than a sale of the company’s assets. In most circumstances, a sale of the company’s stock will constitute a sale of a capital asset eligible for the lower capital gains tax rate, as opposed to a sale of the assets, a portion of which may be subject to tax as ordinary income. Additional tax savings accrue if the business constitutes a qualified small business, the stock of which has been held for at least five years. Generally, 50% of the gain on such a stock sale (limited to the greater of 10 times the taxpayer’s basis in the stock or $10 million) is excludable from income with any remaining gain being taxed at 28%. The qualified small business stock exclusion is 75% for stock acquired after February 17, 2009 and on or before September 27, 2010, and 100% for stock acquired after September 27, 2010, and before January 1, 2015 (the Tax Increase Prevention Act of 2014 temporarily extended the exclusion of 100% of the gain from January 1, 2012 through December 31, 2014). The buyer will typically want to structure the transaction as a sale of assets in order to take advantage of certain depreciation rules; therefore, some negotiation is to be expected. Note that for stock acquired on or after September 27, 2010 and before January 1, 2015, the associated AMT addback is also eliminated.

**PLANNING TIP #13**

Investing inside and outside of retirement accounts. If you expect to be in a higher tax bracket in future years or you expect tax rates to increase significantly in your retirement years, it may be more advantageous to invest in equities outside of your retirement accounts as you approach retirement. By doing so, you can obtain the favorable capital gains tax rate when you sell the investment. You also may consider investing in taxable bonds in your retirement accounts, where the ordinary income generated can be deferred. Retirement plan distributions are generally taxed at ordinary income tax rates, which can be as high as 39.6%. You should run a multi-year tax projection to determine the best method of investing for retirement while keeping taxes to a minimum.

**PLANNING TIP #14**

When selling S-corp or C-corp stock, consider electing to use disposition of assets treatment. If planning on selling C-corp or S-corp stock, consider electing to have certain dispositions treated as a disposition of assets rather than disposition of stock. The election allows a step-up in the basis of the entity’s assets upon the disposition, thus equalizing the inside and outside basis of the assets and eliminating the built-in gain on a future after-sale disposition of the underlying assets. Purchasers other than corporations (e.g., individuals, trusts, estates, and partnerships) may be able to benefit from this type of election that requires the consent of sellers and purchasers. Because the availability and advisability of making this election depends upon each taxpayer’s factual circumstances, you should consult with your tax advisor to explore the possibility of making an election.
Income tax: Planning is always important

Tax rates

Tax rates on qualified dividends
Similar to long-term capital gains rates, the top qualified dividends rate is 20% for taxpayers in the top 39.6% bracket. The 15% qualified dividends rate applies for taxpayers in the 25%-35% tax brackets and for those taxpayers in the two lowest tax brackets, the qualified dividend rate is 0%. Dividends may still be subject to the 3.8% NIIT in 2015 and future years.

“Extraordinary” dividend income
The receipt of “extraordinary” dividends may cause unexpected tax results. Extraordinary dividends are typically the result of larger-than-normal dividends and/or a very low basis in the stock. Dividends are considered “extraordinary” if the amount of the dividend exceeds 10% of the shareholder’s adjusted basis in the stock (5% if the shares are preferred). All dividends with an ex-dividend date within the same 85 consecutive days are aggregated for the purposes of computing whether this threshold is met. Individuals who receive extraordinary dividends and later sell the stock on which the dividends were paid must classify as a long-term capital loss any loss on the sale, to the extent of such dividends. This rule applies regardless of how long the stock was held. Thus, for the investor who anticipated receiving short-term capital loss treatment on the sale, presumably to offset short-term capital gains, unexpected tax consequences may result. Absent this rule, a taxpayer who had already realized a short-term capital gain could buy a stock that was expected to pay out large dividends, hold the stock only long enough to receive the dividend, and then sell the stock at a loss to offset the short-term capital gain while enjoying favorable tax rates on qualified dividends.

PLANNING TIP #15

Investment interest expense planning. Investment interest expense is only deductible to the extent of current year net investment income. Dividends that are taxed at the lower qualified dividends reduced rates are not treated as investment income for purposes of this calculation; therefore, you should consider electing to tax a portion of qualified dividends (or long-term capital gains) at ordinary income rates to increase use of the investment interest deduction. You may elect to recognize just enough of the qualified dividends to be taxed at ordinary income tax rates to offset investment interest expense and allow the remainder of qualified dividends to be taxed at the lower 15% or 20% rate (or 0% rate for lower-income taxpayers). Alternatively, if you anticipate being in a higher tax bracket in 2016, you should consider whether carrying over an investment interest expense into a future year is more advantageous than electing to recognize qualified dividend income (and/or capital gains) as ordinary income for a current-year offset.
Income tax: Planning is always important

Tax rates

**PLANNING TIP #16**

Consider reducing payments in lieu of dividends. Some margin accounts allow a broker to borrow shares held in the margin account and return the shares at a later date. In practice, the broker borrows shares from a pool of investors in order to lend the shares to another investor to execute a short sale. For tax purposes, payments that are made while the shares are on loan are considered “payments in lieu of dividends,” rather than dividends, and thus will not qualify for the lower 15% or 20% rates (or 0% rate for lower-income taxpayers).

Unless your broker already has notified you of its policies regarding share borrowing, consider consulting with your broker to see whether it is the broker’s policy to borrow shares from noninstitutional investors. In certain cases, an investor may want to transfer dividend-paying shares into a cash account or place a restriction on the broker’s ability to borrow the shares. Alternatively, an investor may want to have the ability to call back shares of stock before the dividend date so that he or she will be the owner of the shares on the dividend record date.

**PLANNING TIP #17**

Consider holding underlying stock for at least 61 days. In order to qualify for the reduced rates, the underlying stock upon which a dividend is paid must be held for at least 61 days during the 121-day period, beginning 60 days before the ex-dividend date (91 days of the 181-day period for cumulative preferred stock). In order to qualify, the shares must not be subject to a hedging transaction during this time period; therefore, if you regularly engage in hedging transactions or other derivative transactions, you may want to consider more complicated investment techniques, such as selling a qualified covered call, in order to take advantage of the lower rates.

The kiddie tax

The so-called kiddie tax originally was enacted to prevent the transfer of unearned income from parents to their children in lower tax brackets. It targets investment income earned on investments in the name of a child, taxing such income at the same rates that apply to their parents. For 2015, the kiddie tax may apply if the child’s investment income exceeds $2,100. The kiddie tax applies to: 1) all children under age 19, and 2) full-time students under age 24. Note that the kiddie tax does not apply to a student over age 17 who has earned income that accounts for more than half of the student’s support.

Stock option planning

Traditionally, a favorite form of performance compensation for corporate executives has been the granting of stock options. Stock options provide executives with the flexibility to determine when they want to exercise the options and therefore, control the timing of the tax event. Section 409A changed the tax rules for certain compensatory options. If you now hold or subsequently receive as compensation options on property other than employer common stock (or analogous partnership equity interests in the case of a partnership employer) or with an exercise price less than the fair market value of the property on the date it is granted, discuss the impact of Section 409A on this compensation with your tax advisor. If you have exercised any such options, determine whether additional income taxes apply or if you can take an alternative position to address potential additional income taxes.

There are two types of stock options: nonstatutory options (also known as nonqualified stock options, NSOs, or NQSOs) and statutory options (also known as incentive stock options, ISOs, or employee stock purchase plan options). Generally, NQSOs generate compensation income when exercised. At exercise, the taxpayer pays tax at ordinary income tax rates on the spread between the fair market value of the property received and the exercise price. Historically, taxpayers have waited until near the end of the exercise period in order to delay the tax consequences.
Income tax: Planning is always important

Tax rates

Incentive stock options have a different tax consequence. An ISO cannot be granted with an exercise period longer than 10 years, but the period can be shorter if the company so chooses. Exercising an ISO does not affect a taxpayer’s regular taxable income; however, the exercise may affect the taxpayer’s AMT. Therefore, taxpayers should plan for and control the timing and exercise of ISOs.

Consider exercising ISOs. When exercising ISOs, consider holding the stock for the required holding period to lock in post-grant appreciation at long-term capital gains rates. As many taxpayers have realized over the last few years, however, continuing to hold ISO stock in a volatile market may prove disadvantageous. The long-term capital gains rate should be but one consideration in determining whether to sell or hold ISO stock.

A taxpayer is eligible to use the lower capital gains tax rates if ISO stock is held for two years after the option was granted and more than one year after the option is exercised. The lower capital gains tax rate makes exercising ISOs more attractive. In some cases, exercising ISOs could trigger AMT, but with careful planning, you may avoid the AMT. An eligible person who, in order to comply with federal conflict-of-interest requirements, sells shares of stock after October 22, 2004, that were acquired pursuant to the exercise of an ISO will be treated as satisfying the statutory holding-period requirements for capital gains tax treatment, regardless of how long the stock was actually held.

Consider exercising ISOs at retirement or termination of employment. Many taxpayers continue to hold ISOs at retirement or termination of employment. As a general rule, retirees have only three months after separating from service to exercise the options as ISOs, to exercise any remaining ISOs.
Income tax: Planning is always important

Tax rates

Passive gains and losses
Net losses from passive activities currently cannot be deducted against income from other sources. Instead, these losses are suspended, to be deducted when the activity that generated the loss is disposed of in a taxable transaction, or when the taxpayer’s passive activities begin generating taxable income. Credits arising from passive activities are subject to similar rules. In addition, gifts (either to family members or charity) do not permit the use of suspended passive losses or credits. Planning for passive activities has become increasingly important as passive income may be subject to the 3.8% NIIT.

The tax law treats two types of activities as passive activities
The first is any business activity in which the investor does not materially participate. The second is most rental activities, regardless of the investor’s level of participation (subject to special rules for real estate professionals).

Individuals who own rental properties and are actively involved in management decisions pertaining to such property are able to deduct up to $25,000 of losses per year against other income. This amount generally is phased out by 50% of the amount by which the investor’s income exceeds $100,000. Therefore, the deduction is fully phased out if the investor has AGI of $150,000 or more.

PLANNING TIP #20
Closely monitor participation in activities. Increase your participation in what would otherwise be treated as a “passive activity” or dispose of passive activities with suspended losses or credits. This approach could allow you to use passive activity losses or credits currently that otherwise would be deferred. Alternatively, ask your tax advisor whether decreasing your participation in a profitable business activity will make the income passive so that it can be sheltered by losses from other passive activities. Note however, that passive income may be subject to the 3.8% NIIT.

PLANNING TIP #21
Consider tax benefits of passive activity dispositions. Passive losses that are “freed up” generally through disposition of the activity to an unrelated party may be used to offset ordinary income. Any applicable capital gains generated by the disposition may be eligible for the lower long-term capital gains tax rate and will be treated as passive income to allow utilization of suspended passive losses from other activities. Carefully coordinate the timing of the disposition of a passive activity with other activities throughout the year in order to provide the best possible results.
PLANNING TIP #22

Transfers of passive activities. Remember that, generally, a disposition must be part of a taxable transaction if it is to “free up” any suspended losses. If the activity that generated the passive losses is disposed of in a transaction other than a taxable sale, the suspended losses may be lost to the original holder. For example, if the activity is transferred by gift, suspended passive losses are added to the donee’s (recipient’s) basis and are not deductible by the donee until the activity is sold, at which time the unused losses will reduce gain/increase the donee’s loss. If the activity is transferred by divorce, the suspended passive losses are added to the former spouse’s basis, and the spouse who gives up the property loses the suspended losses. If the activity is transferred by sale to a related party, the suspended losses remain as suspended losses to the seller; when the related party sells the property to an unrelated party in a taxable transaction, the original seller may be able to deduct any remaining suspended losses. If a decedent holds a suspended passive loss upon death, the passive loss is reduced to the extent of any stepped-up basis, if any, and the remainder is deductible on the decedent’s final return. If you are an heir of a 2010 decedent subject to the carryover-basis rules rather than the fresh-basis-at-death rules that apply to most decedents, consult your tax advisor regarding the interaction of the carryover basis rules and the passive loss rules.

PLANNING TIP #23

Be mindful of suspended AMT losses. Each passive activity will almost certainly have a suspended AMT loss. Suspended AMT losses are generally smaller than their regular tax counterparts because each passive activity’s AMT preferences and adjustments are added back. The difference between the regular tax and AMT suspended passive loss is recognized as a separate AMT adjustment in the year of disposition. If the difference is significant, any regular tax benefit may be lost if the taxpayer is in AMT. Further compounding the problem is that the AMT basis of the disposed passive activity will be greater than the regular tax basis in an amount roughly equal to the difference between the suspended losses under the regular tax and AMT. The result is reduced AMT capital gain (thus decreasing the applicability of preferential capital gains rates), or worse, creation of an AMT capital loss, which will be deductible only up to the capital loss limitation of $3,000. Passive activity planning is a complicated area of the tax law — one that you should discuss with your tax advisor.

See the Healthcare taxes section for additional ideas related to passive activities.
Income tax: Planning is always important

Alternative minimum tax

The individual AMT system originally was designed in 1969 to prevent the very wealthy from using a variety of special tax incentives to avoid paying income tax.

The AMT, however, has evolved into an unwieldy system that continues to ensnare millions of unsuspecting taxpayers. Those living in states with high income taxes (such as California, New York, Hawaii, Oregon, and Vermont) or high property taxes (such as New York, Illinois, and New Jersey) and who have deductible personal exemptions are more likely to be affected. However, now that the difference between the highest ordinary income tax rate and the highest AMT rate has increased, as has the AMT exemption, it is likely that fewer taxpayers will be subject to AMT going forward.

Planning for AMT has become increasingly difficult. Taxpayers must be especially mindful of year-end cash payments, such as fourth quarter state income taxes, pre-payment of investment and tax advisor fees, and charitable contributions. Current-year planning around timing of the payment of expenses that constitute itemized deductions not deductible under the AMT system is certainly important, but it may not be enough. In addition, projecting taxable income from hedge funds and managing private activity bonds are among activities that take on special significance. More than ever, meaningful AMT planning requires examining multi-year scenarios.

AMT rates, exemptions, and credits
The AMT exemption for 2015 is $83,400 for married couples filing jointly and $53,600 for single filers. These exemptions are indexed for inflation and phased out as taxpayers reach higher levels of AMT income (AMTI). For instance, the 2015 $83,400 married exemption is reduced by 25% of the amount by which AMTI exceeds $158,900. The phase out for the $53,600 exemption begins as AMTI exceeds $119,200.
Income tax: Planning is always important

Alternative minimum tax

The ability to apply most nonrefundable personal credits (including the Dependent Care Credit, the credit for the elderly and disabled, the credit for interest on certain home mortgages, and the Hope Education Credit) against the AMT expired at the end of 2011, but was reinstated again on a permanent basis as part of ATRA.

PLANNING TIP #1

Perform an AMT self-diagnosis. Falling victim to AMT has many possible causes, but you may be particularly prone to AMT if you have any of the following circumstances:

- Large state and local income or sales tax or property tax deductions
- Large long-term capital gains or qualified dividends
- Large deductions for accelerated depreciation
- Large miscellaneous itemized deductions
- Mineral investments generating percentage depletion and intangible drilling costs
- Research and development expenses in activities in which you do not materially participate
- An exercise of ISOs
- Large amounts of tax-exempt income that is not exempt for state tax purposes
- A large number of dependents
- Tax-exempt income from private activity bonds

If you are affected by one or more of these circumstances, you should discuss your AMT situation with your tax advisor.

PLANNING TIP #2

Consider accelerating ordinary income and deferring certain deductions. If you expect to be subject to AMT in 2015 but not subject to AMT in 2016, consider accelerating ordinary and short-term capital gain income and deferring certain 2015 deductions to 2016 (especially any deductions not deductible for AMT, such as state and local income taxes, real estate taxes, and investment advisory expenses). This approach is contrary to typical planning, but it may reduce your ultimate tax bill.

PLANNING TIP #3

Consider accelerating certain expenses. If you are not subject to AMT in 2015 but expect to be in 2016, consider accelerating expenses that are not deductible for AMT into 2015. For example, consider paying your fourth quarter state estimated tax payment in December of the current year instead of January of the following year.
Income tax: Planning is always important

Alternative minimum tax

PLANNING TIP #4

Do a multi-year analysis of potential planning options. Some of the differences between the AMT and regular tax systems are merely matters of timing. For instance, AMT generally requires slower depreciation than is permitted for regular tax purposes. Other differences are permanent; for example, state income or sales taxes can never be deducted under the AMT system, while under the regular system they are deductible when paid. Paying AMT in one year may generate a credit against a future year’s regular tax when adjustments are due to timing differences. Overall, you may be better off paying AMT currently in order to gain a credit in a later year — but only a multi-year analysis modeling the potential effect of planning options will tell.

PLANNING TIP #5

Consider disqualifying ISO dispositions. Consider whether any stock obtained by exercising ISOs should be disqualified before the end of the year to reduce AMT liability if the stock has dropped in value. A disqualifying disposition will limit compensation income to the difference between the exercise price and the lower value of the stock at sale. If there is a wash sale (i.e., you repurchase the same stock within 30 days of the disqualifying disposition), compensation will be computed on the spread at exercise (at the old, higher value).

PLANNING TIP #6

Watch out for other AMT traps. Income from private activity (municipal) bonds is taxable for AMT purposes, except certain private activity bonds issued in 2009 and 2010. Certain mortgage interest, such as from a home equity loan, is not deductible for AMT purposes as home mortgage interest if the funds from the loan are not used to buy, build, or substantially improve a primary or second home. Be sure to tell your tax advisor if you used the borrowed funds in your business or to make investments, as the home equity loan interest may still be deductible.
Private aircraft
Finding the right flight plan

There’s nothing like your own plane — but when it comes to taxes, you can’t afford to have your head in the clouds.

Private air travel continues to grow. Half the world’s private jets are US-based. It’s easy to appreciate the allure — not to mention access to more than 5,000 US airports, almost 10 times the number commercial flights can reach.*

However, it is just as important to appreciate the regulatory implications. You’re dealing with the FAA in addition to the IRS and state authorities. And at tax time, questions concerning who owns the aircraft, who flew on it, and the reason for the flight may have a dramatic impact.

If owning an aircraft is the right choice, other choices remain. Different situations may necessitate direct personal ownership, ownership through a related entity, shared or joint ownership, or perhaps a leasing structure between related parties.

How often do you use the aircraft?
If it is difficult to predict your usage, it will also be hard to predict the costs and benefits of private air travel. Using charters or a flight card at first may help you amass the information to decide about purchasing the aircraft.

Are your business passengers deductible?
Generally, costs related to business passengers are fully deductible — but it is not always that simple. A single flight may mix business passengers and non-business “hitchhikers.”

Does business mix with pleasure?
It might make sense to use a different aircraft for each purpose to avoid diluting the deductibility of the business flights.

What’s neither business nor pleasure?
“Personal non-entertainment” flights involve destinations like funerals, visiting the sick, or receiving medical treatment. The non-entertainment distinction may impact deductibility.

Is love in the air?
If an executive flying on business brings a spouse who is not an employee, the spouse’s travel is usually not deductible. But there are exceptions — for example, on taxpayer-provided aircraft where the spouse’s travel is considered to be “personal non-entertainment.”

Are you crossing the border?
It may be your plane, but it may also be in someone else’s airspace — and subject to their rules. You should understand where jurisdictions end (including over water) and how taxes and other rules apply. These facts affect not only the cost of the flight, but perhaps also the expenses that members of your party incur on the ground.

Income tax: Planning is always important

Healthcare taxes

Increased tax rate environment
Net investment income (NII) tax

A 3.8% tax levied on certain unearned income of individuals with AGI over $200,000 ($250,000 for joint filers).

Net investment income means the excess of the sum of gross income from the following over properly allowable deductions:

- Interest
- Dividends
- Capital gains
- Annuities
- Rents and royalties
- Passive activities and trading partnerships

Does NOT apply to:

- Income that is derived in the ordinary course of a trade or business and not treated as a passive activity
- Distributions from qualified plans

Increased tax rate environment
Medical hospital insurance (HI)

Employee share increases by 0.9% (2.35%, up from 1.45%) for individual’s wages, compensation, or self-employment income that exceeds threshold amount for filing status:

Married filing jointly $250,000
Married filing separately $125,000
Single $200,000

Self-employed individuals are not permitted to deduct any portion of the additional tax.

This change does not change the employer HI contribution.

In addition to giving thought to income taxes and AMT, taxpayers also need to be mindful of the combined impact of healthcare taxes, which target earned and investment income of high-income taxpayers.
Income tax: Planning is always important

Healthcare taxes

Medicare hospital insurance (HI) tax
The top individual income tax rate of 39.6% in 2015 does not include the rate increases included in the Reconciliation Act. Rather, an additional 0.9% HI tax will apply to earnings of self-employed individuals or wages of an employee received in excess of $200,000 ($250,000 if filing jointly). Self-employed individuals will not be permitted to deduct any portion of the additional tax. If a self-employed individual also has wage income, then the threshold above which the additional tax is imposed will be reduced by the amount of wages taken into account in determining the taxpayer’s liability.

Net investment income tax
An additional 3.8% NIIT also will be imposed on unearned income (income not earned from a trade or business and income subject to the passive activity rules) such as interest, dividends, capital gains, annuities, royalties, rents, and income from businesses in which the taxpayer does not actively participate. Because the tax applies to “gross income” from these sources, income that is excluded from gross income, such as tax-exempt interest, will not be taxed. The tax is applied against the lesser of the taxpayer’s net investment income (after investment related and allowable deductions) or modified AGI in excess of the threshold amounts. These thresholds are set at $200,000 for single filers and $250,000 for joint filers. Some types of income are exempt from the tax, including income from businesses in which the taxpayer actively participates, gains from the disposition of certain active partnerships and S corporations, distributions from qualified plans and IRAs, and any item taken into account in determining self-employment income.

For estates and trusts, the NIIT applies on the lesser of the undistributed net investment income, or the excess of AGI over the dollar amounts at which the 39.6% tax bracket for estates and trusts will begin. This threshold is $12,300 in 2015. Because this threshold is so low, consideration should be given to distributing income to beneficiaries who may be in lower effective tax brackets.

PLANNING TIP #1
Defer capital gains or harvest losses. As discussed above in the capital gains and losses section, consider deferring capital gains or harvesting losses when possible. As part of the analysis as to whether to harvest losses, it is also important to analyze transaction costs, as well as the underlying economic considerations.

PLANNING TIP #2
Consider installment sale treatment. For 2015 sales, consider electing into installment sale treatment (where available) and deferring the gain over the payment period (instead of recognizing the entire amount of gain in the year of sale). This would allow you to defer the income and the associated capital gains tax over the installment payment period. Sales of marketable securities are not eligible for installment sale treatment.

PLANNING TIP #3
Rebalance your portfolio. Consider rebalancing your investment portfolio by increasing investments in growth assets and decreasing emphasis on dividend-paying assets. This will remove income from your earnings and manage your exposure to the NIIT. Keep in mind that sales of taxable income-producing assets will be subject to capital gains rates and potentially to the 3.8% NIIT. You should work with your investment advisor to review your investment strategy in light of the impact of higher tax rates. If you anticipate your tax rate to increase in the future, tax-exempt investments may produce a greater yield than taxable investments.
Income tax: Planning is always important

Healthcare taxes

**PLANNING TIP #4**

**Investment Interest expenses planning.** If you have an investment interest expense carryover into 2015, and do not expect to have interest income, nonqualified dividend income or short-term capital gains in the future, you may consider electing to pay these qualified dividends and long-term capital gains at ordinary tax rates (instead of the reduced qualified rates) on your 2015 income tax return. As discussed earlier, investment interest expense is only deductible to the extent of current-year net investment income. Long-term capital gains and dividends that are taxed at the 20%, 15%, or 0% reduced rate are not treated as investment income for purposes of this calculation unless the election is made to pay them at ordinary rates to allow the investment interest expense. Not only would the election create an itemized deduction for investment interest, it would create a properly allocable expense against net investment income.

By electing to pay qualified dividends and long-term capital gains at the higher ordinary rate, you can utilize the investment interest expense that would otherwise not be able to use currently (assuming you only have long-term capital gains and qualified dividends in the future).

Conversely, if you do anticipate having nonqualified investment income and short-term capital gains in the future, it may be more beneficial to hold the investment interest expense as a carryover to future years and offset the income subject to the higher ordinary tax rates, as well as reduce exposure to the 3.8% NIIT.

**PLANNING TIP #5**

**Regrouping, recharacterizing, and disposing of passive activities.** In 2015, passive income may be subject to the 3.8% NIIT; therefore, if you have multiple passive activities, consider reviewing current grouping elections for each activity that may change such activity from passive to active or vice versa. Passive activity losses (PALs) can be deducted only against passive activity income, which would allow you to reduce the amount of passive activity income subject to the 3.8% NIIT; regroupings may release the otherwise suspended losses.

Alternatively, an appropriate recharacterization from active to passive status may suspend otherwise allowable losses, which could be considered more valuable when projected to be released in a future year when your tax rate may be higher. If you anticipate being in a higher tax bracket in 2016, consider delaying the disposition of the passive activity in order to release the suspended losses in 2016 when the losses would be more valuable.

However, if you think your rate will be lower in 2016, consider accelerating the disposition of a passive activity to free up losses in 2015. Timing of dispositions of passive activities and PAL carryforwards should be carefully coordinated. Passive activity planning is a complicated area of the tax law — one that you should discuss with your tax advisor as it relates to each of these matters.
Income tax: Planning is always important

Healthcare taxes

**PLANNING TIP #6**

Use a charitable remainder trust (CRT) to defer capital gains.

For anticipated sales in 2015 and later, consider using a charitable remainder trust (CRT) to defer capital gains, provided that you also have a charitable intent. Use of a net income makeup charitable remainder unitrust (NIMCRUT) may allow for a longer income-deferral period.

This technique is not available with S corporation stock, and may not be appropriate for some partnership interests.

**PLANNING TIP #7**

Donate appreciated securities.

Consider donating appreciated securities held for more than one year, rather than cash, to charity to receive a charitable deduction equal to the fair market value of the securities and also avoid paying capital gains tax on the stock’s appreciation. Having preserved the cash, consider purchasing new investments with a “refreshed,” higher basis with the cash you would have donated, potentially lowering exposure to the 3.8% NIIT.

**PLANNING TIP #8**

Self-employed retirement contributions.

Consider establishing an appropriate retirement savings vehicle, such as a Keogh or a simplified employee pension individual retirement account (SEP IRA), which would allow for maximum contribution to a qualified plan based on self-employment income.

**PLANNING TIP #9**

Consider converting to an S-corp to save self-employment tax.

Eligible single-member LLCs (SMLLCs) that are disregarded for federal tax purposes may consider converting to an S corporation under certain circumstances. Active shareholders of an S corporation receiving reasonable salaries are not subject to the self-employment tax on distributed and undistributed income passing through to the shareholders.

**PLANNING TIP #10**

Pay HI tax via quarterly installments.

For taxpayers expecting to be subject to the 0.9% HI tax, consider accounting for the additional tax in 2015 quarterly estimates. All wages that are currently subject to Medicare tax are subject to additional HI tax if the wages are in excess of the applicable threshold for an individual’s filing status. The statute requires an employer to withhold the additional HI tax on wages or compensation paid to an employee in excess of $200,000 in a calendar year. However, couples filing under the married filing joint status with separate salaries below the threshold, but once combined are in excess of the threshold, should plan to incorporate the additional liability in their quarterly payments or request that their employer withhold an additional amount of income tax withholding on Form W-4 for 2015 and beyond.
Income tax: Planning is always important

Deductions

With respect to deductions, the key planning issue is determining in which year the deduction will generate the greatest tax benefit. Understanding this allows you to determine the most appropriate timing for deductions. As your tax rate rises, deductions are likely to be more beneficial; conversely, if your tax rate declines, they likely will become less beneficial.

For example, a taxpayer subject to AMT does not receive benefit for many of his or her deductions, including state taxes, real estate taxes, and 2% miscellaneous itemized deductions, whereas an individual in a lower rate environment who is not paying AMT may receive more benefit from deductions than an individual in a higher rate environment who is paying AMT. Additionally, now that the difference between the highest ordinary income tax rate and the highest AMT rate has increased, as has the AMT exemption, it is likely that fewer taxpayers will be subject to AMT going forward. As such, performing multiyear AMT planning with an emphasis upon whether acceleration versus deferral of deductions will reduce AMT exposure and, therefore, provide a more significant benefit for your tax deductions is very important. It is critical that you discuss your AMT situation with your tax advisor.

The Pease limitation is the lesser of 3% of a taxpayer’s AGI over the threshold amount ($309,900 for a married couples and $258,250 for single taxpayers) or 80% of the certain Pease itemized deductions (qualified mortgage interest, state income and sales taxes, property taxes, charitable contributions, and miscellaneous itemized deductions). Assuming the same family has $50,000 of gross itemized deductions, they could potentially lose approximately another $4,200 worth of itemized deductions due to the Pease limitation.

Whether you are navigating ways to reduce the impact of PEP and Pease limitations, identifying where the increased rate spread between ordinary income and AMT rates may lessen exposure to AMT, or reducing unearned income subject to the NIIT through deduction planning, you will need to model your analysis carefully, as all will have significant bearing on the result.

In addition to AMT limiting tax deductions for certain earners, taxpayers may also face the phase out of personal exemptions (the “PEP limitation”) and limitation on itemized deductions (the “Pease limitation”). For 2015, a married couple’s deduction for personal exemptions may be reduced if their AGI exceeds $309,900, and is completely phased out when AGI exceeds $432,400 ($258,250 and $380,750, respectively, for single taxpayers). To illustrate, a family with three children who makes $450,000 a year would lose a $20,000 ($4,000 per person) personal exemption deduction in 2015.
Income tax: Planning is always important

Deductions

Charitable contributions
Charitable contributions or donations must take the form of money or property, and do not include a taxpayer’s time or services. A donation in the form of cash (or check or credit card charge) is considered a donation of money, the value of which is your total out of pocket cost. A taxpayer’s donation of property (for example, household goods, clothing, and motor vehicles) is generally measured by the fair market value of the property donated, with certain exceptions discussed below. Donated clothing and household goods must be in good condition. The IRS has discretionary power to disallow the deduction based on condition. Household items include furniture, furnishings, electronics, appliances, linens, and other similar items. Food, paintings, antiques, objects of art, jewelry and gems, and collections are excluded from the provision and are subject to different rules.

When making donations, one must be mindful of the recordkeeping requirements for sustaining a charitable income tax deduction. For a monetary gift of any amount, either a written record (such as a credit card statement or cancelled check) or a written contemporaneous acknowledgement from the charity is required. For donations of $250 or more, a written acknowledgment from the charity is required, stating the amount of any benefits received in return for the donation. If no benefits were received, the acknowledgment must say so. When property other than cash, inventory, and publicly traded securities is donated to charity, and such property is valued above $5,000, the property must be appraised and summarized on the donor’s income tax return in order to claim a charitable deduction. If the value exceeds $500,000, the appraisal must be attached to the donor’s income tax return, whether the donor is an individual, partnership, or corporation.

With respect to contributions of intangibles, if a donor contributes a patent or other intellectual property (other than certain copyrights or inventory) to a charity, the donor’s initial charitable deduction is limited to the lesser of basis or fair market value. If the donated property provides income to the charity, the donor may deduct certain additional amounts in the year of contribution or subsequent years, based on a specified percentage of the income received by the charity.

Donate to a qualified charity. Gifts to qualified charities qualify for an unlimited deduction for gift tax purposes; therefore, the $14,000 limit that applies to gifts to others does not apply to gifts to charities. In other words, outright gifts in any amount can be made to a qualified charity without paying gift tax. Gifts in trust for charity and gifts of partial interests in property, however, may be subject to gift tax. It is also important to note that certain limitations exist with respect to the aggregate amount of income tax deductions for charitable contributions.
Income tax: Planning is always important

Deductions

**PLANNING TIP #2**

**Donate appreciated securities.** If you are planning to make a contribution to a public charity, consider a gift of appreciated securities. By making such a contribution, you may be able to deduct the full market value of the gift for both regular and AMT purposes (if the securities were held for more than one year), whereas, if the securities are sold and the after-tax proceeds donated, both you and the charity will receive a lesser benefit.

For example, if you contribute an appreciated security that has a basis of $20,000 and a fair market value of $100,000, you may take a deduction equal to $100,000 (subject to certain limitations) and the charity receives a gift worth $100,000. If you sold the securities and donated the after-tax proceeds, both you and the charity will receive a lesser benefit.

<table>
<thead>
<tr>
<th>Charitable gift</th>
<th>Gift of proceeds (net of capital-gains tax)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Charitable gift</td>
<td>$100,000</td>
</tr>
<tr>
<td>Marginal tax rate</td>
<td>39.6%</td>
</tr>
<tr>
<td>Net tax</td>
<td>None</td>
</tr>
<tr>
<td>Benefit of gift</td>
<td>$39,600</td>
</tr>
</tbody>
</table>

**PLANNING TIP #3**

**Replace donated securities to refresh basis.** In addition to receiving a greater tax benefit from donating appreciated securities (rather than cash) to charity, you can use the cash that would have been donated to charity to purchase new investments with “refreshed” basis. For example, assume a taxpayer would like to provide a public charity with a $100 benefit, and the taxpayer is indifferent as to whether the donation is made in cash or other assets. The taxpayer has XYZ stock in his or her portfolio, with a cost basis of $10 and a fair market value of $100. If the taxpayer donates the stock to the charity, he or she will get a charitable deduction of $100, subject to certain limitations. The taxpayer can then use the $100 that he or she would have donated to charity to repurchase XYZ stock. The basis of the taxpayer’s new XYZ stock is $100. In effect, the taxpayer received a step-up in basis of the XYZ stock from $10 to $100 in addition to meeting his or her charitable goals. Remember that the wash sale rules apply only to losses upon sale, not gains; therefore, the wash sale rules do not apply to this situation.
Deductions

PLANNING TIP #4

Maintain proper records. Each single donation of $250 or more requires a contemporaneous, written description of the contribution from the charity in order to qualify for the charitable contribution deduction. A canceled check is not sufficient to support the deduction, nor is an acknowledgment received after a tax return has been filed. These rules apply even if the donation is made to your own family foundation. Also, any gift in excess of $5,000, other than cash or stock in a publicly traded company, requires an appraisal from a qualified appraiser in order to qualify for the deduction. Gifts of inventory, vehicles, and closely held stock valued up to $10,000 also do not require an appraisal in most cases; consult your tax advisor if you think these exceptions might apply to you.

If you donate a used vehicle, boat, or airplane worth more than $500, the deduction will equal the fair market value of the contribution only if the charity uses the property in its tax-exempt function. If the charity sells the item, your deduction will generally be limited to the proceeds the charity actually receives. The charity will be required to furnish donors with a receipt that documents sales proceeds.

When making a noncash donation, consider the following requirements:

**Documentation of charitable deductions**

<table>
<thead>
<tr>
<th>Value Range</th>
<th>Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 to $249</td>
<td>Maintain a bank record or a receipt, letter, or other written communication from the $0 to $249 donee, indicating the donee’s name, the contribution date, and the amount.</td>
</tr>
<tr>
<td>$250 to $500</td>
<td>Obtain a written acknowledgment from the charitable organization.</td>
</tr>
<tr>
<td>$501 to $5,000</td>
<td>In addition to a written acknowledgement, show the means of acquisition, the date acquired, and the adjusted basis of the property.</td>
</tr>
<tr>
<td>More than $5,000</td>
<td>Obtain a written appraisal (publicly traded securities do not require written appraisals).</td>
</tr>
<tr>
<td>More than $500,000</td>
<td>Attach a written appraisal to the tax return if appraisal is required.</td>
</tr>
</tbody>
</table>
**PLANNING TIP #5**

**Contribute to a donor-advised fund (DAF).** A DAF is a fund that is managed under the tax umbrella of a public charity such as a community foundation. The donor makes an irrevocable gift of property (such as stock held for greater than one year) to the host charity and receives a tax deduction equal to the fair market value of the property in the year of the gift. Assets are deposited into an investment account where they can grow tax free. Only one receipt (for the donation to the fund) is required instead of one receipt from each charity receiving a donation from the DAF, which can significantly simplify recordkeeping for tax purposes. The donor retains the right to advise (but not to direct) the host charity in administering the affairs of the DAF. Depending on the policies of the host charity, advice may include naming the fund, managing investments, recommending grants, and selecting a replacement advisor at the death of the donor. DAFs cannot benefit the donor or any other private interest.

**PLANNING TIP #6**

**Consider the “related use” rules when donating personal property to a charity.** Personal property refers to items such as art, jewelry, and household items. If the charity will not use the property in its exempt function, your charitable deduction is limited to the lesser of the value or your basis in the property. For example, art donated to a museum for its collection is deductible at the appraised value, but art donated to the same museum for its fundraising auction is deductible at the lesser of value or your cost. In addition, if the charity does not use the property in its exempt function for three years, the benefit of the initial deduction may have to be recaptured. Exceptions may apply: consult your tax advisor if you think these limitations may apply to you.
Art and finance

Art as an asset class

Value has always been part of the art equation, but “financialization” is a fast-growing factor.

The global market in art and collectible investments is surging past $600 billion.*

Between the art market’s own rapid growth and an array of external forces, there is a greater tendency to treat art as an asset class. That brings new business opportunities, but also requires an awareness of the financial implications.

*Wealthinsight Luxury Investments Report, 2013

A shift in emphasis

Four out of five family offices and almost two-thirds of private banks report a strategic focus on art-based estate planning. Tax authorities recognize three categories of owner — and it’s important to know into which one you fall, because the standards for taxation are different.
Sound retirement planning involves a range of economic and tax considerations. Most importantly, though, it involves consistent discipline to save. Taxpayers sometimes wonder whether they should skip making retirement plan contributions in light of uncertain market conditions. Keep in mind that you cannot make up missed retirement plan contributions in later years, and you will lose the potential for tax-favored earnings on those contributions. Regardless of your current and future tax situation and the market outlook, you should always consider contributing the maximum amount to your retirement plans annually.

**PLANNING TIP #1**

Establish a Keogh plan. Sole proprietors or partnerships may establish a Keogh plan for themselves and their employees. Although you do not have to make contributions until the due date of the tax return (including extensions), you must establish the plan by the end of the year. For 2015, self-employed individuals may contribute the lesser of $53,000 or 100% of self-employment income to a defined contribution Keogh plan; however, any nondeductible amount (generally, any amount above the lesser of $53,000 or, in the case of plans for self-employed individuals with no employees, 20% of net self-employment income) is subject to a 10% excise tax. Self-employed individuals, therefore, generally contribute only the lesser of $53,000 or 20% of their net self-employment income. For purposes of the 20% limitation, net self-employment income includes a deduction for contributions to the plan. Older individuals should consider establishing a defined-benefit Keogh plan, which will likely allow a higher contribution amount.

**PLANNING TIP #2**

Establish a defined-benefit plan. If you are an owner/employee of an S corporation without other employees, you may consider establishing a defined-benefit plan. Generally, an owner/employee may be able to contribute more to a defined-benefit plan than a defined-contribution plan. In addition, you may make contributions to the defined-benefit plan in a year in which you do not receive any compensation (or earned income if you are considered self-employed). On the other hand, to avoid excise taxes, you may be required to make contributions that you would prefer not to make in a given year.

**PLANNING TIP #3**

Establish solo 401(k) plans and SEP IRAs. In addition to contributing to Keogh plans, self-employed individuals are eligible to establish solo 401(k) plans and SEP IRAs. Solo 401(k) plans must be established prior to year-end of the year in which the deduction will be taken, whereas a SEP IRA may be established and funded at the time of filing the individual income tax return (including extensions). Each plan has its advantages and disadvantages; therefore, if you are self-employed, you should discuss retirement plan options with your financial advisor to determine which plan works best for you.
Income tax: Planning is always important

Retirement savings and income

**PLANNING TIP #4**

Board members can establish a Keogh or other self-employed retirement plan. Earning compensation for serving on a company’s board of directors may qualify as self-employment income and, therefore, be subject to self-employment taxes. If you earn self-employment income, you may qualify to sponsor a Keogh or other self-employed retirement plan. Qualification as self-employment income may be possible even if you are an employee of the company, as long as the self-employment earnings are sufficiently segregated from wage income. The rules in this area are complex; if you earn director fees, discuss this topic with your financial advisor.

**PLANNING TIP #6**

Make contributions to a Roth IRA or Roth 401(k). Consider making contributions to a Roth IRA or Roth 401(k) if you believe your tax rate will be higher in retirement. Although contributions to a Roth IRA or Roth 401(k) are never deductible, any income earned within the Roth IRA or Roth 401(k) may be free from federal income tax when you withdraw money from the account. The maximum annual contribution to a Roth IRA is generally $5,500 for 2015. The maximum permitted annual contribution begins to be phased out when AGI reaches $183,000 for joint filers and $116,000 for single filers. Unlike traditional IRAs, Roth IRAs permit contributions after reaching age 70½ and do not require minimum distributions starting at age 70 ½. Also see the Roth 401(k) contribution program discussion below.

**PLANNING TIP #5**

Analyze contributions to employer-sponsored 401(k) plans. The maximum contribution to a 401(k) plan is $18,000 for 2015. Many investors have considered stopping contributions to their 401(k) plans in favor of investing in currently taxable accounts due to the lower capital gain and dividend rates. Recall though that amounts contributed to a 401(k) plan are pretax, which means they may lower your current tax bill and affect AMT planning. Also, if your employer offers matching contributions, you could be giving up “free” money. Talk to your investment advisor to determine how best to invest funds in a currently taxable account or a tax-deferred account.
Income tax: Planning is always important

Retirement savings and income

PLANNING TIP #7

Make catch-up retirement plan contributions. If you are age 50 or older by year-end, you may make additional catch-up contributions to your retirement plans, including an additional contribution of $6,000 to your 401(k) plan in 2015. Check with your plan administrator for the proper procedure to make catch-up contributions to your 401(k) plan. For an IRA or Roth IRA, you may make additional contributions of $1,000 for 2015. Participants in SIMPLE plans may make additional contributions of $3,000 in 2015.

At age 50 or above, contribute an additional yearly:

- 401(k): $6,000
- IRA or Roth IRA: $1,000
- SIMPLE plan: $3,000

PLANNING TIP #8

Establish a spousal IRA. A spouse who has little or no earned income and who is not an active participant in an employer-sponsored retirement plan can still have an individual retirement account. The maximum annual contribution to a spousal IRA is the lesser of $5,500 or the combined taxable compensation of both spouses. The deduction for such contribution begins to be phased out for married taxpayers filing jointly with 2015 AGI of $183,000. Although the contribution may not be deductible, the amounts contributed will still grow tax deferred; therefore, this may still be a good retirement planning option.

PLANNING TIP #9

Make IRA contributions prior to the end of the year. You can do this even though the contributions are not due until the filing date, which is April 18th in 2016. Making contributions earlier increases the effect of compounding on retirement account earnings. As with the spousal IRA, even if the contribution is not deductible, it will grow tax deferred. If your contribution is deductible, your AGI will be lower, possibly allowing you to take advantage of certain credits and deductions that are limited by AGI levels. Take this into consideration when making year-end decisions. Taxpayers are allowed to contribute to both a 401(k) plan and an IRA in the same year; however, if you contribute to a 401(k) plan (or any other employer-sponsored retirement plan), your ability to deduct contributions to an IRA in the same year will be limited if your 2015 AGI exceeds $98,000 for joint filers ($61,000 for single filers).
Income tax: Planning is always important

Retirement savings and income

PLANNING TIP #10

Re-allocate tax-inefficient assets. Consider allocating tax-inefficient assets such as taxable bonds and Treasury inflation-protected securities (TIPS) to tax-deferred accounts such as IRAs and 401(k)s. If you have a Roth IRA, consider using this account for your higher-expected-return, tax-inefficient assets such as real estate investment trusts (REITs) and commodity-futures funds. If you do not have a Roth IRA, consider allocating these assets to your traditional IRA account. Consider allocating low-turnover long-term capital gain assets and municipal bonds to personal accounts.

PLANNING TIP #11

Withdraw excess contributions before year-end to minimize excise tax. An excise tax is imposed on excess contributions to various savings vehicles. Generally, excess contributions to an IRA, medical savings account, health savings account, or Coverdell account (also known as an Education IRA) are subject to a 6% excise tax. Excess contributions to other qualified plans — such as 401(k) plans, Keogh, and pension plans — in excess of the deductible amount are subject to a 10% excise tax. To avoid potential excise taxes, withdraw excess contributions before year end.

PLANNING TIP #12

Skip retirement distributions before age 70½. If a taxpayer is under age 70½ and does not need the funds, consider skipping distributions from qualified plans until required minimum distributions (RMDs) are mandatory. Choose beneficiaries with long life expectancies to delay distributions and make sure these beneficiary designations are always up to date.

Roth IRA conversions

All taxpayers have the opportunity to convert traditional IRAs into Roth IRAs without limitations based on their income level. If you currently have retirement accounts, you and your tax advisor should discuss the possibility of converting to a Roth IRA. While income taxes would be due currently, you and your heirs may have more after-tax wealth as a result of the conversion because qualified distributions from a Roth IRA are tax free, including the income and appreciation components of such distributions. In order for a distribution to be a qualified distribution, a five-year holding period must be satisfied, and one of the following four requirements must be met:

1. The distribution is made on or after the date on which the individual attains age 59½
2. The distribution is made to a beneficiary or the individual’s estate after the individual’s death
3. The distribution is attributable to the individual’s being disabled
4. The distribution is to pay for certain qualified first-time homebuyer expenses (up to $10,000)

A nonqualified distribution may be subject to a 10% early withdrawal penalty.

There are several other advantages to Roth IRAs. Contributions are permitted after the individual reaches age 70½ and the mandatory distribution rules applicable to traditional IRAs during the lifetime of the owner do not apply. There are also income tax benefits to heirs who inherit a Roth IRA. Unlike distributions from a traditional deductible IRA, the distributions are not subject to income tax when withdrawn by a designated beneficiary. (Distributions from a nondeductible IRA will be partially taxable, as the heirs recoup the decedent’s basis in the IRA.)
Income tax: Planning is always important

Retirement savings and income

Additionally, as discussed above, taxpayers may also convert any portion of their balance in an employer-sponsored 401(k) account into a Roth 401(k) under that plan. The conversion option for retirement plans would only be available if the employer plan sponsors this feature.

Roth IRA recharacterizations and reconversions

If your account balance falls after you convert your traditional IRA to a Roth IRA, you may be able to recharacterize your Roth IRA back to a traditional IRA and reconvert at the lower value. This technique effectively gives you the benefit of hindsight when making Roth IRA conversion decisions. Timing restrictions and other limitations apply, so you should consult your tax advisor if you have other IRAs.

Roth 401(k) contribution program

Employees who elect to contribute to a 401(k) plan may designate some or all of these contributions as Roth IRA contributions (designated Roth contributions) if their particular 401(k) plan permits such treatment. Designated Roth contributions are included in taxable income in the contribution year; however, distributions from the designated Roth portion of the 401(k) plan after the employee reaches age 59½ will be tax free. Designated Roth contributions must be accounted for separately within the 401(k) plan. The maximum amount an employee may contribute to all 401(k) plans, including designated Roth contributions, is $18,000 in 2015. In addition to these amounts, taxpayers over age 50 by the end of the year can make additional contributions of $6,000, for a total maximum contribution of $24,000.

Nonspousal inherited retirement assets

An individual receiving an inherited qualified retirement plan from a decedent other than a spouse may roll over the inherited account into an IRA. The rollover must be executed by a trustee-to-trustee transfer. The inherited amounts transferred to the IRA will be treated as an inherited IRA subject to the IRA minimum distribution rules; thus, beneficiaries will be able to continue taking minimum distributions based on the life expectancy of the decedent.

Distributions from tax-preferred retirement savings

In general, a 10% early withdrawal penalty applies to distributions from qualified plans and IRAs for participants who have not yet reached age 59½. There are numerous exceptions to this general rule; therefore, if you need to withdraw funds prior to age 59½ you should consult your financial advisor.

Generally, taxpayers who have reached age 70½ by December 31st must start receiving required minimum distributions from qualified plans or be subject to severe penalties. Generally, minimum distributions must begin for the calendar year in which the taxpayer reaches age 70½ (or when the taxpayer retires, if later) and must be paid no later than April 1st of the following year. For every year thereafter, distributions must be made by the end of the year. The rules differ between self-employed individuals and non-self-employed individuals, so check with your financial advisor to determine whether you are subject to special rules.

An excess accumulation is any amount of a required minimum distribution that is not distributed in a timely manner. A hefty 50% excise tax is imposed for each year the excess is not distributed. Although penalties may be waived under certain circumstances, taxpayers should make every effort to comply with the required minimum distribution rules.
Income tax: Planning is always important

Retirement savings and income

PLANNING TIP #14

Withdrawal funds before age 59½. In general, a penalty is imposed on withdrawals from a qualified plan or IRA prior to age 59½. Ideally, you will not need plan funds prior to age 59½; however, where funds are withdrawn from a qualified plan or IRA prior to age 59½, the withdrawal may take place without penalty if the participant died or suffered a qualified disability. In addition, depending on the type of plan, it may be possible to withdraw funds without penalty under one or more of the following circumstances:

1. The payments are made following separation from service after attaining age 55 (not applicable to IRAs)
2. The payments are made in a series of substantially equal payments over the life of the participant (or joint lives of the participant and beneficiary)
3. Distributions are used to pay qualified medical expenses that exceed 10% of AGI
4. Distributions are made to a nonparticipant under a qualified domestic relations order
5. Distributions are used to pay qualified higher education expenses
6. Up to $10,000 is used for first-time homebuyer expenses
7. Certain distributions of dividends on employer securities are made by employee stock option plans (ESOPs)

Exceptions vary depending on the type of plan; therefore, you should discuss your options with a qualified financial advisor.

PLANNING TIP #15

Consider timing of initial required minimum distribution. Although the first required minimum distribution does not need to be paid until April 1st of the year following the year the taxpayer reaches age 70½, postponement of the initial payment will result in doubling up on payments in the following year. For example, if you reach age 70½ in 2015, the first required minimum distribution does not need to be paid out until April 1, 2016; however, the required minimum distribution for 2016 also must be received by December 31, 2016, resulting in two payments in 2016. This will increase your AGI and may push you into a higher tax bracket in 2016 and potentially bring into play other limitations discussed above.

PLANNING TIP #16

Roth IRAs do not require distributions at age 70½. The required minimum distribution rules do not apply to Roth IRAs during the lifetime of the owner. Distributions from Roth IRAs are required after the death of the participant if the spouse is not the sole beneficiary. When the spouse is the sole beneficiary of a Roth IRA, the Roth IRA may be treated as owned by the surviving spouse after the death of the first spouse.
Income tax: Planning is always important

Retirement savings and income

**PLANNING TIP #17**

Consider impact of distribution of employer securities. In certain situations, an individual may receive a distribution of employer securities out of a qualified retirement plan while deferring taxation on unrealized gain until the securities are subsequently sold. At that point, realized long-term capital gains will be eligible for the lower rates and can be offset by capital losses from other investments. Check with your financial advisor if you currently own employer securities inside of a qualified plan and anticipate a distribution, in order to create a favorable tax outcome.
Income tax: Planning is always important

State income tax planning

Most tax planning focuses on saving federal taxes; however, state tax planning — especially for individuals living, working, or holding property in states with high tax rates — is equally important. Some individuals work and earn income in more than one state, requiring an analysis of the tax laws of several states as well as the possibility of having to file several different state income tax returns.

State laws vary widely, and the interaction between laws can be complicated. This guide cannot possibly cover all aspects of state tax planning; therefore, we encourage you to consult your local tax advisor for more detailed state tax planning techniques.

In addition to a separate income tax, many states have their own gift, estate, and inheritance taxes. In other words, you may be liable for not only federal taxes in these areas, but also state taxes. Consideration of state taxes must be part of any taxpayer’s overall financial planning, especially individuals who are considering moving to another state upon retirement. Although the taxpayer may save income taxes by the move, total taxes in the new locale may create an unexpected tax burden.

Use incentives. Many states offer special business incentives to those who work in or operate a business in that state. For example, multiple states offer an enterprise zone credit that may offset sales tax or provide significant hiring credits.

Consider early tax payment discounts. Certain states may allow a discount for early payment of taxes. For example, some Florida counties provide a discount of up to 4% for early payment of property taxes. It is important to consider these discounts in conjunction with AMT planning.

Consider nexus and filing requirements. Taxpayers (including trusts) who have a sufficient nexus with more than one state may owe taxes and have reporting requirements in multiple states. Nexus may be created through a variety of contacts; however, the most common are working in another state, owning property in another state, or engaging in a business activity in another state. Trusts may have nexus due to the residency of the beneficiary, the trustee, or the person who funded the trust (even if he or she died many years earlier). To complicate matters, each state may have its own definition of nexus, residence, and domicile. Credits may be available in your resident state to offset taxes paid to other states; therefore, you should check with your local tax advisor to determine where taxes may be due, what credits may be available, and whether you must file a return in more than one state.
**Income tax: Planning is always important**

**State income tax planning**

**Business tax changes**

While the focus of this publication is primarily individuals and their estates, certain business changes that have been implemented over the last year or so could adversely impact individuals who own businesses that use pass-through entities. Owners and their businesses should observe the legislative process closely and evaluate risks. Examples of specific issues that you may want to explore include changing accounting methods to accelerate expenses or defer income, analyzing depreciation methods, evaluating transactions with related parties, considering a change in entity status, and analyzing opportunities surrounding investments in private enterprises with NOLs.
Income tax: Planning is always important

Year-round tax planning

Evaluate your tax position for 2015 and beyond on an annual basis to determine the potential impact of increased tax rates. Planning for higher tax burdens requires careful analysis and should be done with the assistance of a trusted tax advisor. A long-term commitment to a thoughtful tax planning process can help mitigate the risks of a dramatically higher tax landscape.

To that end, you should:

- Adopt a multiyear perspective in reviewing your tax situation, evaluating the tax implications of shifting income or deductions.
- Consider the effect of the AMT. The expected outcome of deferring or accelerating income and deductions may be different after determining the AMT consequences. The result may not necessarily be intuitive.
- View transactions with regard to both their economic and tax implications.
- Stay engaged with understanding the tax changes being debated or adopted by Congress.
- Review your tax situation with a trusted advisor regularly.

A long-term commitment to a thoughtful tax planning process can help mitigate the risks of a dramatically higher tax landscape.
Wealth transfer taxes: The new world

Significant changes to the US transfer tax system that took effect three years ago have created a new frontier for estate and gift tax planning. In this section, we share insights on many facets of planning for passing on a legacy — from general tax parameters for wealth transfer planning to the correlation of lifetime income tax planning and an estate’s income tax planning. Notably, significant transactions commonly used in transfer tax planning today are clearly the object of increased scrutiny. If targeted tax planning appeals to you, then you would be well advised to consider taking action currently.

Within wealth transfer, we also highlight how the US Supreme Court’s decision on same-sex marriage is likely to result in tax changes for same-sex couples tying the knot. Further, we report on the broad global forces that are fundamentally transforming the role of corporate tax departments, the way tax executives lead their organizations and the very structure of tax departments from talent and succession perspectives — shifts that may be transforming wealth transfers for privately held companies, family offices, and private foundations, too. We also highlight practical considerations regarding the wealth transfer implications of an affluent individual’s international travel and cross-border activities.
Wealth transfer taxes: The new world

Continuing to explore the new frontier — finding more advantages

It’s been three years since the taxpayer friendly overhaul of the transfer tax system took place. Current thinking about tax planning is crystallizing. Given the sustained low interest rate environment and the recent volatility in capital markets, there is no time like the present to utilize advantages found within the new rules — particularly for those concerned about transfer taxation.

Projections based on the new rules indicate that over the next decade, fewer than 0.2% of decedents would be required to file a federal estate tax return. This finding implies that, for many, wealth transfer planning may no longer be required.

“For many, wealth transfer planning may no longer be required.”

States with estate, inheritance, and gift taxes

At the date of publication, six states have inheritance taxes, sixteen have estate taxes (including the District of Columbia), two have both estate and inheritance taxes, but only Connecticut has a gift tax. Of note, only two states with an estate tax (Delaware and Hawaii) have an exclusion equal to the federal exclusion amount and index the exclusion for inflation.

The disparity in state tax rules produces transfer tax planning efforts that are based even more fundamentally by one’s state of legal domicile. In states that have estate and/or inheritance taxes, transfer tax planning is paramount. In states without transfer taxes but with high income taxes, planning has become much more demanding, very fact-specific and is often centered more on using the transfer tax system as an income tax planning tool for one’s heirs.
Gift tax

As a quick overview, most uncompensated transfers of property during life are subject to the federal gift tax. The gift tax is computed based on the fair market value of the property transferred. Some types of transfers are excluded in determining the total amount of gifts that are subject to tax.

Gift tax annual exclusion

In 2015, gifts of up to $14,000 per recipient are generally covered by the gift tax annual exclusion and are not subject to gift tax. The annual exclusion is adjusted for inflation in increments of $1,000. The exemption last changed to $14,000 in 2013, and given the recent inflation environment, the next incremental increase is not expected for several years.

To qualify for the gift tax annual exclusion, gifts must be of a present interest. A present interest implies that the beneficiary has a substantial present economic benefit arising from the gift property. Such a benefit implies that the assets received can be readily converted to cash or that the assets received are income producing from the outset. As such, many outright transfers (including gifts of cash, marketable securities, and income-producing real estate) qualify for the annual exclusion. However, unless expressly permitted by statute, transfers encumbered by restricted access generally will not qualify. For example, most transfers in trust cannot qualify as a present interest unless the beneficiary is given the immediate right to withdraw the value of such transfer out of the trust. Similarly, the IRS has been successful in asserting that transfers of interests in certain family investment entities, which do not consistently distribute earnings to their owners, do not qualify for the annual exclusion. However, while highly restricted, transfers under the Uniform Transfer to Minors Act and funds contributed to section 529 educational savings plans qualify as present interests by statute.

Gift tax annual exclusion quick facts:

- The annual gift tax exclusion for 2015 is $14,000
- Gifts must be of a present interest
- Gifts to section 529 educational savings plans generally qualify
- Gifts in trust without special trust provisions generally do not qualify
- Transfers of interests in certain family investment entities may not qualify

What if my spouse is not a US citizen?

Transfers to a spouse who is a US citizen are covered by the unlimited gift tax marital deduction; therefore, such transfers may be made totally free from gift tax. If a spouse is not a US citizen, then the amount that can be transferred to the spouse free of gift tax in 2015 is $147,000 and, although yet to be formally announced, it is anticipated that the 2016 exemption will be $148,000. If either you or your spouse is not a US citizen, it is imperative that you make your estate planning advisor aware of this fact.
Wealth transfer taxes: The new world

Gift tax

The lifetime gift tax exclusion

In addition to the $14,000 annual exclusion (and the $147,000 annual exclusion for a noncitizen spouse), every individual taxpayer can transfer a certain amount of property during his or her lifetime without paying gift tax. The amount of property that can pass tax-free is referred to as the applicable exclusion amount. The applicable exclusion amount is used to calculate the credit available to offset the gift tax calculated for current-year transfers. The applicable exclusion amount for 2015 is $5.43 million; and, although yet to be formally announced, it is anticipated that the exclusion for 2016 will be $5.45 million. For 2015, the top marginal gift tax rate is 40%, which is applicable to gifts in excess of $1 million. Taking into account the applicable exclusion amount and the current rate structure, the applicable credit amount for 2014 is $2,117,800.

For those who have already made some gifts, determining the additional amount that can yet be given before incurring a gift tax liability may be challenging. This is especially true if one made taxable gifts prior to 2010. It is a function both of how much was given in the past and the applicable credit amount for the year in which the past gifts were made. Thus, while it can be computed, the outcome can vary widely given the disparate variables. However, in working through the math, one quickly observes that regardless of how benevolent one has been in the past, full use of the $4.43 million incremental increase in the applicable exclusion amount is assured, because there will, in every event, be $1,772,000 available to offset the computed tax for the gifts made since 2010 when the applicable exclusion amount was increased from $1 million.

<table>
<thead>
<tr>
<th>Taxable amount in Column A</th>
<th>Taxable amount not over in Column B</th>
<th>Tax on amount in Column C</th>
<th>Rate of tax on excess over amount in Column A</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000</td>
<td>$10,000</td>
<td>$1,800</td>
<td>18%</td>
</tr>
<tr>
<td>$20,000</td>
<td>$40,000</td>
<td>$3,800</td>
<td>20%</td>
</tr>
<tr>
<td>$40,000</td>
<td>$60,000</td>
<td>$8,200</td>
<td>22%</td>
</tr>
<tr>
<td>$60,000</td>
<td>$80,000</td>
<td>$13,000</td>
<td>24%</td>
</tr>
<tr>
<td>$80,000</td>
<td>$100,000</td>
<td>$18,200</td>
<td>26%</td>
</tr>
<tr>
<td>$100,000</td>
<td>$150,000</td>
<td>$23,800</td>
<td>28%</td>
</tr>
<tr>
<td>$150,000</td>
<td>$250,000</td>
<td>$38,800</td>
<td>30%</td>
</tr>
<tr>
<td>$250,000</td>
<td>$500,000</td>
<td>$70,800</td>
<td>32%</td>
</tr>
<tr>
<td>$500,000</td>
<td>$750,000</td>
<td>$155,800</td>
<td>34%</td>
</tr>
<tr>
<td>$750,000</td>
<td>$1,000,000</td>
<td>$248,300</td>
<td>37%</td>
</tr>
<tr>
<td>$1,000,000</td>
<td>$345,800</td>
<td>$345,800</td>
<td>40%</td>
</tr>
</tbody>
</table>

Wealth transfer taxes: The new world

Gift tax

Prior use of the applicable exclusion
If you have used the applicable exclusion amount, the range of continuing planning that remains available to you is still quite broad. We have organized transfer considerations around three broad themes:

1. Outright gifts,
2. Structured nongift transfers, and
3. Blocking and tackling through using the annual index increases.

Outright gifts
Considering when to pay the transfer tax. Family wealth is preserved when it is taxed at the lowest possible effective tax rate. The gift tax is assessed only on the value of the property transferred whereas the estate tax is assessed on the aggregate value of all of the decedent’s wealth including the funds with which the estate tax will be paid. Thus, the effective tax rate for gifts is always lower than for bequests.

Although such a consideration may perhaps seem counterintuitive, taxpayers might consider making gifts large enough to pay gift tax. Because lifetime transfers are currently subject to a 40% gift tax rate, a taxpayer has the opportunity to transfer assets at an effective tax rate of 28.57% (i.e., the tax divided by the sum of the gift and the tax). This conclusion remains true even taking into account the time value of money. Thus, the “tax exclusive” nature of the gift tax makes taxable gifts a generally more efficient method of transferring wealth. Federal and state governments, aware of this advantage, generally require the gift taxes paid with respect to any gifts made within three years of death be added back to the gross estate. Doing so recaptures the “tax exclusion” benefit and thereby discourages so-called “death bed transfers.”

While the advantages of paying the gift tax over the estate tax are clear, it remains prudent to retain sufficient wealth such that, under any reasonable circumstance, it will absorb what is left of the unused applicable credit amount in the computation of the estate tax. Although this computation will be unique to each person, and
Wealth transfer taxes: The new world

Gift tax

requires a projected indexed exclusion amount, one can still make reasonable assumptions. For example, using the Consumer Price Index (CPI), the average annual inflation rate since 1980 has been around 3.6% (since 1990 around 2.8%). Projected using a 2.8% inflation rate, one might reasonably expect the applicable exclusion amount (assuming no prior taxable gift) to approximate $8 million by 2030.

Under current law, there are two caveats to securing the gift tax benefit described in the example below. First, as has always been the case, each taxpayer must live at least three years from the date of the gift. Otherwise, the gift tax paid of $1,828,000 by each spouse is added back to each respective gross estate, thus eliminating the gift tax benefit. Second, intuitively one realizes that because the exclusion amount is indexed, at least for estates that are likely to be only modestly greater than the indexed exclusion amount, there will now always be a break-even point at which retaining the assets, undiminished by the gift tax, and paying the estate tax will result in greater retained family wealth than will having paid a gift tax in an earlier year when the exclusion amount was lower.

Net gifts and bargain sales. A net gift is a gift conditioned on the donee reimbursing the donor for the related gift tax. It is called a net gift because the amount subject to tax is the net of the value of the property transferred less the amount that the donee will reimburse the donor. In the example below, under a net gift scenario, the donors would agree to transfer assets to the trust with a value of $23,656,000 on condition that the trust reimburses them $1,828,000 for the resulting gift tax.

EXAMPLE

Give now or later?
A couple, each with a joint actuarial life expectancy of 15 years, who has never before made a taxable gift, determines that they can afford to transfer up to $20 million of their $30 million estate and pay the resulting tax. They are deciding whether to do so now or to wait. They believe that at the end of their life expectancies in 2030, their estate will have tripled in value. Since they intend to transfer the assets to a long-established trust, they expect the transferred $20 million will also have tripled in value by 2030 (e.g., a compound growth rate of 7.6%). That being said, they feel inflation will not exceed its post-1980 average of 3.6%. Projecting forward, that implies that the applicable exclusion amount in 2030 will be $9,240,000 for each of them. Under these assumptions, if the couple does not make the gift, the value of their estate will be $70,968,000 greater in 2030 (3 x $23,656,000). Using the current rate schedule, the computed aggregate tax on this amount would be $28,333,000. As discussed above, the projected applicable exclusion amount in 2030 will be approximately $9,240,000 per person, so the applicable credit amount will be $3,641,800 for each of them. The net estate tax liability on the $70,968,000 would then be $21,049,400 leaving an after-tax legacy of $49,918,600. By contrast, the trust receiving the $20 million gift would hold assets of $60,000,000 in 2030. Thus, all other things being equal, paying gift tax now will act to preserve after-tax family wealth — in this example by $10,081,400 an increase of 20.2% and total tax expenditures will have decreased by $17,393,400.
Wealth transfer taxes: The new world

Gift tax

of $20 million. The reimbursement of the gift tax of $3,656,000 is treated as consideration for the transfer and thus, one has a bargain sale — a sale of property having a value of $23,656,000 for $3,656,000, resulting in a taxable “net gift” of $20,000,000.

A net gift can be useful when:

1. You want to make a significant transfer, but either lack the liquidity to pay the resulting tax or are unwilling to bear the tax burden, or
2. In situations where the asset being transferred is illiquid and the donee is better positioned to shoulder the burden of paying the related gift tax.

Thus, net gifts are transacted with individuals or long-established trusts that have the wherewithal to make the tax reimbursement. There is, again, a caveat. Because consideration is being received, the donor must consider whether there will be any income tax consequences arising from the transaction. To experience a taxable gain, the consideration must exceed the property’s basis.

All other things being equal, a premature death cannot give rise to a tax outcome worse than if the parties had never entered into the transaction in the first place (assuming the death occurs three years after the transfer).

The consideration in a net gift transaction need not be paid at any set point in time. If the donor is in a position to pay the tax with available liquid assets, the donee can agree to pay the bargain sales price through an installment note. Although beyond the scope of this discussion, the interest expense may be income tax deductible as investment interest. The value of using a note is that it will limit the growth of the donor’s estate to the consideration plus the after-tax amount of the interest income received. In any event, even if the donor does not have the liquid assets necessary to pay the gift tax, the donee is not required to remit the cash any earlier than the following April 15th. Thus, the donee would be free to enjoy the earnings on the reimbursement amount until the following April 15th.

The reimbursement required of the donee does not make the donee the primary obligor for the gift tax. Consequently, as is the case with all taxable gifts, the donor’s death within three years of the net gift will result in the gift tax being added back to the gross estate. Should this occur, all other things being equal, a premature death cannot give rise to a tax outcome worse than if the parties had never entered into the transaction in the first place except in one circumstance — when the donee also agrees to reimburse the executor’s estate for the estate tax arising with respect to the gift tax accretion to the gross estate arising from a death within three years. Consequently, while this modification to the classical net gift is currently quite popular due to a high profile Tax Court decision, its gift tax advantage is fully negated and the estate tax liability increased if the donor in fact dies within three years of the transaction.
Wealth transfer taxes: The new world

Gift tax

Structured nongift transfers
Wealth transfers that result in no taxable gift are called for when:

1. One has already fully utilized the applicable exclusion amount, and
2. The payment of gift tax is not reasonably possible.

The possible transfers under this scenario generally employ a trust that limits or eliminates the taxable gift by employing one or more of three techniques:

1. The grantor retains an interest in the trust, thus limiting the size of the gift transfer (e.g., the classic zeroed-out grantor retained annuity trust (GRAT)),
2. An interest in the trust is transferred only for full and adequate consideration (i.e., an asset “exchange” of equal value is not a gift since the grantor’s estate has not been diminished), or
3. A transfer of an interest in the trust qualifies for a gift tax deduction (e.g., the marital or charitable deduction).

Charitable transactions are addressed under separate sections in this in this guide; this section will concentrate on the first two variations. The discussion that follows is representative of the planning that occurs in this area, but it is by no means a comprehensive discussion.

Grantor retained annuity trusts (GRATs). A GRAT is an irrevocable trust that names the grantor as its sole beneficiary for a set period of years during which the trust is required to make an annuity payment to the grantor. The annuity amount, as a function of prevailing interest rates, is set at a level where the net present value of the aggregate annuity payments is nearly 100% of the value of the property contributed by the grantor to the trust. If the assets consistently outperform the prevailing interest rate, then the remainderman of the GRAT, whether an individual or a continuing trust, will succeed to that excess. Because the grantor only parts with the value of the trust remainder, the gift tax cost of a GRAT is nominal. However, because the trust is established fundamentally for the grantor’s benefit, should death occur during the annuity period, the full value of the trust, as a general rule, will be included in the grantor’s gross estate as if no prior planning had ever taken place. To diminish this estate inclusion risk, most GRATs have short two-year terms and make large annuity payments. Ideal assets for funding a GRAT include publicly traded stock that has reasonable prospects of near term appreciation; stock in a company planning an IPO, sale, or other merger or acquisition in the near future; or, any other asset that is expected to rise in value and/or produce income at a rate greater than the applicable federal rate set for these purposes under section 7520 of the Internal Revenue Code.

PLANNING TIP #1

Use an escalating GRAT. The escalating feature increases the annuity amount up to 20% each consecutive year. In general, assuming assets will generally appreciate over time, increasing annuity payments can produce more value for the beneficiaries at the end of a term than would constant annuity payments simply because more of the GRAT’s assets remain in the GRAT for a longer period of time. For example, an individual funds a GRAT with $2 million of stock which the grantor feels is on the cusp of a rally with appreciation of 8% this year and 30% in the second year. The GRAT has a term of two years. Assume the current Section 7520 rate is 2%, and the annuity payments are made at each anniversary. The first-year annuity payment on the first anniversary date is $1,124,754. At the end of the two years, the remainder of $464,763 passes on to the beneficiaries free of gift tax. If the grantor had selected a level-payment GRAT, the remainder would be $438,821. The escalation feature resulted in a 5.91% increase in the amount of wealth transferred to the beneficiaries.
Wealth transfer taxes: The new world

**Gift tax**

A GRAT is a relatively high-maintenance transaction and exhibits that risk inherent to all transactions incorporating extraordinary leverage, specifically, any set back in anticipated appreciation and yields during the annuity period will likely nullify the planning. GRATs should be reserved for those who need to engage in higher-complexity planning, and/or those who need to “zero out” the immediate gift tax consequences of a current transfer (e.g., those who have used their applicable exclusion amount). That being said, the appeal of GRATs to all donors will remain high so long as:

- Prevailing interest rates remain low (note that the prevailing rate required to be used in GRAT gift tax calculations in October 2015, while up from its all-time low in September 2012 of 1%, is still only 2%),
- The assets to be deployed are value-stressed, and
- Short-term GRATs continue to be legislatively permitted.

**Remainder purchase marital trusts**

The remainder purchase marital (RPM) trust in many ways resembles a GRAT; however, unlike a GRAT, the spouse’s interest cannot be for the shorter of term or life. Generally, in times like these when interest rates are low, structuring the transaction is more effective when an annuity interest is transferred. The opposite is true when interest rates are high; then an income interest may prove more effective.

It is important that the spouse receive only a straight income or annuity interest. Any discretionary rights to trust principal make the interest he or she receives incapable of valuation which, in turn, makes the transaction impossible to complete. For the same reason, a termination on divorce clause is also not possible. What is required is a benefit structure that results in a readily ascertainable value of the remainder interest in the trust, which is only possible if the income or annuity interest also has a readily ascertainable value.

Unlike with a GRAT, the object with a remainder purchase marital trust is not to “zero out” the value of the remainder. The value of the remainder interest must be substantial. While such a determination is subjective, the value should be sufficiently large that the fiduciary of the purchasing trust is interested in protecting its interest.

Funding an RPM trust does not give rise to a taxable gift because the spouse’s income or annuity interest in the RPM trust qualifies for the gift tax marital deduction, and the trust remainderman acquired its interest from the donor for full and adequate consideration when the RPM trust was created. However, the transfer to the spouse will be a taxable gift if the remainder interest is not sold for full and adequate consideration. This requirement may limit the types of assets contributed to the RPM trust. Ideally, the value of the contributed asset should also be readily ascertainable; otherwise, a valuation contest may lead to a determination that the remainder interest was not transferred for full and adequate consideration thus potentially resulting in a loss of the gift tax marital deduction and a large taxable gift.

A formula valuation clause, discussed more fully below, should be considered.
Wealth transfer taxes: The new world

Gift tax

The assets of the RPM trust, unlike those of a GRAT, are not includable in the donor’s estate because the donor retained no interest in the trust. Additionally, even though the spouse’s interest qualified for the gift tax marital deduction, the RPM trust assets are not included in the spouse’s estate because a) the spouse’s interest terminates before or at death, b) the spouse’s interest is not subject to an election that would require estate inclusion of the trust assets, and c) the spouse has no powers over the disposition of trust assets significant enough to give rise to estate inclusion.

As is the case with all estate planning, the success of the transaction is ultimately a function of the performance of the assets involved. If the fund used to buy the remainder interest might have been more profitably employed elsewhere, then the purchase of the remainder interest will not have helped to preserve family wealth.

Blocking and tackling — using the annual index increases. The indexing feature of the applicable exclusion amount provides a significant amplification to the annual giving plan discussed more fully in “Basic blocking and tackling.” While the amount of any annual increase can’t be known before it is announced, it is reasonable to expect that the increase will be not less than 2% annually. Since 1970, there have only been two years with inflation less than 2% (1986 and 2010) and only one year with no inflation at all (2009). At 2%, the annual increase should be approximately $100,000 in any given year.

Consider gifting the annual index increase in January. For those in a position to do so, consideration should be given to instituting a program of transferring the annual index increase at the beginning of each calendar year. Recall that a principal benefit of gift transfers is to remove the future appreciation and income of the transferred assets from the donor’s estate. The compounding effect of moving the annual index amounts across time will be profound. For a discussion of how to choose assets that are likely to have greater wealth transfer effect, see the “Simple outright gifts” section.
Utilizing the now $5.43 million applicable exclusion amount

With the applicable exclusion amount at $5.43 million in 2015, and projected to be $5.45 million in 2016, a greater range of planning possibilities is available now, assuming you have not fully utilized your exclusion. We’ve organized transfer considerations around four broad themes:

1. Leveraging gift transfers,
2. Proper care and feeding,
3. Simple outright gifts, and
4. Basic blocking and tackling.

Leveraging gift transfers

It is an option, particularly in a low interest rate environment, to move assets in excess of the $5.43 million exclusion amount ($10.86 million per couple) by using the increased exclusion amount as seed capital to engage in leveraged transactions with the grantor (i.e., sales for notes).

A common form of this transaction involves making a seed money gift to a grantor trust. Grantor trusts are trusts in which the grantor has retained either an economic interest or powers over trust property that are significant enough to require the income of the trust to be taxed to the grantor, thus making the trust a disregarded entity for income tax purposes. Such trusts are permitted to transact with the grantor without income tax consequence. Assets are generally sold to the trust in exchange for a secured, term note having a face amount equal to the fair market value of the assets acquired and bearing a safe-harbor interest rate to avoid being considered a below-market rate loan. This safe-harbor rate, because of how it is determined, is always less than prevailing commercial interest rates. Remember, it is imperative when dealing with debt that the borrower/buyer be able to perform the necessary debt service as detailed in the note. Debt service terms are, in turn, a function of the expected cash flow considerations of the acquired property. Additional subsequent sales to the same trust can be contemplated as the economic circumstances of the trust permit, that is, when net equity and anticipated cash flow considerations support a subsequent sale. In general, this is regarded as no more than 90% debt and 10% equity.

Evaluate leveraged gift transfers. Compare the projected wealth transfer over time between an outright gift using the $5.43 million exclusion amount and a leveraged gift transfer using the same amount as seed money.

To illustrate the comparison in this planning tip, consider the following scenarios:

Gift scenario: In 2015, an individual with an actuarial life expectancy of 20 years funds a trust with a $5.43 million interest in the wholly-owned family business — an S corporation. The trust is to terminate in favor of the grantor’s children at his or her death. The taxpayer has made no prior taxable gifts. For purposes of this example, assume that annual distributions from the S corporation stock are $450,000 per year and the stock appreciates, on average, 3% per year. Furthermore, there will be no trust distributions until the trust terminates. Instead, earnings on the invested cash are used to pay trust expenses. Under these assumptions, the trust will have received $9.0 million in cash distributions, and the business interest will be worth $9.8 million at the end of the 20th year for a total value in this illustration of $18.8 million.

Planning tip continued on next page >>

Continuing to explore the new frontier — finding more advantages

Gift tax
- Gift tax annual exclusion
- The lifetime gift tax exclusion
- Prior use of applicable exclusion
- Utilizing the now $5.43 million applicable exclusion amount

Generation-skipping transfer (GST) tax
- Leveraging the GST exemption — dynasty trusts
- Tuning up prior GST planning
- GST blocking and tackling

Estate tax — a primer
- Portability
- State estate and inheritance tax considerations
- A cautionary tale regarding income taxes and estate planning

Estate tax and estate’s income tax return
- The public debate regarding the long-term viability of estate tax has quieted
- The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015

Beyond 2015
- Possible forthcoming regulations regarding discount valuation limitations
- Future tax rates and exemption amounts
- Grantor retained annuity trust (GRAT) limitations
- Limited duration of GST tax exempt status
- The estate tax treatment of grantor trusts
- Simplifying the gift tax exclusion for annual gifts
- Eliminate stepped-up basis for appreciated assets at death, tax donors, currently gifted appreciated property
- Concluding thoughts

Transformational topics
- Globalization
- Marriage equality
- Tax transformation
Wealth transfer taxes: The new world

Gift tax

PLANNING TIP #3 (CONTINUED)

Purchase scenario: By comparison, assume the taxpayer funds the trust with $5.43 million in cash and then engages in a purchase of $48.9 million of additional S corporation stock — a debt to equity ratio of 9 to 1. Distribution and growth rates remain the same. The note has a 20-year term and bears annual interest at 2.55% — the lowest rate permitted for such a note in October 2015 (date of the acquisition). Given these assumptions, by the end of the 20th year, the trust would have received distributions of $81.0 million, enough to satisfy the note and leave $18.6 million in cash behind, plus the original $5.43 million and the business interest would be worth $88.3 million for a total value in this illustration of $112.3 million.

In comparing and contrasting the two scenarios, we can make the following observations.

• All other things being equal, the successful use of leverage increased family wealth by $93.5 million in our example.

• No gift tax would be due in either scenario, since each involves a $5.43 million gift of either S corporation stock or cash. The gift simply utilizes the grantor’s available applicable exclusion amount.

• In the stock gift scenario, the grantor would have retained $48.06 million in S corporation stock that would have a value of approximately $88.3 million at the date of death and would be subject to estate tax. In the purchase scenario, that S corporation stock resides in the trust and would not be included in the gross estate.

• In the purchase scenario, the grantor receives $62.4 million in note payments. Assuming most of the S corporation distributions are required to pay income taxes that the grantor owes on the trust’s income, the aggregate note payments would be substantially dissipated and would not substantially increase the grantor’s gross estate.

• By the same token, in the gift scenario, the grantor would be paying income taxes on the trust’s income from his or her other available resources, thus the estate would also be reduced somewhat more than by the value accumulated in the trust.

• While it is unlikely that a trust would accumulate for its entire 20-year term, this example points out the wealth accumulation possibilities inherent in a trust where the undistributed wealth is not subject to income taxes payable by the trust.

On a cautionary note, one cannot enter into a leveraged transaction without appreciating the inherent economic risk associated with extreme leverage. The example assumed cash distributions sufficient to satisfy the purchase money debt. If the S corporation does not make sufficient distributions and the note must ultimately be paid in kind, not only is the efficacy of the transaction reduced, but there is a risk of having the sale disregarded and the purchased property treated as an indirect gift.
Wealth transfer taxes: The new world

Gift tax

Proper care and feeding
Many estate tax planning transactions require attention over an extended period of time. Inattention to either plan specific developments or planning trends may jeopardize anticipated results.

PLANNING TIP #4
Dispose of interests in family investment entities. Consider disposing by sale or gift any interest you might have in a family investment entity you obtained as an initial contributing owner; or, alternatively, consider terminating the entity.

Since 2004, the IRS has successfully challenged family investment entities, including family-controlled investment partnerships and LLCs. It is now common in estate tax examinations for the IRS to audit, in depth, the circumstances behind the creation and the business and investment activities of any family controlled investment partnership or LLC in which the decedent was an initial contributing owner and in which the decedent owned an interest at death.

Where the IRS detects anomalies in the creation and funding of the entity or where the economic behavior of the entity over time exhibits events that suggest that there had been an “indirect” agreement among the parties to permit the now deceased owner to continue to exercise dominion and control over the contributed assets, then the entity will be ignored for estate tax purposes and the entity assets attributable to the decedent’s capital contributions to the entity will be included in the gross estate at full fair market value.

That the deceased owner might have disposed of some of his or her ownership interest by gift or sale prior to his or her death does not change this outcome. Should this occur, the result is almost always a significant increase in the value of the gross estate, and therefore, the ultimate estate tax paid. This can be particularly troubling when the decedent’s estate plan relied on the estate tax marital or charitable deduction to limit taxes, which it can no longer do with respect to ownership interests that have already been transferred.

“Tuning up” includes effectively addressing risks that arise as tax laws change and develop.
Wealth transfer taxes: The new world

Gift tax

PLANNING TIP #5

Act promptly when a loan is in default. It is quite common for parents to extend credit either directly to children and trusts for descendants, indirectly to businesses or investment entities owned by descendants or trusts for descendants, or in selling property for a note to descendants or trusts for descendants. It is also common for such loans to become nonperforming. The failure to act when a note is in default raises transfer tax concerns, not only surrounding the delinquent payments but also regarding the propriety of the original transaction.

In situations where the original terms of the note are unlikely to be met, accelerating the note and foreclosing against any security is often the better course of action. In situations where the note’s payment is not reasonably in doubt but payment under the original terms of the note are unlikely, consider renegotiating the formal terms of the note (e.g., extending the term of the note, reducing the interest rate, etc.). Be aware, however, that there are gift and income tax considerations to both borrower and lender that must be addressed in forgiving, refinancing or otherwise modifying any existing note except when the borrower is a grantor trust. Where the transaction is between a grantor and his or her grantor trust, there can be no income tax consequences, since the loan transaction is disregarded for income tax purposes.

Alternatively, consider gifts of assets to the borrower that may in turn promote the satisfaction of the note. This option deserves heightened consideration when considering forgiving a note to an entity. Given the more complicated gift and income tax considerations, consider subscribing for a new or increased interest in the entity for cash (a transaction that will dilute the ownership of the other owners but will not be treated as a gift), and then use the new working capital to promote the satisfaction of the debt. Thereafter, you can consider transferring the newly acquired equity interest by gift or sale.

PLANNING TIP #6

Grant life interest in qualified personal residence trusts. A qualified personal residence trust (QPRT) is a trust where a donor’s home is transferred subject to the donor’s retained use of the home for a period of years. Like a GRAT, the value of the retained use will not be a gift if the retained use conforms with certain requirements. One such requirement is that the trust document must preclude the sale of the residence back to the donor. The result is that the grantor is required to rent the home from the new owners of the residence (e.g., often the grantor’s children or a trust for the children). Failure to rent results in the inclusion of the residence in the grantor’s gross estate at its value on the date of gift, thus defeating the planning. These rental arrangements often are uncomfortable for all concerned. With the increased exclusion amount, the children could consider a gift back to the parent(s) of the life interest in the residence. Such a transfer would negate the need for rent payments. Under the current low prevailing interest rates, such a life interest could be quite modestly valued, depending on the parents’ life expectancies.
Wealth transfer taxes: The new world

Gift tax

Simple outright gifts
For a great many taxpayers, the $5.43 million exclusion ($10.86 million per couple) for gifts made in 2015 is more than enough to cover their wealth transfer goals — thus reducing the need for more complicated wealth transfer transactions. When this is true, minority interests in closely held businesses, fractional interests in real estate, interests in private equity funds, or other investment entities (perhaps even interests in family-owned investment entities like family limited investment partnerships or family investment LLCs), may prove more effective candidates for gift transfers by virtue of how they are valued.

A minority interest in a closely held enterprise is generally valued at less than its proportionate share of going-concern value (for a business enterprise) or net asset value (for an investment entity) because of lack of control and/or lack of marketability discounts. This valuation outcome has been the government’s primary motivation in challenging the veracity of family-owned investment entities. Successful valuation outcomes depend on the determination that the existence of any closely held entity is demonstrably motivated by reasons other than tax efficiency and that the entity is operated in a business-like manner. Still, even if the taxpayer prevails with respect to discount valuation determinations, such discounts simply lower the threshold required for a wealth transfer to be successful or, in the alternative, reduce the tax cost of the transfer if the enterprise is not ultimately successful. Although it might seem compelling to transfer a property that can be discounted, one must remember that the success of a gift transfer is fundamentally a function of an asset’s post-transfer growth and earnings prospects — not its current value.

Mitigating valuation risks in gift transfers: taxpayers have long attempted to mitigate valuation hazards by employing formula valuation adjustment clauses. Such clauses generally treat any upward adjustment in property values in one of three ways: 1) where a purchase is involved, the sales price is correspondingly increased; 2) where a gift is involved, property corresponding to the value of the upward adjustment is moved in a manner which qualifies for the unlimited marital or charitable deductions; or 3) where a gift is involved, the formula fixes the amount of property transferred to a specified value and requires the parties to “true up” the economic consequences to those that would have obtained had the finally determined property transfer been known from the beginning.

Until recently, the IRS has generally prevailed in asserting that to give the required adjustment clause credence would be to nullify their ability to enforce the law by “returning” property to the grantor in an amount sufficient to eliminate any gift tax liability; consequently, such clauses were against public policy. The IRS has publicly stated that it will continue to fight the effectiveness of formula adjustment clauses notwithstanding several legal setbacks in the Tax Court. Consequently, while employing these clauses is prudent, it is advisable to carefully adhere to the models arising from the successful court cases. As noted in prior editions of this guide, the ultimate success of the adjustment clause may well be conditioned on the taxpayer’s acting in good faith. Specifically, such a clause must be supported by a contemporaneous appraisal of the transferred property by a qualified appraiser and by timely “truing up” the economic results arising from any actual adjustment to value.
Wealth transfer taxes: The new world

Gift tax

Basic blocking and tackling
Although the indexed $5 million applicable exclusion amount has greatly increased planning flexibility and opportunity, tried and true estate-planning techniques are still important.

PLANNING TIP #7

Make transfers to grantor trusts. Grantor trusts are trusts in which the grantor has retained either an economic interest or powers over trust property that are significant enough to require the income of the trust to be taxed to the grantor, thus making the trust a disregarded entity. Interestingly, the retention of some powers over trust property will not also cause the trust to be disregarded for transfer tax purposes. Properly employed, these powers can cause the grantor to be legally liable for the income taxes arising from the trust’s tax attributes but not in a manner that causes estate tax inclusion. From an estate tax perspective, such trusts represent the gifts that keep on taking (from the grantor’s estate) — a situation that can be perpetuated for as long as the grantor is willing to pay the continuing income tax liability.
Wealth transfer taxes: The new world

Gift tax

PLANNING TIP #8

Use an annual gifting program. Consider shifting wealth down generational lines through an annual gifting program. There is even more benefit if the gifted asset:

- Can be valued on a discounted basis,
- Is likely to appreciate and/or generate income that will be excluded from the donor’s estate, or
- Is given to a grantor trust that permits the trust assets to grow income-tax free while the grantor, who reports and pays tax on the trust’s income, further reduces his or her estate by the amount of any income tax paid, but without having to declare the indirect benefit to the trust as a taxable gift.

To demonstrate the power of annual gifting, assume a couple has three children. In 2015, this couple can transfer up to $28,000 per child, or $84,000 to all three children. If each child has a spouse, the maximum amount that can be given to the children and their spouses is $168,000 without incurring a taxable gift. If the couple has grandchildren, the ability to further reduce their taxable estates through annual gifts expands.

As discussed earlier, the indexing feature applied to the $5 million exclusion amount provides a wonderful amplification to the annual giving plan. For those in a position to do so, consideration should be given to instituting a program of annual exclusion transfers in conjunction with full utilization of the annual index increase at the beginning of each calendar year. Doing so fully realizes the primary benefits of an annual gift program, removing the future appreciation and income from the transferred assets from the donor’s estate. The compounding effect of such a program across time will be profound.

Through gift-splitting, a married couple that has three children can transfer up to $28,000 per child, per child’s spouse, or per grandchild. In this case, $196,000 could be transferred free from gift tax.
Wealth transfer taxes: The new world

Gift tax

PLANNING TIP #9

Make a cash gift. If a child or grandchild has earned income, consider making a cash gift. The child or grandchild may use that gift to contribute $5,000 or the amount of the donee’s earned income, whichever is less, to a traditional IRA or Roth IRA. Funds contributed to a Roth IRA will grow tax deferred, and qualified distributions will be tax free for federal income tax purposes. Funds contributed to a traditional IRA may be deductible by the child or grandchild for income tax purposes.

PLANNING TIP #10

Education and Medical Gift Exceptions. Certain payments made directly to educational institutions and health care providers are not taxable gifts. For example, a grandmother who wishes to help pay for a granddaughter’s education can write tuition checks directly to the school without making a taxable gift. If she writes the check to the granddaughter, however, she will have made a taxable gift to the extent the amount gifted exceeds the $14,000 annual exclusion. Tuition is not limited to college tuition; any qualified medical expense, including health insurance premiums, can be paid under this exclusion.

PLANNING TIP #11

Make future educational gifts through a Section 529 plan. Using a special election, a donor can fund up to five years of annual exclusions into these plans in one year. Specifically, in 2015, one can contribute $70,000 to one grandchild’s Section 529 plan without incurring a taxable gift or a generation-skipping transfer (GST), discussed in more detail later. If other gifts are made by the donor to that grandchild during 2015-2019, however, those gifts would use some of the donor’s applicable exclusion amount, as well as some of the donor’s GST tax exemption. By funding these plans in advance, the growth in the fund occurs in an income tax-exempt environment.
As individuals and families move from place to place for personal, career, or business reasons, information reporting requirements and financial transparency affect more people than ever before. It is increasingly common for family members to have different nationalities, to live in several countries during their lifetimes, and to accumulate assets in various jurisdictions. The United States and many other countries require increasing amounts of information reporting and financial transparency. The Foreign Account Tax Compliance Act (commonly known as “FATCA”), Common Reporting Standards (“CRS”) and related legislation will result in global information sharing to ensure compliance with local and international tax and reporting requirements.

Modern wealth is mobile
More people are crossing borders for business and personal reasons — which means cross-border tax planning and reporting is more relevant than ever.

Choose your status wisely
Citizen, “Green Card holder,” visitor, investor: your immigration status may affect your tax status and reporting requirements.

Get used to the spotlight
CRS, FATCA, and other forces are changing reporting standards. Newcomers to the United States and other jurisdictions may be unprepared for the required levels of transparency and self-reporting.

Look before you leap
Whether your move is personal or professional, there are immigration and tax planning considerations on which you should seek advice before you become a tax resident of a new jurisdiction.
Wealth transfer taxes: The new world

Generation-skipping transfer tax

The generation-skipping transfer (GST) tax is imposed on transfers during life and at death that are made to a “skip person” — a recipient who is at least two generations younger than the donor or decedent, such as a grandchild. If there were no GST tax, a transfer to a grandchild would be subject to the gift or estate tax once, while a gift to a child who then gifts or bequeaths those assets to a grandchild would be subject to transfer tax twice. The GST tax is intended to tax the gift to the grandchild twice at the time it is made (both the gift tax and GST tax), to compensate for the otherwise skipped level of tax. Furthermore, with respect to a taxable gift, the GST tax actually paid is, itself, subject to gift tax.

For GST tax purposes, when a gift or bequest is made within a family, the focus is on the relationship of the transferor and the transferee and not their age difference. For example, a donor may have siblings who are significantly younger than he or she and who, therefore, have children who are significantly younger than the donor and his or her children. A transfer to a nephew who is 40 years the donor’s junior is not subject to GST tax because the nephew is only one generation removed from the donor. Conversely, a transfer to a grandnephew who is only 30 years the donor’s junior is subject to GST tax because the grandnephew is two generations removed. Marital and former spouses are considered to be in the same generation, regardless of the spouses’ age difference.

When the transferee is not related to the transferor, the age difference becomes important. If a donor transfers assets to a friend who is less than 12 ½ years younger, that friend is considered to be in the donor’s generation and is not a skip person. If the friend is more than 12 ½ years younger, but less than 37 ½ years younger, that friend is considered to be in the donor’s generation and is not a skip person. If the friend is more than 37 ½ years younger, the friend is considered two generations removed and is, therefore, a skip person.

There is also an annual exclusion amount available for transfers subject to GST tax. The GST tax annual exclusion amount, like the gift tax annual exclusion amount, is $14,000 for transfers made in 2015. Unlike the gift tax annual exclusion, however, the GST tax annual exclusion is very limited for gifts to trusts.

Because dynasty trusts are intended to skip multiple generations, they represent the most tax efficient use of a taxpayer's GST tax exemption. The GST tax exemption amount permits the transfer of that amount of assets free of current and subsequent GST tax. The GST tax rate is equal to the maximum federal estate tax rate (40% in 2015) for the year that the skip person receives or becomes indefeasibly (permanently) vested in assets. The GST tax exemption in 2015 is $5.43 million, coinciding with the gift and estate tax applicable exclusion amount. It, too, is inflation adjusted.

Leveraging the GST tax exemption — dynasty trusts

A GST tax-exempt dynasty trust is used to transfer income and/or principal to multiple generations, including children (hence the title “dynasty trust”), while paying estate or gift tax only upon the initial transfer to the trust. This is accomplished by allocating all or part of the transferor’s $5.43 million GST tax exemption to the trust in an amount equal to the value of the transferred property on the date of the transfer. The wealth accumulated in the trust thereafter avoids both estate tax and GST tax at each subsequent generation until such time as the trust terminates. Because dynasty trusts are intended to skip multiple generations, they represent the most tax efficient use of a taxpayer’s GST tax exemption. Although gift tax annual exclusions may be available when funding a dynasty trust, transfers to dynasty trusts do not qualify for the GST tax annual exclusion, so the donor’s unused $5.43 million GST tax exemption will be allocated dollar for dollar when these trusts are funded.

Dynasty trusts are permitted in all states, but laws in many states limit the duration of a trust to a term from 80 to 110 years. Many states allow the trust to continue until 21 years after the death of the last surviving descendant of the trust creator who was living at the time of the trust’s creation. This concept is known as a “rule against perpetuities.” Other states have recently amended their trust statutes to permit trusts to exist in perpetuity. An individual may create a trust in a state other than his or her state of residence; consequently, dynasty trust planning is open to everyone.
Wealth transfer taxes: The new world

Generation-skipping transfer tax

As discussed further below, while the tax attributes of a dynasty trust are compelling, the governance provisions of a trust intended to last centuries and to govern wealth access to increasing numbers of beneficiaries is relatively untested. Common sense, good judgment, and competent counsel are a must if costly future judicial intervention is to be avoided or mitigated.

PLANNING TIP #1

Consider using dynasty trusts. Consider dynasty trusts as a tax-efficient tool for leveraging your GST tax exemption while building wealth for future generations. Consider this example: In 2015, a couple each funds a nongrantor irrevocable dynasty trust with $5.43 million. Neither spouse has previously made taxable gifts. No gift or GST tax will be due as a result of funding the trusts because each spouse utilizes his or her available gift tax applicable exclusion amount and his or her GST tax exemption. Assume the trusts have an after-tax growth rate of 3%, which is added to trust principal each year. After 110 years, the trusts, in the aggregate, will be worth approximately $280 million. Under present law, no transfer taxes are due on distributions during the duration of the trust or when the trust terminates.

Potential growth of dynasty trust

$10.86 million ($5.43 million per spouse)  $280M

Growth rate 3%

110 years

PLANNING TIP #2

Consider leveraging dynasty trusts. The most leveraged form of a GST transaction would have each spouse fund a dynasty trust, each in the form of a grantor trust, with $5.43 million. Thereafter, the trusts would engage in a purchase of property, at a reasonable multiple of the $5.43 million value of the trust, from the grantor. Returning to the previous example regarding the value of a leveraged transfer over 20 years (see “Leveraging gift transfers”), if the term is extended to 110 years, the stock value of the trust at the end of that term would have grown from $48.87 million to $1.26 billion appreciating 3% annually, even if we assume that all cash receipts were expended or distributed. Although a trust leaving its corpus intact while also maintaining a 3% compounded growth for the entire 110-year term is highly unlikely, the example demonstrates the wealth accumulation possibilities inherent in a dynasty trust where the undistributed wealth is subject only to income taxes — not transfer taxes — and then only after the grantor’s death when grantor trust status terminates.
Wealth transfer taxes: The new world

Generation-skipping transfer tax

Tuning up prior GST planning

Given the greater GST tax exemption currently available, if you have existing GST trusts that have an inclusion ratio of between zero and one (that is, a trust where a distribution to a skip person would be partially subject to GST tax), you should consider allocating the increased exemption to those trusts. When a trust has an inclusion ratio of between zero and one, the amount of GST tax exemption required to obtain an inclusion ratio of zero (thus making the trust thereafter exempt from GST tax) is a function of the value of the trust’s assets at the time the additional GST tax exemption allocation is made. In an appreciating economic environment, time is of the essence.

GST blocking and tackling

While the indexed $5.43 million GST tax exemption amount has increased the opportunity for larger scale GST tax planning, it need not — and should not — detract from the use of tried and true estate planning techniques that have GST tax implications.

Establish a minor’s trust. Grandparents wanting to make a substantial gift to a grandchild should consider establishing a minor’s trust, also known as a section 2503(c) trust. Gifts to a minor’s trust qualify for both the gift and GST tax annual exclusions. For example, a married couple can currently transfer up to $28,000 per year to each grandchild without incurring gift or GST tax. The property and associated income must be available for distribution before the grandchild attains age 21 and, generally, any remaining balance must be distributed to the grandchild at age 21.

Use a section 2503(b) trust. Another type of trust sometimes used for gifts to minors, known as a Section 2503(b) trust, requires all income from the trust to be distributed annually, but does not require the trust to terminate when the grandchild reaches age 21. Note, however, that a $14,000 gift to a section 2503(b) trust may not be fully excludible through the gift and GST tax annual exclusions. These limitations may be overcome if the trust contains special additional provisions to fully qualify the gift for the gift and GST tax annual exclusions.
Marriage equality, tax questions

When same-sex couples tie the knot, important tax changes can follow.

Some of the “dominoes” of the Supreme Court decision about marriage equality are logical, but there are other areas where tax law hasn’t caught up — and the marriage decision may have both tax advantages and disadvantages.

A level playing field... Now, married is married. That means same-sex spouses enjoy unlimited tax-free transfers (if both are US citizens), family medical leave, and recognition by state intestacy laws.

...that cuts both ways Being married also opens the door to divorce, alimony, and child custody issues, as well as potential exposure to the “marriage penalty.”

A look forward into the past For those same-sex spouses who were lawfully married prior to full federal recognition, it may be advisable to analyze past income or gift tax returns for which the statute of limitations remains open and consider whether to file amended returns.

Back to the fine print Couples who marry may find it advisable to revisit Forms W-4, along with beneficiary choices in wills, revocable trusts, retirement plans, and life insurance policies.
Wealth transfer taxes: The new world

Estate tax — a primer

In its simplest manifestation, the taxable estate is determined by taking the aggregate value of all includible assets, reduced by all allowable exclusions and deductions, and increased by the taxable gifts made by the decedent after 1976. A tentative tax is then computed on the taxable estate. Assuming no prior gift tax was actually paid, this tentative tax is then offset by the applicable credit amount. For 2015, that amount is the estate tax on the $5.43 million base exclusion amount, computed using the rate structure in effect on the date of death ($2,117,800 in 2015). Any estate where the tentative tax is less than the applicable credit amount avoids a federal estate tax liability (although state estate and/or state inheritance taxes may apply).

If gift tax has previously been paid, then an additional credit is allowed for some or all of the gift tax actually paid. As mentioned previously, this credit permits those that have made gifts in excess of past exclusion amounts to take advantage of the million incremental increase in the old unindexed $1 million exclusion amount in the law prior to 2010. The credit is a hypothetical amount determined using the rate structure existing at the date of death, but taking into account the applicable credit amount in effect at the date of each gift; as a consequence, the credit will not equal the amount of gift tax a decedent actually paid during life.

Any estate where the tentative tax is less than the applicable credit amount avoids a federal estate tax liability — although state estate and/or state inheritance taxes may apply.

Quick taxable estate calculation

Take the aggregate value of all includible assets
- allowable exclusions and deductions
+ taxable gifts made by the decedent after 1976
= taxable estate

Portability

A surviving spouse can use his or her own base exclusion amount of $5.43 million plus the unused exclusion amount of his or her most recent deceased spouse to offset the tax on subsequent gifts or to offset his or her estate tax. The deceased spouse’s unused exclusion amount (DSUE) will not be available to the surviving spouse unless the executor of the deceased spouse’s estate makes an election to convey it and computes the amount to which the surviving spouse is entitled. Relief will be extended only in extraordinary circumstances to an executor who fails to make a timely election. In enforcing the carryover, the IRS is permitted to review the deceased spouse’s prior filed gift tax returns and estate tax return to determine the proper DSUE amount, even after the statute of limitations with respect to those returns has closed.
EXAMPLE

Portability vs. credit shelter trust

Assume, for the sake of illustration, that the wife died in 2011, having made no taxable gifts and leaving a gross estate of $10 million. Assume she left her entire estate to her surviving husband outright, thus reducing her taxable estate to zero, leaving her basic exclusion amount of $5 million unused and causing full inclusion of the $10 million in her husband’s estate. Assume an election is made on her estate tax return and he succeeds to her deceased spouse’s unused exclusion amount (DSUE) of $5 million. The husband does not remarry and dies in 2018, having not made any taxable gifts. At death, his taxable estate is valued at $20 million. This includes the property he inherited from his wife, which has now appreciated to $15 million (i.e., 50% growth in the intervening seven years). His applicable exclusion amount is $11 million ($5 million of deceased spouse’s unused exclusion amount, plus his own base exclusion amount of $6 million — an assumed inflation-adjusted exclusion amount for individuals dying in 2018). The husband will pay an estate tax of $3.6 million — 40% of the difference between the $20 million estate and the $11 million applicable exclusion amount. As a result, the family’s net worth, after estate taxes, would be $16.4 million.

Now assume that the wife had instead used her entire applicable exclusion to place $5 million of her estate in a trust for her husband that did not qualify for the marital deduction and left the remaining $5 million to her husband outright. On the husband’s subsequent death, the value of the trust is $7.5 million (reflecting the same 50% appreciation over the husband’s life), which is excluded from his taxable estate. Now, the amount of the husband’s taxable estate is not $20 million, but $12.5 million. His estate will pay an estate tax of $2.6 million (40% of the difference between the $12.5 million estate and the presumed $6 million applicable exclusion amount). As a result, the family’s net worth, after estate taxes, would be $17.4 million — 40% of the trust’s $2.5 million of appreciation, which, because it is in the trust, is not taxed in the husband’s estate.

Portability could greatly simplify the tax planning that once had to occur before or upon the death of the first spouse to die. No longer will it be necessary to make sure that both spouses own property equal to the prevailing applicable exclusion amount. Even where each spouse individually controls assets in excess of the applicable exclusion amount, the need to affirmatively plan for its use in the testamentary plan of the first spouse to die is removed (unless that spouse desires to affirmatively use his or her GST tax exemption, which is not portable). In fact (subject to the GST tax exception just noted and ignoring state estate/inheritance tax considerations), there would now appear to be no tax detriment to a classic “sweetheart” disposition — leaving one’s assets fully to one’s surviving spouse either outright or in trust.
Wealth transfer taxes: The new world

Estate tax — a primer

**PLANNING TIP #1**

Evaluate portability vs. credit shelter trusts. As favorable as the potential simplicity promised by portability is, it is no panacea. In fact, family wealth may likely be better preserved under the classic credit shelter trust arrangement — one in which both spouses have wealth equal to at least their base exclusion amount and affirmatively plan its use.

The example illustrates how waiting to use a spousal unused exclusion may be poor tax planning. The savings noted in the example would be replicated if the surviving spouse did not include in his or her testamentary plan the greater family wealth preservation associated with having the first spouse to die fund a credit shelter trust with the federal exclusion amount would give rise to a state estate tax of $431,600 assuming that the state tax is equal to what the state death tax credit would have been in 2000 (a common approach employed by many states to avoid a reduction in state estate tax revenues).

Many states do not now and will not hereafter conform to the federal estate tax rules.

An additional advantage of portability is that the problem of federal/state disparity can be eliminated. Specifically, if all assets pass to the surviving spouse in a manner qualifying for the marital deduction except for enough to fund a credit shelter trust equal to the state’s exemption amount and a corresponding DSUE election is made, there is no transfer subject to state estate taxation until the surviving spouse dies. However, the same analysis made above with respect to the greater family wealth preservation associated with having the first spouse to die fund a credit shelter trust with the federal exclusion amount remains true. By paying state estate tax at the first death, all future appreciation on a federal credit shelter trust’s assets escapes state estate taxation upon the death of the surviving spouse. Whether that future savings justifies a current state estate tax liability is ultimately a function of nontax factors.

**PLANNING TIP #2**

Give gifts in states that do not levy gift tax. The better solution to the problem of a state’s estate tax is to utilize the other significant difference between federal and state estate/inheritance tax systems; specifically, other than Connecticut, states do not levy a gift tax. Thus, except in Connecticut and subject to one caveat, the state estate tax base does not include prior taxable gifts notwithstanding they are an element in the federal estate tax base. The caveat, of course, is that all transfers made within three years of death can be treated as “death bed” transfers and are added back to the state estate tax base.
Wealth transfer taxes: The new world

Estate tax — a primer

A cautionary tale regarding income taxes and estate planning

As discussed in the introduction to this section, with the indexed $5 million exclusion amount, an overwhelming majority of Americans will no longer be subject to estate taxes. Moreover, almost all inherited assets continue to obtain a step-up in asset basis at death to their fair market value at the date of death. As a result, for most Americans, “tax” planning for one’s estate has now taken a 180 degree turn. Specifically, if one finds him or herself with an estate less than the applicable exclusion amount (or for a surviving spouse, the sum of his or her individual base applicable exclusion amount, plus their deceased spouse’s DSUE), it becomes advantageous to pull assets into the taxable estate in order to secure a step-up in income tax basis for those assets.

Not unmindful of the issue, the Internal Revenue Code restricts the ability to get a basis step-up on assets given to the decedent within a year of death that return by bequest to the donor. Consequently, finding assets for estate inclusion is more profitably directed at trusts in which the decedent had an interest (for example, a credit shelter trust set up by a predeceasing spouse) or trusts formed by the decedent where access to trust assets might be obtained through trust amendment.

With the indexed $5 million exclusion amount, an overwhelming majority of Americans will no longer be subject to estate taxes.

Distributing assets before death

A surviving spouse is the beneficiary of a bypass trust established by a predeceased spouse. The trust has been in place for many years and holds real estate and securities with relatively low basis. The trustee has the power to distribute income or corpus to the spouse in the trustee’s discretion. Trust assets are to be distributed per stirpes to the decedent’s children upon the death of the surviving spouse. A combination of substantial extended care expenses and spendthrift children has depleted the surviving spouse’s personal estate to approximately $2 million. The surviving spouse’s estate plan leaves her assets directly to the decedent’s children at her death. Given the surviving spouse’s deteriorating condition, the trustee determines to distribute real estate and other assets that are likely to be sold following the surviving spouse’s death. The fair market value of the distributed assets is thought to be about $3 million. The basis of the assets distributed to the surviving spouse is $500,000. Assuming none of the $3 million is consumed by the surviving spouse, the outcome is that the family will take the $3 million of assets with a basis stepped up from $500,000 to $3 million. Assuming, conservatively, that the assets are all capital assets, the federal income tax savings arising from the trust distribution is at least $595,000 (23.80% [the 20% capital gains rate and the 3.8% net investment income surtax] of the step-up of $2.5 million). Additional savings arise if state income taxes apply or if the real property distributed was depreciable, and depreciation recapture is avoided.

PLANNING TIP #3

Retain the power to reclaim assets. In any event, any newly created trust should consider a provision, which allows the grantor the conditional power to reclaim assets in the event a determination is made that his or her estate is valued beneath the exclusion amount in existence at the date of death. Care must be taken, though — if not structured properly, such a power can greatly complicate the income and gift taxation of such trusts.
Things don’t show up at your door as a tax issue. They show up as a business issue, and it’s your job to find out whether there is a tax issue.” — a tax executive

A tax advisor needs to be like a skier — his eyes should be way down the hill, not on his feet underneath him.” — a tax executive

From abstraction to action:
Start with a plan
• Define a vision
• Prioritize initiatives
• Build a work plan
• Develop transformation roadmap

“Things don’t show up at your door as a tax issue. They show up as a business issue, and it’s your job to find out whether there is a tax issue.” — a tax executive

“An advisor needs to be like a skier — his eyes should be way down the hill, not on his feet underneath him.” — a tax executive

Whether you are the head of a large corporation or the owner of a private company, you probably have been feeling the heavy demands being put on your tax function. Today’s tax departments are under increasing pressure to deliver additional value to their organization. Tax leaders must be able to understand the challenges faced, determine priorities and develop and execute an action plan — leading to enhanced operational efficiency, improved risk management, and strategic alignment with the business.

Evolutional expectations
What do tax pros feel their organizations want more of?

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Aspect</th>
</tr>
</thead>
<tbody>
<tr>
<td>28%</td>
<td>Strategic partnership</td>
</tr>
<tr>
<td>22.3%</td>
<td>Better tech, data, process</td>
</tr>
<tr>
<td>16.4%</td>
<td>Effective communication</td>
</tr>
<tr>
<td>8.8%</td>
<td>Talent and succession</td>
</tr>
</tbody>
</table>

Accelerating trends
What do tax pros view as the most powerful forces at work?

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Aspect</th>
</tr>
</thead>
<tbody>
<tr>
<td>33.6%</td>
<td>Globalization</td>
</tr>
<tr>
<td>34.5%</td>
<td>Regulation</td>
</tr>
<tr>
<td>17%</td>
<td>Technology</td>
</tr>
</tbody>
</table>

Evolving expectations
What do tax pros feel their organizations want more of?

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Aspect</th>
</tr>
</thead>
<tbody>
<tr>
<td>28%</td>
<td>Strategic partnership</td>
</tr>
<tr>
<td>22.3%</td>
<td>Better tech, data, process</td>
</tr>
<tr>
<td>16.4%</td>
<td>Effective communication</td>
</tr>
<tr>
<td>8.8%</td>
<td>Talent and succession</td>
</tr>
</tbody>
</table>

Accelerating trends
What do tax pros view as the most powerful forces at work?

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Aspect</th>
</tr>
</thead>
<tbody>
<tr>
<td>33.6%</td>
<td>Globalization</td>
</tr>
<tr>
<td>34.5%</td>
<td>Regulation</td>
</tr>
<tr>
<td>17%</td>
<td>Technology</td>
</tr>
</tbody>
</table>
Wealth transfer taxes: The new world

Estate tax and estate’s income tax return

Estate administration expenses may be deducted in computing the estate tax or the income tax but not both. In prior years, when federal estate tax rates were significantly higher than federal income tax rates, these expenses were always deducted in determining the estate tax liability. Now, with many states not assessing an estate tax, and the federal estate tax rate just slightly higher than the highest income tax rate (i.e., 40% compared to 39.6%), where to deduct estate administration expenses is now a matter of some analysis.

For estates subject to both federal and state estate or inheritance taxes, it still makes sense to deduct all administration expenses on the estate tax return. In estates that do not face a state estate tax liability but only a state income tax liability or that are subject to the federal net investment income tax of 3.8%, it may now be less expensive to deduct all administrative expenses on the estate’s income tax return. Depending on circumstances, this may be true even when the result is a higher federal estate tax.

This analysis is complicated by the fact that for income tax purposes, estate administration expenses can be deducted only in the year paid and then only to the extent of available income. Excess deductions are simply lost except in the year of the estate’s termination when they can be distributed out as a deduction to the estate’s beneficiaries.

For estates subject to both federal and state estate or inheritance taxes, it still makes sense to deduct all administration expenses on the estate tax return.

The public debate regarding the long-term viability of estate tax has quieted

Nevertheless, over the past seven years, budget proposals and other activities have begun to flesh out what the transfer tax landscape of the future might look like — one dramatically different from what we see today.

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015

Signed into law by the President in July 2015, this law contained provisions for new basis conformity rules, which impose upon executors a new requirement to inform both the IRS and the beneficiaries of an estate, excluding the spouse and any charity, of the basis to be reported by the beneficiaries with respect to their inherited property. Such basis is the value determined for estate tax purposes, with multiple such filings required if the estate tax return is audited and property values are altered. The IRS has announced that a form for this purpose is being prepared for use by executors, and that the requirement (namely that the form be filed within 30 days of filing the estate tax return for all such returns filed after July 31, 2015) is being suspended until February 29, 2016.

Over the past seven years, budget proposals and other activities have begun to flesh out what the transfer tax landscape of the future might look like — one dramatically different from what we see today.
Wealth transfer taxes: The new world

Beyond 2015

Possible forthcoming regulations regarding discount valuation limitations

Much has been made recently of speeches during which government officials have commented on the imminent release of regulations regarding (the “Administration”) use of discounts to determine the value of property for estate and gift tax purposes. It has been implied that the regulations will resemble an Obama Administration budget proposal that was abandoned as a proposal in 2013.

The limitation provisions pursued in the 2013 budget proposal would have acted to preclude a discount for certain restrictions that appear frequently in entity operating agreements. As such, the proposal would augment existing rules which already preclude discounts for any contractual obligation that is more restrictive than underlying state law.

Some believe that this type of restriction is fundamentally obsolete. Courts have consistently ruled that discounts will not be allowed except where reliable empirical evidence exists to measure them. It is difficult to identify any discount specific to a contractual limitation; consequently, such discounts have already been effectively eliminated. Notwithstanding, it is possible that the new regulations, when ultimately released, may take a more restrictive approach than do current valuation practices.

Future tax rates and exemption amounts

The Obama administration has indicated its continuing support of a return to the rules as they existed in 2009, namely, a gift tax exclusion amount of $1 million; an estate tax exemption amount and a GST tax exemption amount of $3.5 million; with a top gift, estate, and GST tax rate of 45%.

Grantor retained annuity trust (GRAT) limitations

The current administration has consistently stated its intention to seek a 10-year minimum term for GRATs. GRATs and the reasons for their popularity are discussed in detail in the “Gift tax” section. More recently it has refined its proposal to also require a remainder interest that is at least 25% of the value of the contributed asset and will require restrictions on the ability of the grantor to transact with the trust. These later requirements will impose a significant current gift tax burden which does not exist with “zero out” GRATs. As a GRAT is established fundamentally for the grantor’s benefit, should death occur during the annuity period while the grantor is still collecting annuity payments, the full value of the trust, as a general rule, will be included in the grantor’s gross estate as if no prior planning had ever been undertaken. In such an event, a decedent would get credit for any gift tax paid with respect to the transaction; notwithstanding, a 10-year minimum term will dramatically affect the appeal of GRATs as estate planning vehicles.

Requiring GRATs to have a minimum 10-year term has also been endorsed by certain lawmakers. For example, in addition to the GRAT change being included in the budgets, members of both houses of Congress introduced legislation in 2010 and 2011, which included similar provisions. Given the current political appetite for deficit reduction and balanced budgets, the prospects for such legislation in the future remain high. Also keep in mind the current condition favoring the use of GRATs — historically low interest rates — should change with an improved economy.

Logic would suggest that GRATs will be used less frequently given the inflation indexed $5.43 million applicable exclusion amount.

Plan now for shorter-term GRATs. If shorter-term GRATs appeal to your specific situation, consideration should be given to current planning and implementation.
Wealth transfer taxes: The new world

Beyond 2015

Limited duration of GST tax exempt status

In its last five budgets, the Obama administration has proposed a provision that would limit the benefit of GST dynasty trusts by requiring the trust’s inclusion ratio (the percentage of the trust that is subject to a GST tax upon certain events) to be increased to 100% upon the 90th anniversary of the creation of the trust. This proposal would apply to trusts created after enactment, and to the portion of any then existing trust attributable to additions to such trust made after the date of enactment.

The primary effect of any such legislation, if enacted, would be to preclude the effectiveness of any trust not subject to a rule against perpetuities by “forcing” such trust back into the tax base. In other words, the trust could continue, but its GST tax profile would change after 90 years. The administration of dynasty trusts subject to such a provision will become more difficult and costly since a GST tax may thereafter be due with every distribution and at the death of every beneficiary.

The estate tax treatment of grantor trusts

In the latest three budget proposals, a “hard to complete” rule has been suggested which focuses on negating the estate tax benefits of the transaction discussed at “Leveraging gift transfers.” The new proposal would apply to that “portion” of a grantor trust, which engages in a sale, exchange, or other comparable transaction with the “deemed owner of the trust.” In most cases, the deemed owner of the trust is the trust’s grantor. The “portion” of the trust to which the rule would apply includes the acquired property (at its value when the transfer is ultimately complete under the hard to complete rule), the retained income produced by the acquired property, and reinvestments of any sales proceeds of the acquired property. The affected portion of the trust would not include any trust property that was acquired as a result of a taxable gift.

The “hard to complete” rule is so named because making a completed gift of the affected trust portion would be difficult to accomplish. Specifically, any distributions (including distributions of income) out of that portion of the grantor trust to someone other than the deemed owner of the grantor trust portion would be treated as a completed gift by the deemed owner of the trust. Similarly, the termination of the affected portion’s grantor trust status prior to the deemed owner’s death would be considered a completed gift of the full value of that portion of the trust. Lastly, and perhaps most importantly, the undistributed assets of the affected trust portion would be includible in the deemed owner’s gross estate.

It remains clear that the means to avoid the unwelcome outcomes described above is to use only nongrantor trusts in one’s planning where a sale, exchange, or other comparable transaction is under consideration. Using a nongrantor trust to affect such a transaction will impose an income tax cost on several transactions that are currently quite popular, but otherwise would not inhibit the types of planning that occur today.

Based upon the attendant difficulties of implementing such a regime, the proposal is unlikely to obtain much traction but does serve to continue to stir the issue of whether or not grantor trusts will have a reduced prominence in the transfer tax planning landscape of the future. Many issues remain unresolved, not the least of which is the treatment of trusts that, while not grantor trusts at inception, later become grantor trusts and whether the GST tax exemption can be effectively allocated to other than the affected portion of the trust.
Wealth transfer taxes: The new world

Beyond 2015

Simplifying the gift tax exclusion for annual gifts

In 2015, a donor may give $14,000 of gifts to an individual donee without being subject to tax. There is no limit on the number of donees to whom a donor may give such excluded gifts in any one year. However, each gift must be of a present interest rather than a future interest (e.g., many gifts in trust), in the donated property. However, in Crummey v. Comm’r, the Ninth Circuit held that a transfer to a trust can qualify as a present interest if the beneficiary has the unrestricted right to withdraw the value of the contribution from the trust, if even for a limited period of time.

The Administration argues that the Crummey rules are creating significant compliance and enforcement costs and that the IRS is increasingly concerned about the lack of a limit on the number of beneficiaries to whom Crummey powers are given. The last two budgets have proposed to eliminate the present interest requirement for gifts that qualify for the gift tax annual exclusion, but it would impose an annual limit of $50,000 (indexed for inflation) per donor on transfers of certain property.

The new category of transfers subject to the proposed annual $50,000 limit per donor would include:

- All transfers in trust with very limited exceptions;
- Transfers of interests in passsthrough entities;
- Transfers of interests subject to a prohibition on sale; and
- Other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee.

The proposal would not eliminate the unlimited number of donees who could receive up to the annual exclusion amount (currently $14,000) for gifts that do not fall in the above new category. This would include simple outright gifts of cash, outright gifts of marketable securities, and gifts to certain trusts, which, as a general rule, can benefit only one beneficiary or that beneficiary’s estate.

Eliminate stepped-up basis for appreciated assets at death; tax donors currently on gifted appreciated property

In the Administration’s 2016 budget proposal, transfers of appreciated property — whether by a decedent at death, or by gift during a donor’s lifetime — generally would be treated as a sale of the property. In the case of a decedent, the gain would be reportable on the final income tax return, and the related income tax liability would be deductible on the estate tax return (if one must be filed). While the proposal implies that the gain would be capital gain, it is anticipated that ordinary income would also be recognized under existing income tax rules (for example, if depreciation recapture is recognized). Consistent with existing gift and estate tax rules, the proposal provides exceptions to the gain recognition rule if the donee is a charity or the transferor’s spouse. In such cases, carry-over basis would apply. The proposal’s language implies that following enactment any unused capital loss carryforwards that would expire under current law would be allowed to offset ordinary income in the final individual income tax return.

The proposal would allow a $100,000 per-person exclusion with respect to capital gains recognized by reason of death, which would be indexed for inflation and portable between spouses — resulting in a total exclusion of $200,000 per couple that would increase over time. Similarly, an indexed portable exclusion of $250,000 per person would apply to capital gain on a decedent’s principal residence — resulting in a total exclusion of $500,000 per couple that would increase over time. The proposal further implies that capital gains recognized by reason of a gift are not offset by either the $100,000 or $250,000 exclusion amounts. The proposal also would exempt gain on tangible personal property and personal effects — except for collectibles. While the proposed rule is clearly intended to avoid the need for appraisals of the artifacts of daily life, what constitutes a collectible is not defined.

According to the proposal, tax otherwise due on transfers of small family-owned and operated businesses could be electively deferred until the business is sold or ceases to be family-owned. During testimony before the Senate Finance Committee, Treasury Secretary Jack Lew explained that this option would be available to businesses “under $1 million,” although he did not specify whether...
Wealth transfer taxes: The new world

Beyond 2015

this threshold refers to the value of a business, or its total assets, revenues, or some other measure. Additionally, except for liquid assets (e.g., publicly traded stocks and bonds) and businesses for which the previously mentioned deferral election is made, a 15-year fixed-rate payment plan would be available with respect to tax due on the deemed sale of illiquid appreciated assets transferred at death — presumably to avoid the need to liquidate appreciated illiquid assets. Any tax deferral would bear interest; however, the tax deductibility of such interest is not discussed. Lien provisions would be operative while the tax is deferred. Last but not least, the proposal suggests that rules would be enacted that would achieve “consistency in valuation for transfer and income tax purposes.” While the full scope of that language is not explored, it portends a renewed challenge on the discounting of assets.

Concluding thoughts

As the previous discussion indicates, significant transactions commonly used in transfer tax planning today are clearly the object of scrutiny. If targeted estate tax planning appeals to you, then you would be well advised to consider taking action currently. In any event, keeping informed of tax legislative developments will give you opportunities to plan ahead and respond as changes transpire.
The 2016 essential tax and wealth planning guide is intended as a start to a conversation that will continue and progress as your personal situation changes and grows. We are now in a period of relative stability, but there will always be important tax law updates that may affect you. You can find current resources to reflect new developments on our website.

To find a member of the Private Wealth group who specializes in your area of interest, please contact us at PrivateWealth@deloitte.com.

Additional tax and wealth planning resources

- **Private Wealth** — Materials focused on tax and wealth planning issues for individuals.

- **Deloitte Growth Enterprise Services** — Cross-functional resources specific to privately held and mid-market companies.

- **tax@hand** — Knowledge when you need it. Instantly link to the latest insights from Deloitte Tax on your iPhone, iPad, or Android device.

- **@DeloitteTax** — Sharing news and insights to keep you in front of tax developments. Follow us on Twitter today.

- **Tax News & Views** — Published by the Deloitte Tax LLP Tax Policy Services group in Washington, D.C., this newsletter provides a compact, reader-friendly perspective on the latest corporate tax developments coming out of Congress, the Internal Revenue Service (IRS), the Department of the Treasury, and the federal courts.

- **Private Companies Dbriefs webcast series** — Webcasts focused on topics of interest to privately held and mid-market companies and their owners.
Disclaimer
We produce this guide for our clients and others who are concerned about planning and managing their personal financial affairs. Each individual’s financial situation is unique, and the material in this guide is not intended to constitute specific accounting, tax, investment, or legal advice. This guide is not intended to be a substitute for specific advice, as certain of the described considerations will not be the same for every taxpayer or investor. Accordingly, where specific advice is necessary or appropriate, consultation with a competent professional advisor is highly recommended. This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

This guide is not intended or written to be used, and it cannot be used by the taxpayer, for the purpose of avoiding any penalties that may be imposed by any governmental taxing authority or agency.

Copyright © 2015 Deloitte Development LLC. All rights reserved.
Member of Deloitte Touche Tohmatsu Limited