Dear Reader,

The old adage, "if it's not broken, don't fix it," may apply to mechanical devices, but not to tax and wealth planning. The world is changing rapidly. Planning tools need to change accordingly ... be refreshed regularly ... be easy to access ... and, most importantly, cultivate ongoing dialogue between you, your family members, and your tax advisors.

That is why the 2017 essential tax and wealth planning guide looks very different from previous years. You'll receive it in a series of releases over the next few months rather than as a single document. With each new release, you will still have access to previous editions, so this phased rollout will make the information even more timely, accessible, and relevant for you than before.

The first installment presented sections on Tax policy and elections, Individual income tax planning, Wealth transfer planning, and Unique investments. This installment provides a Post-election tax policy update, Post-mortem considerations, Philanthropy, and Tax implications of fund investing. As life events and market and regulatory changes unfold around you, it just makes sense to plan early and revisit plans often to understand the immediate and long-term benefits of charitable and wealth transfer planning. In addition, understanding the tax implications of holding managed security, hedge fund, private equity, and real estate funds can help you better quantify the after-tax investment return associated with these investments. These sections will support your long-term view even as you shape and refine your strategies over time.

The final installment will be released following the New Year, offering you insights on Family office and Globalization. Both areas grow increasingly complex each year, so kicking off the new year with fresh perspectives on them gives you ample time for thoughtful consideration and consultation.

We believe this new format and the considerations it contains will help you plan for whatever comes in 2017. With a steady stream of timely, pertinent, and easily digestible information, 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 Industry Leader
Private Wealth
Deloitte Tax LLP
Post-election tax policy update

On November 8, the nation elected Donald Trump as its forty-fifth president and in so doing handed him significant authority over federal tax law and regulations. The election of a new president typically ushers in the prospect of significant policy changes and along with it an awareness of the complexity involved as proposals are released, debated, modified, and, in some cases, enacted. From the standpoint of tax policy, however, it is unclear whether the tax code changes that Trump has envisioned will be enacted into law in their current form.
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This lack of clarity could be due in part to the fact that in the months leading up to the election tax policy never really emerged as a top-tier issue on the campaign trail or in the general media. To be sure, Trump and his Democratic challenger Hillary Clinton acknowledged the importance of tax policy and each developed proposals to show how they hoped to reshape the tax code in their respective administrations. But Trump, like Clinton, generally addressed tax issues only in broad strokes. The proposals he discussed in his speeches and position papers in many cases lack technical details to explain how specific provisions would operate, and we may not see any fully fleshed-out proposals until his administration sends its first tax-and-spending plan to Congress in 2017.

In some ways, Trump’s tax policy platform is a work in progress. He released his original tax reform plan in September 2015, well before he had won the GOP nomination. That plan was criticized by Democrats, as well as some Republicans, for being too costly—the nonpartisan Tax Policy Center estimated the plan could lose nearly $10 trillion in revenue over the next decade—and for targeting its tax reductions primarily at upper-income households. More recently, he has attempted to recalibrate his plan in an effort to make it less costly and target its benefits on the individual side more toward the middle class.

A familiar playbook

Based on the public statements Trump has made regarding tax policy, two things seem apparent. First, he appears intent on changing the nation’s tax laws by working within the confines of the current income tax system rather than attempting to move toward a consumption-based tax or other alternative system.

Second, the changes he is likely to propose once in office largely reflect the Republican Party orthodoxy of lowering tax rates for business and individual taxpayers while simultaneously broadening the base through limiting—or in some cases eliminating—some longstanding tax deductions, credits, and incentives.
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**Working with a Republican Congress**

Trump’s goal of reforming the tax code likely will be made easier by the fact that Republicans will control the House of Representatives and the Senate in 2017. But the president-elect and Republican congressional leaders do not necessarily walk in lockstep on all issues related to tax reform. House Republicans unveiled a tax reform “blueprint” this past June which they intend to develop into a formal legislative proposal that they hope to move through the chamber next year. Although Trump’s plan and the blueprint overlap in some key areas—such as individual tax rates—they differ in others.

Moreover, the GOP will have smaller majorities in both chambers in the incoming 115th Congress than it currently enjoys. In the Senate, Republicans remain well short of the 60-vote threshold needed to avoid the threat of a Democratic filibuster and advance controversial legislation. If Trump and Republican lawmakers come to an accord on tax reform, they conceivably could take advantage of the “budget reconciliation” process to sidestep Democratic opposition. But that option involves some very real policy and procedural challenges. If Republicans opt not to use reconciliation, they likely would need to work with Senate Democrats to ensure that legislation can move through that chamber.

The discussion that follows looks at where President-elect Trump stands on key tax policy issues based on the positions he has articulated in his public statements and on his campaign website, as well as details published by the Tax Policy Center and the Tax Foundation—two nonpartisan think tanks—based on information from campaign officials. It also looks beyond Trump’s campaign platform to consider how the make-up of Congress in 2017 could affect his ability to get his tax agenda enacted into law.

**Ordinary income rates and brackets**

Throughout the campaign, Trump called for compressing the number of individual income tax brackets from seven under current law to three and for reducing the top rate from its current-law level of 39.6 percent. His original 2015 tax plan called for brackets of 10 percent, 20 percent, and 25 percent. In his speech at the Detroit Economic Club this August, Trump modified his position and called for rate brackets of 12 percent, 25 percent, and 33 percent, as proposed in the House GOP blueprint.
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- Medicare Hospital Insurance tax repealed: Trump has called for repealing the Patient Protection and Affordable Care Act (PPACA). As a result, the current-law 0.9 percent Medicare Hospital Insurance tax on individuals with income over $200,000 and joint filers with income over $250,000 would be repealed.

- Capital gain income tax
- Trump’s plan would retain the current-law preferential rate structure for income from long-term capital gains and qualified dividends. According to the details posted on Trump’s website, the three rate brackets for long-term capital gains would correspond with his proposed brackets for ordinary income. Thus, taxpayers in the 12 percent ordinary income tax bracket would pay no tax on their realized capital gains; taxpayers in the 25 percent income tax bracket would face a capital gains rate of 15 percent; and taxpayers in the 33 percent income tax bracket would pay capital gains tax at the top rate of 20 percent. Based on the entry points for these brackets, certain taxpayers could find their capital gain and qualified dividend income taxed at a higher rate under Trump’s plan than under current law. (See the table on page 22 for details.)

The House GOP blueprint calls for taxing long-term capital gains, qualified dividends, and interest as ordinary income, but subject to a 50 percent exclusion, which would result in a maximum effective tax rate of 16.5 percent.

- Net investment income tax repealed: Under both the Trump plan and the House GOP blueprint, the current-law 3.8 percent net investment income tax on individuals with income over $200,000 and joint filers with income over $250,000 would be repealed.
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Passthrough income

Trump's position on the treatment of business passthrough income evolved over the course of the campaign. The original tax plan he released in 2015 proposed to reduce the top rate on passthrough business income to 15 percent—well below the current-law top rate of 39.6 percent and the proposed 25 percent top rate that would later be included in the House GOP blueprint. He likewise proposed a 15 percent top rate for corporate income.

The first sign of a shift in that position came in September of this year when a fact sheet released by the campaign in conjunction with a speech Trump gave at the Economic Club of New York reaffirmed his commitment to reducing the corporate tax rate to 15 percent but was silent on whether there would be a rate reduction for passthrough businesses. An updated fact sheet released shortly after the speech affirmatively stated that the 15 percent rate would be “available to all businesses, both small and large, that want to retain the profits within the business.”

A Trump policy advisor subsequently sought to clarify the candidate’s position in comments to the press, stating that Trump’s proposal would in fact allow passthrough entities to elect to be taxed as if they were corporations, thus letting them benefit from the lower business rate. However, owners of passthrough entities that make such an election would also be subject to a second layer of tax on distributions from the business—just as shareholders generally must pay tax on corporate dividends. (Under Trump’s plan, dividends would be taxed at a top rate of 20 percent, and, as already noted, the 3.8 percent net investment income tax would be repealed.)

Certain small passthrough entities reportedly would be exempt from the second layer of tax, but it remains unclear as to where that threshold would be set and by what measure (for example, assets, gross income, etc.). The Trump campaign has indicated that those details would be worked out with Congress after the election.

These aspects of the proposal continue to generate questions within the tax policy community; however, the Trump team has not provided additional clarifications.

Anti-abuse rules: According to campaign staff, Trump’s administration will work with Congress to develop anti-abuse rules to prevent passthrough business owners from attempting to recharacterize wage income—subject to a top rate of 33 percent under his plan—as more lightly taxed business income. As a point of comparison, the House Republican blueprint—which similarly calls for divorcing the rate on passthrough business income from the top individual rate—states in general terms that passthrough entities would pay or be treated as having paid reasonable compensation to their owner-operators, which would be deductible by the business and subject to tax at the graduated rates for families and individuals. The blueprint does not elaborate on what would be considered “reasonable compensation.”

Trump’s position on the treatment of business passthrough income evolved over the course of the campaign.
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Carried interest income

Trump has consistently called for taxing income from carried interests as ordinary—therefore subject to his proposed top rate of 33 percent—rather than capital gain.

Because his plan appears to allow for some pass-through business income to be taxed at just 15 percent, however, some commentators have suggested that recipients of carried interests might attempt to restructure these arrangements to classify the income as business income, resulting in a lower total tax rate than the 23.8 percent long-term capital gains rate they pay on carried interest today. As already noted, Trump and his advisors have stated that his administration would work with Congress to propose anti-abuse rules, but they have so far offered no specifics on what form those rules might take.

The House GOP blueprint does not propose changes to the tax treatment of carried interests, so presumably they would continue to be taxed as capital gains; however, as already noted, the top effective rate on long-term capital gain income under the blueprint would be reduced to 16.5 percent from 23.8 percent under current law.

Itemized deductions

Throughout the campaign, Trump has called for limiting or repealing many itemized tax deductions to help offset the cost of his proposed reductions in individual tax rates. His initial proposal, announced as part of his 2015 tax plan, called for phasing out most itemized deductions and tightening the so-called “Pease” limitation while retaining the deductions for mortgage interest and charitable giving in their current form. But he modified his position in September, proposing instead to cap itemized deductions at $200,000 for joint filers and $100,000 for single filers.

The House GOP blueprint calls for retaining the deductions for mortgage interest and charitable giving, but suggests that taxwriters may consider unspecified modifications in the future to make these deductions “more effective and efficient.” It also proposes to modify the incentives to save for retirement and higher education. Most other incentives and deductions would be repealed.

Standard deduction

Trump has consistently called for a significant expansion in the standard deduction to simplify the tax code and reduce the number of taxpayers who have to itemize. His 2015 plan proposed to increase the standard deduction to $50,000 for joint filers and $25,000 for individuals. But he has since narrowed that proposal to $30,000 for joint filers and $15,000 for individuals. He also now calls for eliminating personal exemptions and the head-of-household filing status. According to some analysts, the net effect of those changes will be higher taxes for certain middle-class families. The Trump campaign has not directly acknowledged that but has indicated Congress would be instructed to prevent such an outcome.

The House GOP blueprint calls for consolidating the standard deduction and personal exemption into one larger standard deduction of $12,000 for single taxpayers, $18,000 for single taxpayers with a child, and $24,000 for married filers.

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The Trump campaign announced an entirely new set of tax breaks specifically targeting families, including a new above-the-line deduction for taxpayers facing child care and elder care expenses, and a new tax-preferred savings account to encourage families to set aside funds for caregiving expenses.

AMT

Trump has consistently called for repeal of the individual alternative minimum tax, as does the House GOP blueprint.

Estate tax

Trump also has consistently called for repealing the estate, gift, and generation-skipping transfer taxes. However, in a significant change from the original plan, the campaign announced in September that Trump would tax capital gains on appreciated assets held at death to the extent such gains exceed $10 million. It is unclear whether the $10 million threshold would apply per person or per couple.

Without elaborating, the tax policy platform on Trump’s website also states that, in order to prevent abuse, “contributions of appreciated assets into a private charity established by the decedent or the decedent’s relatives will be disallowed.”

The House Republican blueprint calls for repealing the estate tax and generation-skipping transfer tax outright.

Family tax provisions

Also in September, the Trump campaign announced an entirely new set of tax breaks specifically targeting families, including a new above-the-line deduction for taxpayers facing child care and elder care expenses, and a new tax-preferred savings account to encourage families to set aside funds for caregiving expenses.

Deduction for child care/elder care expenses: According to his campaign website, Trump would provide an above-the-line deduction for child care expenses for up to four children per family, from birth to age 13, with the deduction amount capped at “the average cost of child care” based on the child’s age and state of residence. The deduction would be available to itemizers and non-itemizers, and would apply to families that use paid child care providers, as well as families that rely on a stay-at-home parent or an unpaid relative to meet their child care needs.

The deduction would be limited to couples earning up to $500,000 a year and individuals earning up to $250,000. To assist families with no income tax liability, the proposal calls for a “spending rebate” through the Earned Income Tax Credit that would be capped at “half of the payroll taxes paid by the taxpayer (based on the lower-earning parent in a two-earner household)” and subject to an income limitation of $31,200 for individuals and $62,400 for joint filers.

A similar above-the-line deduction would be available to families who incur expenses for home care or adult day care for an elderly dependent relative. The deduction would be capped at $5,000 a year, indexed annually for inflation.
Dependent Care Savings Accounts:
In addition to the new deduction, Trump proposes the creation of tax-preferred Dependent Care Savings Accounts (DCSAs), which according to a campaign fact sheet would allow families to “set aside extra money to foster their children’s development and offset elder care for their parents or adult dependents.” The fact sheet indicates the accounts would be “available to everyone” and would “allow both tax-deductible contributions and tax-free appreciation year to year.”

DCSAs would be established for the benefit of specific individuals. Those established for a minor child—including an unborn child—could “be applied to traditional child care, after-school enrichment programs, and school tuition.” Accounts established for an elderly dependent could “cover a variety of services, including in-home nursing and home care.”

Contributions to a DCSA would be capped at $2,000 a year from all sources, which according to the campaign would include the parents of a minor child, the individual establishing an elder care account, immediate family members of the account owner, and the employer of the account owner. Rollovers of accumulated account balances would be permitted from year to year. Contributions to a DCSA established for a child would not be permitted once the child reaches age 18; however, any funds remaining in the account when the child reaches 18 could be used to pay for education expenses.

Lower-income parents who open a DCSA for a minor child would receive a government match for 50 percent of the first $1,000 deposited per year. The campaign also notes that parents who qualify for the Earned Income Tax Credit (EITC) would be able to “check a box [on their tax returns] to directly deposit any portion of their EITC into their Dependent Care Savings Account.”
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At first glance, the fact that Donald Trump is headed to the White House and will be working with a Republican Congress in 2017 would appear to clear a path for possible action on tax reform; nonetheless, some obstacles are likely to remain.

Trump's tax plan, which adopts a traditional Republican approach of broadening the base and lowering the rates, may present practical difficulties. As we've noted, the original version, which was introduced in 2015, has been recalibrated in recent months to address concerns that it would substantially add to the deficit. But according to an analysis by the Tax Policy Center, his revised tax plan still would decrease federal receipts by an estimated total of $6.15 trillion (net) between 2016 and 2026 based on a traditional "static" scoring model. Under so-called "dynamic" scoring that takes into account certain macroeconomic feedback effects of the plan on the economy and in turn on federal revenue levels, the Tax Policy Center estimates a slightly smaller 10-year drop in federal receipts of between $5.97 trillion and $6.03 trillion. (The Center analyzed the plan using two dynamic models).

At first glance, the fact that Donald Trump is headed to the White House and will be working with a Republican Congress in 2017 would appear to clear a path for possible action on tax reform; nonetheless, some obstacles are likely to remain.

For its part, the Tax Foundation cites a range of estimates under both its static and dynamic models, noting some of the uncertainties around Trump's proposals for taxing business pass-through income. Based on available information, the Tax Foundation estimates the 10-year revenue loss under Trump's plan to be between $4.37 trillion and $5.91 trillion under its static model. That drops to between $2.64 trillion and $3.93 trillion when macroeconomic feedback is factored in.

Given that federal receipts over the next decade are projected to total roughly $42 trillion, Trump's plan as it is currently structured would require either a very large reduction in federal spending or a significant increase in the deficit.

Where congressional leaders stand:

Of course, tax policy is not written exclusively by the president. Congress will want to have its say; and the truth is that lawmakers do not speak with one voice.

House Republicans—The tax reform blueprint released in June of this year by Speaker Paul Ryan, R-Wis., and Ways and Means Committee Chairman Kevin Brady, R-Texas, is similar to Trump's plan in its calls for significant rate cuts for business and individual taxpayers. But the blueprint differs markedly from Trump's plan in other ways: most notably, the blueprint envisions a transition to a territorial system for taxing foreign-source income of US multinationals (something Trump's original tax plan did not include and which his revised plan did not address), coupled with a destination-based cash flow tax based on jurisdiction of consumption and not production.
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The blueprint as released lacks sufficient detail to allow for an accurate revenue score. It probably will not be revenue neutral—under a static estimating model—when it is fully fleshed out; however, it is intended to have relatively little revenue loss when the dynamic effects on tax receipts of faster economic growth are included.

Senate Republicans—In the Senate, Majority Leader Mitch McConnell of Kentucky has not been nearly as strong an advocate of tax reform as House Speaker Ryan, who cites the issue as one of his top priorities. Finance Committee Chairman Orrin Hatch, R-Utah, supports comprehensive tax reform. With that goal out of reach under President Obama, however, Hatch has spent much of this past year working on an alternative approach: a corporate integration plan that is expected to propose lowering the corporate tax rate by combining a dividends paid deduction with a withholding tax on dividend and interest payments. The details of the plan—which Hatch may release later this year as a discussion draft—have not yet been made public. Although his Republican colleagues have yet to embrace this approach, Hatch could continue to make the case that his incremental proposal is a meaningful improvement to the tax code and not incompatible with potential broader reform further down the road.

Senate Democrats—Because Republicans did not win a 60-vote supermajority in the Senate, they may need to compromise with Democrats if they want to move significant legislation through the chamber. And the two Democratic lawmakers likely to exert the most influence on tax policy are long-time Finance Committee members Ron Wyden of Oregon and Charles Schumer of New York. Wyden, the ranking Democrat on the Finance Committee, has urged Congress to act in the short term on the issue of inversions, but he has also been working on a broader vision of tax reform over the last several years. He unveiled a comprehensive tax reform plan in 2010 and again in 2011—both times with a Republican co-sponsor—when he was just a Finance Committee “back bencher.” This year, Wyden released three targeted tax reform discussion drafts aimed at (1) streamlining depreciation rules to move from asset-by-asset tracking to a simplified “pooling approach”; (2) simplifying the taxation of certain derivative contracts to provide for mark-to-market treatment at the end of each year; and (3) tightening rules related to tax-favored retirement accounts—especially for the wealthy—by, among other things, capping contributions to certain high balance accounts.

For his part, Schumer—who will become the Senate Democratic leader when the new Congress convenes—has been active primarily in the area of business tax reform. (In 2015, he attempted to negotiate a deal with Paul Ryan, who at the time was chairman of the House Ways and Means Committee, for a business tax reform package that included revenue for infrastructure spending; Schumer also served as co-chair of the Finance Committee’s bipartisan working group on international tax reform.)
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House Democrats—House Democratic leaders generally have staked out a position on tax reform similar to that of Democratic presidential candidate Hillary Clinton. Ways and Means Committee ranking Democrat Sander Levin of Michigan, for example, is a vocal supporter of legislation to tighten current-law rules governing inversions and backs increasing taxes on large corporations and wealthier individuals, but he has not developed a comprehensive tax reform plan of his own that would serve as a counterpoint to the House GOP blueprint. Interestingly, House Minority Leader Nancy Pelosi, D-Calif., recently told reporters that there is general agreement for lowering corporate tax rates and closing perceived “loopholes,” but she has not taken the lead in building a case for comprehensive tax reform within her caucus, and it is unlikely she would push her members to support broader tax reform as envisioned by either President-elect Trump or House Republicans.

Reconciliation comes with major procedural and policy challenges, so getting tax reform done this way is not a sure thing.

Senate with only 51 votes and without having to worry about winning Democratic cooperation. (This is the same process that Democrats invoked in 2010—when they lacked a filibuster-proof Senate majority—to pass the Patient Protection and Affordable Care Act and that Republicans used in 2001 and 2003 to pass the Bush-era tax cuts.)

However, reconciliation comes with major procedural and policy challenges, so getting tax reform done this way is not a sure thing. To begin with, congressional Republicans would have to agree on a budget resolution—something they were not able to accomplish in 2016—that includes reconciliation instructions on tax reform. But perhaps the greater challenge arises from the likelihood that a GOP-only tax reform will increase the deficit—that is, it will include more tax cuts than offsetting base broadening. Generally, under current reconciliation rules, bills that are not deficit-neutral after the first decade must sunset in order to avoid a 60-vote threshold for passage in the Senate. This means Republicans could be forced to (1) scale back their vision of reform, (2) enact “temporary” tax reform (something that would be difficult to do from the standpoint of drafting legislative language and transition rules and would likely frustrate individuals and businesses who are affected by the rule changes), or (3) find a procedural avenue around that hurdle. Recall that the 2001 and 2003 tax cuts were enacted under reconciliation, leading to moments of high anxiety for taxpayers between the time those provisions approached their scheduled expiration at the end of 2010 and the time they were finally addressed in a permanent way in the early days of 2013. Those anxieties would be multiplied if it is not just marginal rates but the entire structure of the tax code that is in danger of sunsetting. Despite these concerns, though, reconciliation may be an imperfect alternative that Republicans are willing to pursue, given the difficulty in reaching bipartisan consensus on tax reform.
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If reconciliation is out, is compromise possible?: Without using reconciliation, the 60-vote threshold to avoid a Democratic filibuster in the Senate would require some level of bipartisan compromise if any legislation is to be enacted. House Ways and Means Committee Chairman Brady is among those who have recently expressed a preference for finding common ground so that tax reform can proceed on a bipartisan basis. But one question is whether Senate Democrats would find it in their interest to help pursue tax reform or whether they would think themselves better served by blocking key agenda items of the Trump administration and protecting potentially vulnerable Democratic incumbents in the 2018 mid-term elections.

A second question is whether the House Freedom Caucus—a vocal minority within the GOP Conference that in the past has been skeptical of leadership-driven compromises with Democrats—will pressure leadership to avoid bipartisan dealmaking, even if the alternative is gridlock. The Freedom Caucus will be a larger presence in the 115th Congress both in terms of raw numbers and as a share of the GOP's majority in the House, and its influence is likely to play a role as Speaker Ryan contemplates his policy agenda and his own political future.

More clarity likely as budget process moves forward

The path forward for action on tax reform next year will become clearer as the Trump administration sends a detailed tax-and-spending blueprint for fiscal year 2018 to Capitol Hill, Congress decides how—or whether—to proceed on specific proposals, and the Joint Committee on Taxation staff develops official revenue estimates of their economic impact.

Exactly when the budget process for fiscal year 2017 will formally kick off is currently unclear. Federal law requires every presidential administration to submit its budget proposal for the coming fiscal year by the first Monday in February, which means the budget for fiscal year 2018 would be due on February 7, 2017. However, that deadline frequently slips—especially in years when a new president takes office. President Bill Clinton, for example, submitted his first budget blueprint (for fiscal 1994) on April 8, 1993; President George W. Bush submitted his first budget (for fiscal 2002) on April 9, 2001; and President Obama submitted his first budget (for fiscal 2010) on May 7, 2009.
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The following table highlights the individual provisions in Donald Trump’s tax plan and shows how they stack up against current law and the proposals in the House Republican tax reform blueprint released on June 24, 2016. Proposals marked with an asterisk were included in the House GOP’s health care reform blueprint released on June 22, 2016. *Highlighted* material indicates discrete proposals from Senate Finance Committee leaders Orrin Hatch, R-Utah, and Ron Wyden, D-Ore., that also could influence the tax policy debate next year.

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<td>- Seven brackets: 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%</td>
<td>• Three brackets: 12%, 25%, and 33%</td>
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<td>- Additional 0.9% Medicare Hospital Insurance tax on individual filers with AGI &gt; $200,000 and joint filers with AGI &gt; $250,000</td>
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<td>Trump campaign has explained that</td>
<td>• Top rate of 23% will apply to active business income of sole proprietorships and passthrough entities (partnerships, LLCs, and S corps)</td>
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<td>• Passthrough businesses may elect to be taxed at the 15% corporate rate or under the individual side of the code</td>
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<td>• Large passthroughs electing the 15% rate would be subject to second-level tax on distributions to owners, but small ones would not (no details on threshold for determining when or how second-level tax would apply)</td>
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<td>• Anti-abuse provisions to prevent taxpayers from misclassifying wage income as business passthrough income to take advantage of 15% rate would be negotiated with Congress</td>
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• Estate tax
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Overview of Trump’s tax plan: Individual provisions

Selected individual provisions

<table>
<thead>
<tr>
<th>Provision</th>
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<th>Trump</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Interest income</td>
<td>Taxed as ordinary income</td>
<td>No changes specified; presumably taxed as ordinary income</td>
<td>Taxed at ordinary rates with 50% exclusion (effective tax rates of 6%, 12.5%, and 16.5%)</td>
</tr>
<tr>
<td>Capital gain and qualified dividend income</td>
<td>Short-term capital gains (held &lt; 1 year) taxed at ordinary income rates. Long-term capital gains (held ≥ 1 year) taxed at preferential rates, with top rate of 20%. Additional 3.8% net investment income tax applies to individual filers with AGI = $200,000 and joint filers with AGI = $250,000. Dividends taxed as ordinary income, while qualified dividends are taxed at the preferential capital gains rates.</td>
<td>Retain current-law rates and brackets for capital gain and dividend income. Repeal 3.8% net investment income tax.</td>
<td>Taxed at ordinary rates with 50% exclusion (effective tax rates of 6%, 12.5%, and 16.5%). Repeal 3.8% net investment income tax*</td>
</tr>
<tr>
<td>Carried interest income</td>
<td>Taxed as long-term capital gain</td>
<td>Tax as ordinary income (see details on proposed rates above)</td>
<td>No changes to the tax treatment of carried interest are specified, though the top effective rate on long-term capital gain income would be reduced to 16.5% from 23.8% (see additional details on capital gain income above)</td>
</tr>
<tr>
<td>AMT</td>
<td>Imposed on taxpayers who have certain types of income that receive favorable treatment, or who qualify for certain deductions that can significantly reduce the amount of regular income tax; subject to exemption amounts indexed annually for inflation</td>
<td>Repeal; treatment of accumulated AMT credits not specified</td>
<td>Repeal; treatment of accumulated AMT credits not specified</td>
</tr>
</tbody>
</table>

Post-election tax policy update

Overview of Trump’s tax plan: Individual provisions

Resources
## Post-election tax policy update

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</table>
| **Estate tax** | - Top rate: 41%  
- Exemption: $5.49 million per spouse for 2017 (adjusted annually for inflation)  
- Additional tax may apply to generation-skipping transfers | - Repeal, but appreciated assets held at death will be subject to capital gains tax to the extent they exceed $10 million  
- Disallow contributions of appreciated assets into a private charity established by the decedent or the decedent’s relatives* | Repeal estate tax and generation-skipping tax |
| **Patient Protection and Affordable Care Act (PPACA) taxes** | - 0.9% Medicare Hospital Insurance tax on individual filers with AGI > $200,000 and joint filers with AGI > $250,000  
- 3.8% net investment income tax on individual filers with AGI > $200,000 and joint filers with AGI > $250,000 | - Repeal PPACA and the business and individual taxes enacted as part of that legislation | Repeal PPACA and the business and individual taxes enacted as part of that legislation |
| **Treatment of employer-provided health care benefits** | Exclude from income and payroll taxes | No changes specified | - Cap exclusion at unspecified threshold*  
- Provide a refundable credit to allow individuals without access to employer-provided health insurance to purchase insurance in the open market* |
| **Treatment of life insurance contract “inside build-up”** | Investment income on premiums credited under a life insurance contract not subject to current taxation; amounts received under a life insurance contract by reason of the death of the insured or with respect to an insured who is terminally ill or chronically ill are excludable from income | Unclear: 2015 tax plan proposed to “[phase] out the tax exemption on life insurance interest for high-income earners” but the issue has not been addressed in subsequent iterations of Trump’s tax plan | No changes specified |
| **Mortgage interest deduction** | Itemizers may deduct mortgage interest on up to $1 million in acquisition indebtedness and up to $100,000 in home equity indebtedness | Cap itemized deductions at $200,000 for joint filers and $100,000 for single filers | Retain deduction; Ways and Means Committee will “evaluate options” to make the current-law deduction “more effective and efficient,” but no future changes will affect existing mortgages or refinancings |
| **Charitable giving deduction** | Charitable contributions fully deductible for itemizers | Cap itemized deductions at $200,000 for joint filers and $100,000 for single filers | Retain but “develop options to ensure the tax code continues to encourage donations, while simplifying compliance and record-keeping and making the tax benefit effective and efficient” |

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- Resources: Ordinary and capital gain income

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- Overview of Trump’s tax plan: Individual provisions
- Trump’s proposed individual rate brackets: Ordinary and capital gain income

### Post-election tax policy update

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<tr>
<td><strong>State and local tax deduction</strong></td>
<td>Itemizers may deduct state and local income taxes, or general sales taxes in lieu thereof</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Standard deduction and personal exemptions; provisions for children and families</strong></td>
<td>- Standard deduction: $6,350 for single individuals, $9,350 for heads of households, $12,700 for joint filers</td>
<td>- Increase standard deduction to $15,000 for single filers and $30,000 for joint filers</td>
<td>- Consolidate standard deduction and personal exemption into one larger standard deduction of $12,000 for single taxpayers, $18,000 for single taxpayers with a child, and $24,000 for married filers</td>
</tr>
<tr>
<td></td>
<td>- Additional standard deduction: $1,250 for individuals who are elderly or blind</td>
<td>- Eliminate personal exemptions and head-of-household filing status</td>
<td>- Consolidate personal exemption for children and child tax credit into a single $1,500 credit, $1,000 of which is refundable</td>
</tr>
<tr>
<td></td>
<td>- Personal exemptions for taxpayer, taxpayer’s spouse, and any dependents: $4,050 for each personal exemption</td>
<td>- Create new above-the-line tax deductions for child care and elder care expenses</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Child tax credit: Refundable credit of $1,000 for each qualifying child under age 17, subject to phase-out</td>
<td>- Create new tax-preferred savings accounts to encourage families to set aside funds for child care and elder care expenses</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(Deduction/credit amounts are those in effect for 2017)</td>
<td>(Deduction/credit amounts are those in effect for 2017)</td>
<td></td>
</tr>
<tr>
<td><strong>Personal exemption phase-out (PEP) and limitation on itemized deductions (Pease)</strong></td>
<td>PeP and Pease limitations apply for taxpayers with AGI exceeding certain thresholds</td>
<td>No changes currently specified (2015 plan called for “steepening the curve” of PEP and Pease)</td>
<td>Not specified (although the blueprint identifies these provisions as problems with the current tax code)</td>
</tr>
<tr>
<td><strong>Higher education incentives</strong></td>
<td>- Four higher education tax benefits — American Opportunity Tax Credit (AOTC), Hope Scholarship Credit, Lifetime Learning Credit, and qualified tuition deduction</td>
<td>No changes specified</td>
<td>Blueprint indicates the Ways and Means Committee will seek to streamline the credits, retaining incentives for both college and vocational study</td>
</tr>
<tr>
<td></td>
<td>- Various deductions and exclusions for education assistance programs, interest paid on education loans, qualified tuition and related expenses, discharge of student loan indebtedness</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Exception to additional 10% tax for early distributions from retirement plans and Individual Retirement Accounts used to pay for higher education expenses</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Selected individual provisions**

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<tbody>
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<td>Retirement savings incentives</td>
<td>Individuals may contribute to tax-preferred traditional and Roth IRAs, subject to contribution limits and income phase-outs, and to employer-sponsored plans such as 401(k)s, subject to maximum elective contribution limits</td>
<td>No changes specified</td>
<td>Retain current retirement vehicles; Ways and Means Committee will “work to consolidate and reform the multiple different retirement savings provisions in the current tax code to provide effective and efficient incentives for savings and investment,” and also consider creation of new vehicles, such as a Universal Savings Plan</td>
</tr>
</tbody>
</table>

Wyden draft proposal: Prohibit additional contributions to Roth IRAs with balances over $5 million; eliminate Roth IRA conversions; generally require retirement account assets to be distributed within 5 years after account holder’s death; expand savings opportunities for working families and younger individuals.
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Overview of Trump’s tax plan: Individual provisions

Trump’s proposed individual rate brackets: Ordinary income

The table below compares the proposed marginal rates on ordinary income under the Trump plan—and the income thresholds at which those rates would apply—with current-law brackets and the inflation-adjusted income thresholds in effect for 2017.

### Trump ordinary rate brackets v. current law

<table>
<thead>
<tr>
<th>Rate</th>
<th>Current law</th>
<th>Trump</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>$0 to $9,325</td>
<td>—</td>
</tr>
<tr>
<td>12%</td>
<td>$0 to $18,650</td>
<td>$0 to $37,500</td>
</tr>
<tr>
<td>15%</td>
<td>$37,951 to $91,900</td>
<td>$37,501 to $112,500</td>
</tr>
<tr>
<td>25%</td>
<td>$91,901 to $191,650</td>
<td>$37,501 to $112,500</td>
</tr>
<tr>
<td>28%</td>
<td>$191,651 to $416,700</td>
<td>$153,101 to $233,350</td>
</tr>
<tr>
<td>33%</td>
<td>$416,701 to $418,400</td>
<td>$233,351 to $416,700</td>
</tr>
<tr>
<td>35%</td>
<td>$418,401 and above</td>
<td>$225,001 and above</td>
</tr>
</tbody>
</table>

1 Current law imposes an additional 0.9% Medicare Hospital Insurance Tax on certain upper-income individuals. This tax would be repealed under the Trump plan. Sources: Inflation-adjusted brackets in effect for 2016 listed in IRS Revenue Procedure 2016-55. Trump data from the candidate’s website.
Post-election tax policy update

Trump’s proposed individual rate brackets: Capital gain income

This table compares the proposed marginal rates on long-term capital gain income under the Trump plan—and the income thresholds at which those rates would apply — with current-law brackets and the inflation-adjusted income thresholds in effect for 2017.

Trump capital gain rates and brackets v. current law

<table>
<thead>
<tr>
<th>Bracket</th>
<th>Single filers</th>
<th>Married-joint filers</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>$0 to $37,950</td>
<td>$0 to $37,500</td>
</tr>
<tr>
<td>15%</td>
<td>$37,951 to $418,400</td>
<td>$37,501 to $112,500</td>
</tr>
<tr>
<td>20%</td>
<td>$418,401 and above</td>
<td>$112,501 and above</td>
</tr>
</tbody>
</table>

1 Rates shown in this table do not reflect the 3.8% net investment income tax imposed on certain high-income individuals that is in effect under current law. (The net investment income tax would be repealed under the Trump plan.)

Post-mortem considerations

In an ideal world, every wealthy individual has prepared for an orderly estate distribution, either in favor of his or her family, charity, or both, by proactively transferring wealth during his or her lifetime and by leaving a thoughtful, well-constructed estate plan that has also taken taxes into consideration. But in the real world, many estate plans remain a work in progress for reasons ranging from evolving business complexity to family conflict, ill health, and indecision. Consequently, the need for post-mortem planning is inevitable.
Post-mortem considerations

US tax concerns during the administrative process for an estate

Developing a thoughtful, well-constructed estate plan during life leaves fewer actions and decisions to be taken by executors, trustees, and post-mortem advisors, thus conserving both time and resources. The converse is also true; an estate plan that is vague, incomplete, or nonexistent is generally tax inefficient and leaves major decisions regarding asset management, estate liquidity, and the timing and nature of distributions to the estate’s fiduciaries, advisors, and the courts, which consumes both time and resources.

For the families and beneficiaries of high net worth individuals, settling an estate can be all-consuming and stressful, beginning with the process of gathering information to create a net asset inventory (complete with necessary valuations of assets) and ending—often many years later—with the final distribution of assets. The period in between, the post-mortem administrative period, often gives rise to complex tax, financial, and family considerations. While estate administration has its own legal and tax cadence, there is typically pressure to accelerate outcomes, even during the initial period of emotional loss.

Every high net worth estate is unique. The type and level of activities required for settling the estate will depend on a host of factors, including the nature of the assets and liabilities, family considerations, and the extent of the decedent’s estate plan. For example, the approach for an individual who dies intestate (without a will or other testamentary declaration) will be very different than the approach for someone who dies with a thoughtful, well-constructed estate plan and a family office actively involved in its administration.

Effective post-mortem administration requires flexibility when responding to an estate’s unique mix of assets, liabilities, and family considerations. It requires one to be versatile enough to think outside of the box as circumstances arise while winding up the decedent’s affairs.

Effective post-mortem administration requires flexibility when responding to an estate’s unique mix of assets, liabilities, and family considerations.

While managing tax liabilities is often a specific goal during post-mortem administration, equally important are the steps taken to accumulate and efficiently manage estate assets, proactively approach administrative costs, close the estate in a timely manner, and anticipate the impact of the estate’s settlement on an existing family office or other asset management structure. While this is a much more complex topic than we can cover in a few pages, with implications as unique as the individuals involved, there are important considerations during this stage of family wealth management that require attention.
US tax concerns during the administrative process for an estate

At a minimum, the executor or personal administrator will be responsible for filing federal and state income and estate tax returns. For income taxes a chronological view is instructive, with the first major hurdle being the coordination of the decedent’s unfiled individual Form 1040 (and related state income tax returns) with the filing of the estate’s initial Form 1041 (and related state income tax returns). Hopefully, the final Form 1040 for the year of death will be the only unfiled individual income tax return. Because the final Form 1040 reports income properly reported only through the date of death with all post-mortem income being reported on the first Form 1041, income in the year of death must be allocated. While conceptually simple, making the allocation and reporting that allocation properly can be tedious, particularly in situations where the decedent owned interests in pass-through entities, including trusts, partnerships, limited liability companies (LLCs), and/or S corporations.

Additional complexities arise because the income tax basis of assets passing from a decedent is reset at their fair market value as finally determined for estate tax purposes. Again, while conceptually simple, accounting for and tracking the new basis can be onerous, particularly if estate tax values are adjusted later during the estate tax examination process—especially for depreciable or depletable assets and assets that are jointly owned with others (e.g., community property and joint tenancy). Complexity is increased exponentially if offshore investments exist. Consideration should be given to consolidating the preparation of the final Form 1040 and the initial Form 1041 with one tax advisor.

Having the same tax advisor prepare the tax returns of entities substantially owned by or controlled by the estate or the family also may be advisable in order to manage the potential for errors. For example, if the decedent owned partnership interests, then a section 754 election must be considered. This election, made by the partnership, allows the partnership to reflect internally the change in the income tax basis of the partnership interest to fair market value at the date of death by allocating the change among the partnership’s assets. The benefit (or potential detriment) to the estate (and its successors) is that coordinating the inside basis of assets with the basis of the partnership interest hastens basis recovery but also reduces or prevents anomalies that can arise when the partnership is liquidated or the partnership interest is sold.

Steps from death to distribution

Executor retains tax advisor for the estate
Obtain asset, liability, and cash flow information
Calculate federal, state, and foreign estate taxes
Plan for liquidity to pay estate tax
Report information to relevant taxing authorities

Disagree
TAX
TAX controvery process
Pay additional tax, if determined
Distribute assets pursuant to will and trusts, considering the income tax effects of those distributions

Agree

Post-mortem considerations

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Post-mortem considerations

US tax concerns during the administrative process for an estate

There are tax elections that must be made for the estate on its initial Form 1041. For example, the estate must elect a tax year and has the option of electing a fiscal year. Typically, a 12-month tax year is desirable, but it could be a different one, including a calendar year, if considerations dictate otherwise. A similarly fundamental election must be considered when the decedent had established revocable trusts. These trusts can be combined with the estate in a consolidated Form 1041 during most of the post-mortem administrative period. Because of specific tax benefits provided only to estates, such a consolidation is recommended almost universally. However, as is the case with many tax elections, utilizing the benefits that they permit often introduces an element of complexity. Thus, the logistical implications of the election must be understood before the election is made.

The estate will continue to file federal and state income tax returns for each year of the post-mortem administrative period. Eventually, the estate will terminate as assets are distributed to beneficiaries or, commonly, in favor of continuing trusts. Continuing trusts will be new taxpayers but, unlike estates, they must utilize a calendar year. Situations where any pecuniary bequest (distributions of a sum certain), whether in trust or otherwise, is funded with assets other than cash will result in gain or loss and should be planned carefully. Additional complications arise when a fiscal year-end estate terminates to a calendar year-end trust (or trusts) if income bunching and other problems are to be avoided.

In addition, the executor or personal administrator must prepare and file the estate tax return (Form 706), the decedent’s as yet unfiled gift tax returns (Form 709), and any applicable state tax forms related to the items reported on the federal forms. Estate tax returns for high net worth estates can be highly complex due to:

- Complicated issues regarding assets that may have been inherited recently from others,
- Prior asset transfers that may need to be included in the taxable estate,
- The includibility and taxation of assets owned jointly (for example, community property and joint tenancy),
- The determination of asset values generally through appraisals, and
- Technical issues regarding qualification for various estate tax deductions and credits.

These returns take substantial time and effort to complete. Also, the estate tax return is the last chance to reflect the decedent’s generation-skipping transfer (GST) tax desires. Care should be exercised to convey clearly the intended use of the decedent’s GST exemption.

States may impose additional filing requirements, depending on the situation. For example, if a decedent owns real estate in multiple states, these states may require their own estate tax returns and ancillary probate procedures. Similarly, if the decedent owned foreign property, the estate may be responsible for foreign estate and income tax returns.

The estate will continue to file federal and state income tax returns for each year of the post-mortem administrative period.
Post-mortem considerations

Tax implications for settling the estate

It is clear from IRS statistics that estate tax audits are effective in generating revenue because estate taxes are based fundamentally on asset values. Valuation is a less precise measurement process than those generally employed to measure income and, consequently, it is frequently the basis for controversy. Thus, estate tax returns—particularly returns showing taxes due—historically have been subject to a nearly 100 percent audit coverage rate. For high net worth estates, there is almost no question that estate tax returns will be subject to audit.

The executor has a fiduciary obligation to take tax positions within established norms. Particular care should be exercised in asset valuation where the burden of proof is clearly on the estate. Failure to do so could subject the estate to penalties—up to 40 percent of the deficiency assessment. Executors and personal administrators are well advised to seek competent advisors, especially valuation specialists, when preparing the estate tax return.

Although valuation controversies with the IRS are common, having a tax controversy turn into tax litigation remains uncommon. Statistically, well over 95 percent of controversies raised by an examiner are either resolved at the exam level or (more frequently) are resolved through the IRS internal appeals process.

For the high net worth estate, involving appraisers and professionals experienced in estate tax controversy, including appeals (either because of prior employment with the IRS or specialization in such proceedings) early in the exam process will generally save time, headaches, audit support costs, and, hopefully, tax dollars as valuation positions are sustained and controversies are settled efficiently.

Statistically, well over 95 percent of controversies raised by an examiner are either resolved at the exam level or (more frequently) are resolved through the IRS internal appeals process.
Tax law allows the estate to take a second snapshot of asset value six months after the date of death and, if certain conditions are met, to elect to use this alternate valuation in filing returns. To use the alternate valuation date, two conditions must be present: the value of the estate’s assets must have declined since the date of death, and use of the alternative valuation must result in a reduction in aggregate estate and GST taxes. In other words, the estate must have a tax liability. If the entire estate goes to a surviving spouse or to charity, the executor cannot elect to use alternative valuation.

The valuation approach becomes particularly important during periods of value volatility, such as that experienced in late 2008 and much of 2009. In periods of market decline, it is possible that the downward trend may extend beyond the alternative valuation date. Although skilled appraisers will work this into their summaries, it is difficult in practice since appraisals are typically based on information and events that occurred well before the alternative valuation date. In an audit, which typically takes place several years later, the IRS has the benefit of hindsight and will take issue with valuations that it believes are too aggressive.

Periods of declining value also have important income tax implications, particularly as the estate is distributing assets to successors. Estates are taxpayers in their own right; to the extent that an estate makes distributions, those distributions carry out tax attributes to the distributees and will reduce the estate’s taxable income. But, the law is clear that tax attributes carried out during administration are limited to income and some credits.

If the estate is generating losses—either net operating losses or capital losses, as is common in turbulent economic environments—those losses must be accumulated at the estate or trust level and carried forward until the estate terminates, at which point they are distributable to certain beneficiaries. Excess administrative costs in any year cannot be carried forward to offset future income and simply lapse, except in the final year of the estate when the excess expenses for that year are also distributable to certain beneficiaries.

Tax law allows the estate to take a second snapshot of asset value six months after the date of death and, if certain conditions are met, to elect to use this alternate valuation in filing returns.
Post-mortem considerations

Alternatives for paying estate tax liabilities

For many high net worth estates, one of the specific considerations in the final phase of post-mortem administration is planning how to pay the estate tax liability. Unless the estate has earmarked cash for this purpose, it usually has two choices: borrow funds or sell assets to generate cash to pay the taxes.

Historically, the government has allowed estates with closely-held businesses to pay off the tax liability arising from those businesses over a period of up to 15 years at favorable interest rates. However, the government recently has begun requiring the estate to bond for the outstanding liability and has become more aggressive in applying liens to estate assets, thus making this avenue more expensive for business owners. Another option, particularly for high net worth families, is to borrow from a related party at market rates, with the interest payments indirectly benefitting family members. Because greater care must be exercised when borrowing directly from a beneficiary, it is more common to borrow from a life insurance trust, from a closely-held business, or against real estate. The interest paid to third parties can, if properly structured and documented, be considered a cost of administration that is deductible in determining the estate tax liability, thus decreasing the effective interest rate actually paid. Furthermore, if properly structured, the estate liability can be determined and the estate terminated before the borrowing is paid in full, often resulting in an estate that terminates earlier than would an estate that utilizes the government’s 15-year tax deferral. In many cases, families use a combination of sources—government, banks, and related parties—to meet tax obligations.

The other alternative, selling assets, also can require careful planning. Sales arising from buy/sell or other owners’ agreements can be particularly troubling since the terms of many such agreements, while legally binding, are not necessarily binding for estate tax purposes. Sales proceeds generated through corporate and partnership redemptions are subject to special income tax rules. Some sales transactions can give rise to ordinary income treatment where other options might have permitted capital gain treatment. Similarly, sales transactions that give rise to losses may complicate the future administration of the trust because losses generally are suspended until the termination of the estate. Finally, if there are to be excess sales proceeds not needed to pay taxes, liabilities, or the expenses of administration, it may be prudent to retain accounting and investment advisory specialists.

For many high net worth estates, one of the specific considerations in the final phase of post-mortem administration is planning how to pay the estate tax liability. Unless the estate has earmarked cash for this purpose, it usually has two choices: borrow funds or sell assets to generate cash to pay the taxes.
Post-mortem considerations

High net worth individuals

Discussions about changes to the estate tax code have been circulating since its inception in 1916. Future legislation is by its nature speculative; however, the compromises which led to the estate tax as it now exists are more likely to preserve the tax than to contribute to its repeal. That said, estate taxes should not drive the estate plan. Prudence dictates having an estate plan in place that accomplishes your current non-tax objectives and then making adjustments if tax developments either facilitate or prevent the accomplishment of the plan’s objectives. How well the plan is accomplishing its desired ends need not be a matter of speculation, it can be determined. Where possible, creating documents with a degree of administrative flexibility may help in periods of uncertainty but are essential if the estate plan calls for continued asset management through trusts. Remember, the endgame is meeting wealth transfer goals in a manner that does not create or exacerbate family tensions.

Prudence dictates having an estate plan in place that accomplishes your current non-tax objectives and then making adjustments if tax developments either facilitate or prevent the accomplishment of the plan’s objectives.
Philanthropy

A person’s legacy may often be defined as the actions and contributions that are made during a lifetime. It is what you want to be remembered for after you pass, and it often gives future generations of your family the guiding principles that you encourage them to live by after you are gone. Planning for your legacy will be driven by many motivations: a hope that you will be remembered by family and friends, a desire to leave wealth to charities about which you are passionate or a need to build a vehicle that will connect your family for generations to come.
Philanthropy

Introduction

If you intend to build your legacy through charitable efforts, you may also recognize tax benefits. Arguably, a tax deduction for charitable contributions does not create great philanthropists, but it does enable people to give more. High net worth families often share their wealth through philanthropy for various reasons—reasons that sometimes can be very personal. Even philanthropists who know the intrinsic value of a donation to charity may seek to benefit the greater good in the most tax-efficient manner.

There are many options to help accomplish your charitable objectives. However, the right option depends on your particular goals over your lifetime. Some pitfalls exist that may reduce or totally eliminate the tax benefit received from charitable transfers. It is critical that you take time to understand the rules affecting both the amount of your deduction and when you will receive it prior to making a donation or charitable pledge.

Before starting charitable giving, ask yourself:

• How much wealth am I willing to part with?
• What type of assets do I have to work with?
• How much control do I want?
• What is the desired income stream for me, my family and my charity?
• What percentage of my income do I want to spend on philanthropy?
• Do I anticipate an income event that will enhance or limit the benefit I receive from a charitable donation?
• When does the charity need the funds to meet both my goals and the charity's need for the funds?
• What is my desired timing for receiving an income tax deduction for the charitable gift?
Introduction
Charitable planning:
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The amount of charitable deduction that you will be allowed is directly impacted by the type of property you contribute, as well as the type of charitable organization receiving the donation. In many situations, you may choose to contribute cash to a charitable organization. Typically, when you contribute cash, you are allowed a deduction in the year of donation equal to 50 percent of your adjusted gross income (AGI), and any excess charitable contributions can be carried forward for the next five years.

While you may be able to offset income with a charitable deduction, the deduction itself is often not the deciding factor in making a donation. In other situations, you may choose to contribute appreciated assets. The chart below summarizes the amount of charitable deduction allowed depending on the type of appreciated asset contributed and the annual AGI limitation applicable depending on the classification of the donee organization.

Contributions of appreciated property

<table>
<thead>
<tr>
<th>Type of property</th>
<th>Type of organization</th>
<th>Contribution amount is</th>
<th>Deduction limited to</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary income property</td>
<td>50% organization*</td>
<td>Adjusted basis (or FMV if less)</td>
<td>50% AGI</td>
</tr>
<tr>
<td>Long-term capital gain property</td>
<td>50% organization</td>
<td>Fair market value (FMV)</td>
<td>30% AGI</td>
</tr>
<tr>
<td>Long-term capital gain property (tangible personal put to unrelated use)</td>
<td>50% organization</td>
<td>Adjusted basis (or FMV if less)</td>
<td>50% AGI</td>
</tr>
<tr>
<td>Long-term capital gain property (reduced deduction elected)</td>
<td>50% organization</td>
<td>Adjusted basis</td>
<td>50% AGI</td>
</tr>
<tr>
<td>Qualified appreciated stock</td>
<td>30% organization**</td>
<td>FMV</td>
<td>20% AGI</td>
</tr>
<tr>
<td>Short-term capital gain property</td>
<td>30% organization</td>
<td>Adjusted basis (or FMV if less)</td>
<td>20% AGI</td>
</tr>
</tbody>
</table>

* 50% organizations: Public charities, private operating foundations, and certain private non-operating foundations
** 30% organizations: Private non-operating foundations not meeting the definition of a 50% organization

While you may be able to offset income with a charitable deduction, the deduction itself is often not the deciding factor in making a donation. In other situations, you may choose to contribute appreciated assets. The chart below summarizes the amount of charitable deduction allowed depending on the type of appreciated asset contributed and the annual AGI limitation applicable depending on the classification of the donee organization.

Alternatively, you may be driven to achieve an immediate philanthropic goal. Consulting with a tax advisor to evaluate more tax-efficient funding options may uncover philanthropic goals that transcend...
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In that circumstance, if your donations exceed the amount that may be deductible, then you may carry the excess contributions forward five years, but the 50 percent, 30 percent, and 20 percent limitations continue to apply in those future years. Additionally, in any subsequent year, the current year contributions must be claimed before any carryovers can be considered. If carryovers involve more than one year, a first-in, first-out principle is applied.

However, sometimes large donations do not carry forward but are completely eliminated by an overall phaseout of your itemized deductions. The Pease limitation, named for its author, Representative Donald Pease (D-Ohio), requires higher-income individuals to reduce the total amount of most itemized deductions allowed. Under current income tax rates, depending on facts and circumstances, the value of a deduction may range from 39.6 percent to only 4 percent. The chart below summarizes the impact of the Pease limitation on the total itemized deductions allowed.

While you may desire to make an immediate gift, a tax advisor may assist by projecting the deductibility over time for increased efficiency of the deduction. This critical information will help you to determine how to achieve your desired philanthropic goal at a mutually agreeable time for both the charity and you.

---

**Pease limitation is equal to the lesser of:**

- 3% of AGI over the applicable threshold
- 80% of itemized deductions

**2017 thresholds are:**

- $261,500 for single filers
- $313,800 for joint filers

**Limitation applies to:**

- Deductions for taxes
- Mortgage interest expense
- Charitable contributions
- Miscellaneous itemized deductions

**Limitation does not apply to:**

- Investment interest expense
- Casualty losses
- Medical expenses
- Gambling losses
Contributions of complex assets

Sometimes the asset that you want to contribute is more complex than cash or publicly traded stock. Unique rules apply to contributions of complex assets.

Partnership interests
Donation of a partnership interest may result in issues for the charity that should be anticipated. An individual who contributes a partnership interest to a 50 percent organization generally receives an income tax deduction equal to the FMV of the property, assuming it is long-term capital gain property. If you decide to donate a partnership interest, such as an interest in a fund, then you must obtain an appraisal for the transfer of any interest with a value greater than $5,000 that is transferred to a charity.

Charitable gifts of partnership interests are inherently more complicated than gifts of publicly traded securities. For example, a charity may be less willing to accept an interest in a partnership that will produce taxable income not substantially related to the exercise or performance of its charitable, educational, or other purpose or function constituting the basis for its exemption. This is called unrelated business taxable income (UBTI). Unless the charity can be assured of receiving sufficient cash distributions from the partnership to pay the resulting tax liability on the UBTI, it may not be willing to accept the gift.

Additionally, you should consult with a tax advisor regarding whether there may be a deemed sale related to partnership debt allocated to you and if the amount of the charitable deduction may be reduced to the extent of ordinary income recapture on the partnership interests transferred. Unlike in noncharitable situations where there may be no gain depending on whether your basis exceeds the debt at issue, a transfer to a charity almost invariably gives rise to gain because the donor’s basis must be allocated between the charitable element and the sale element. It may be that if you are considering donating a partnership interest with associated suspended passive losses, then you should consider selling the interest, recognizing the suspended loss, and making a charitable gift of the sales proceeds.

Individual retirement accounts (IRAs)
If you are age 70½ or older, another specific asset you may consider gifting is a contribution from an individual retirement account (IRA) to an eligible charitable organization. These contributions are not subject to the above limitations in certain circumstances. You may transfer up to $100,000 annually directly from the IRA trustee to the eligible charity. Distributions from employer-sponsored retirement plans, including simplified employee pension plans, are not eligible. If these IRA requirements are met, then you do not include the amount of the distribution as taxable income. However, the taxpayer does not receive a corresponding charitable deduction for the amount transferred to charity.
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Contributions of complex assets

You may want to gift art or an antique to a cultural institution. It is important to analyze and implement appropriate donation strategies, consult on related-use requirements, and review appraisal requirements for income and transfer tax returns.

Art and antiques
You may want to gift art or an antique to a cultural institution. It is important to analyze and implement appropriate donation strategies, consult on related-use requirements, and review appraisal requirements for income and transfer tax returns. Additional considerations may include fractional donations and charitable remainder trusts. For art and other tangible personal property with a long-term holding period, the charitable deduction is FMV only if the property will be put to a use related to the exempt purpose of the charity. For more about these rules, please review the “Unique assets” section of the 2017 Essential tax and wealth planning guide.

Conservation easements
If you have a particular piece of land in mind with specific conservation objectives, you may consider a conservation easement that would allow you to keep ownership and control while those objectives are achieved. A conservation easement gives power over the land to a qualified private land conservation organization, sometimes called a "land trust," or a government municipality to constrain the owners' use of the land to achieve certain conservation purposes.

A qualified appraiser must determine the value of the easement donation. For income tax purposes, the value of the donated conservation easement. As a result, taxes will be lower because heirs will not be required to pay taxes on the extinguished development rights. The conservation easement "runs with the land," meaning it is applicable to both present and future owners of the land. As with other real property interests, the grant of a conservation easement is recorded in the local land records and becomes part of the property's chain of title.
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When making donations, you should consult with tax advisors regarding the recordkeeping requirements necessary to sustain the charitable income tax deduction. For a monetary gift of any amount, either a written record (such as a credit card statement or canceled check) or a written contemporaneous acknowledgment 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. In this circumstance, 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. The acknowledgment letter from the charity must include any benefits received from the donation. If none are received, the acknowledgment letter 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 to claim a charitable deduction. If the value exceeds $500,000 ($20,000 for artwork), the appraisal must be attached to the donor's income tax return, whether the donor is an individual, partnership, or corporation.

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Recordkeeping

When making donations, you should consult with tax advisors regarding the recordkeeping requirements necessary to sustain the charitable income tax deduction.

Non-cash contributions requirements

<table>
<thead>
<tr>
<th>Value of donation</th>
<th>Documentation required</th>
</tr>
</thead>
<tbody>
<tr>
<td>$250 to $500</td>
<td>A written acknowledgement from the charitable organization is required</td>
</tr>
<tr>
<td>$501 to $5,000</td>
<td>In addition to written acknowledgement, taxpayer must show the:</td>
</tr>
<tr>
<td></td>
<td>• Means of acquisition</td>
</tr>
<tr>
<td></td>
<td>• Date acquired</td>
</tr>
<tr>
<td></td>
<td>• Adjusted basis of the property</td>
</tr>
<tr>
<td>More than $5,000</td>
<td>Most contributions over $5,000 require a written appraisal</td>
</tr>
</tbody>
</table>
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Timing considerations

Simple issues with timing may create a risk of being denied the donation in the current year or at all. Generally, timing for charitable donations follows the “mailbox” rule, which means that if the check is in the mail on December 31 of a given year and the check is cashed in a reasonable amount of time thereafter, then you may deduct it. Similarly, for donations charged on credit cards on or before December 31, the payment of the charge can occur in the following year. For gifts of securities, the security must have been transferred out of the donor’s brokerage account by close of business on December 31. For gifts of real estate, state law will control when the donation became effective, but the transfer will likely need to be recorded before the end of the year. For other assets, state law will control. You should consider consulting with legal counsel regarding whether they can provide an opinion about the effective date of complex, last-minute donations.

The timing rules create a higher risk that deductions may be lost when the timing of an asset donation relates to an imminent liquidity event. The issue to be considered is whether you must still recognize the income pursuant to the assignment of income rules. A gift of appreciated property will generally not result in income to the donor so long as he or she gives the property away entirely before the property gives rise to income by way of sale. Many last-minute donations are not at risk, especially if they are simply a donation of stock followed by a public sale of the stock by the charitable donee. However, in more complicated cases, such as a corporate redemption, you should seek counsel as to whether or not the donation may be made without the donor having to recognize the income.

All of these factors—type of asset, type of charity, timing of the donation, and record keeping—make planning for a philanthropic goal complicated. Strict adherence to tax rules is not necessary to benefit the common good. However, it may indeed be possible for you to receive the simultaneous benefit of feeling that you have made an impact on the goals of the charity while also making an impact on your overall tax burden. In the end, if the gift is made in a more tax-efficient manner, then you will have more assets remaining to be able to achieve future philanthropic goals. Therefore, it is extremely important that you plan ahead—perhaps years in advance—to achieve your intended goals.
Charitable planning approaches

If you wish to engage in more complicated planning, it may be possible to maintain partial control over an asset being contributed to a charity or, in limited situations, to maintain a cash-flow stream from the asset. If control is your primary concern, then using a vehicle such as a donor-advised fund or a private foundation may be subject to discussion. However, if a cash flow stream is desired, then a split-interest charitable trust may be more advisable.

**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. You would make an irrevocable gift of property (such as stock held for greater than one year) to the host charity and receive 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 acknowledgement letter 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. You retain 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 you directly or any other private interest.
Charitable planning approaches

Private foundation

A private foundation is formed to administer the charitable interests of an individual or family, according to their wishes. Income tax deductions are generally less favorable than those to public charities. You would receive a charitable deduction subject to the 30% AGI limit for contributions of cash. If you are donating appreciated securities or assets, you would be subject to the 20% AGI limit and the value would generally be your adjusted basis unless it was a donation of “qualified appreciated stock.” You would not retain any rights to the assets, but could retain certain rights to administer the foundation, subject to the self-dealing rules. Some donors prefer a private foundation because it allows them or their family more control over giving. A private foundation can be used to “fund” several years of normal charitable giving. Private foundations can also be used to give assets that are not easily divided, such as real property, or provide a means to fund foreign charitable endeavors. There is a minimum annual asset distribution requirement. While a private foundation may be a significant part of the legacy you leave and the vehicle that brings your family together after your passing, you should consider the administrative complexities of maintaining a private foundation when you assess whether it is the right vehicle for you.
### Charitable planning approaches

The chart below summarizes the factors you should consider when evaluating where to contribute assets.

#### Matching your charitable vision to the right planned giving strategy

<table>
<thead>
<tr>
<th>Planned giving options</th>
<th>Private foundation</th>
<th>Donor advised fund</th>
<th>Public charity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deductible contributions?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Contribution limit?</td>
<td>30% of AGI for cash contributions; 20% of AGI for noncash</td>
<td>50% of AGI for cash contributions; 30% of AGI for noncash</td>
<td>50% of AGI for cash contributions; 30% of AGI for noncash</td>
</tr>
<tr>
<td>Donor controls grantmaking?</td>
<td>Yes</td>
<td>No, but donor can advise</td>
<td>No</td>
</tr>
<tr>
<td>Donor controls investment decisions?</td>
<td>Yes</td>
<td>No: Donor may choose investment plan, but sponsoring organization has control</td>
<td>No</td>
</tr>
<tr>
<td>Donor manages operations and administers organization?</td>
<td>Yes</td>
<td>No: Donor pays a fee to sponsoring organization to provide administrative services</td>
<td>No</td>
</tr>
<tr>
<td>Annual distribution requirements?</td>
<td>Yes (5% of fair market value of non-charitable use assets)</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Organization subject to income/excise tax?</td>
<td>Yes (1% or 2% excise tax on net investment income and an income tax on unrelated business income)</td>
<td>No, unless there is unrelated business income</td>
<td>No, unless there is unrelated business income</td>
</tr>
<tr>
<td>Organization subject to excise tax for prohibited actions?</td>
<td>Yes. Potential excise tax due for engaging in acts of &quot;self dealing,&quot; having &quot;excess business holdings,&quot; and making &quot;jeopardizing investments&quot; or &quot;taxable expenditures.&quot;</td>
<td>Yes. Potential excise tax on excess business holdings, taxable distributions, and excess benefit transactions</td>
<td>Generally, no. (Potential excise tax on political activities.)</td>
</tr>
<tr>
<td>Organization required to file an annual tax return?</td>
<td>Yes (Form 990-PF)</td>
<td>No: An annual filing by sponsoring organization, not each separate donor advised fund</td>
<td>Yes (Form 990)</td>
</tr>
</tbody>
</table>
Charitable lead trust
A CLT can be designed to pay in two different ways: as a fixed annuity payment or a unitrust amount to the charity. This means that the charity can be paid a fixed dollar amount annually or a fixed percentage of the FMV of the assets in the trust. A CLT may be useful when the asset being contributed has a high potential for future appreciation. It may also be appropriate if your heirs are still young and not capable of assuming control of a substantial amount of assets. In creating and funding a CLT, you would make final arrangements for the disposition of the assets by your estate but defer the time when your beneficiaries can actually take control of and receive property. In the interim, the charity receives ongoing and immediate benefit from the trust. When assets do eventually pass to the beneficiary or beneficiaries, they are not subjected to federal transfer tax. Timing for the charitable deduction depends on the terms of the trust.

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If a cash flow stream is desired, either prior to or after the asset is transferred to charity, then a split-interest charitable trust may be a tax-efficient alternative to transfer the asset. The financial interest from these trusts is split between the charitable and non-charitable beneficiaries (including the donor). The two most common kinds of split-interest charitable trusts are a charitable lead trust (CLT) and a charitable remainder trust (CRT). Both of these trusts are related, but they are fundamentally different.

The CLT will make distributions to a charity for a particular amount of time. After that, the assets within the trust, which are called the remainder interest, will pass to desired non-charitable beneficiaries. With the CRT, the assets placed within the trust will provide distributions to the non-charitable beneficiaries (typically the donor) for a certain time period or lives of the beneficiaries. The assets will then become property of the charity. These two trusts are inverses of one another and are taxed in significantly different ways.
Charitable planning approaches

**Charitable remainder trust**

Alternatively, a CRT will first pay the beneficiary, which could be yourself, before the remaining assets are permanently awarded to the charity. Like the CLT, the payment to the beneficiary can be an annuity, which is a fixed dollar amount, or a unitrust, which is a fixed percentage of the fair market value of the assets in the trust. The amount distributed each year must be set at the creation of the trust to be at least 5 percent of the initial FMV of the trust assets. A CRT may be a good planning option if you have an appreciated asset that you would like to sell and diversify, but be able to defer the gain over time. Income is taxed only when the income is distributed out, assuming there is no UBTI. Income distributions keep their character and any applicable preferential rates. CRTs are exempt from the 3.8 percent net investment income tax. You would receive a charitable deduction in the year of transfer equal to the remainder value for the charity, which must be at least 10 percent of the amount contributed.

**CRUT**

Beneficiary receives an annual annuity or a specified percentage of the total FMV of assets in the trust for a set term

Charity receives balance at the end of the term. The present value of the charitable remainder must be at least 10% of the initial FMV of assets contributed to the CRT.
Planning for philanthropic goals is one aspect of implementing a long-term commitment to holistic tax planning. As we analogized in our earlier edition’s discussion of year-round personalized income tax planning, you likely will identify many different planning levers each and every year which can be used to position yourself to achieve your personal goals, philanthropic or otherwise.

These levers are ammunition that can be used to provide a more tax-efficient result. Charitable contributions are often the largest controllable lever for an individual. For those trying to achieve tax efficiency, there are many areas that require thoughtful consideration: the type of asset to donate, the timing of the gift, the vehicle to use to fund the gift, and the type of organization to receive it. It is critical to work with an advisor specializing in this area to navigate your way through these decision points effectively for the sake of both your philanthropic goals and your tax planning.
The idea of pooling resources and spreading risk using investment funds (or funds) is not a new idea. It has been used for a long time and the complexities associated with funds continue to grow. Similar to traditional investments, such as a direct investment in a marketable security, the economic cycles from the Great Depression, to the dot-com era, to the global financial crisis of 2008/2009 impact the success of these vehicles. However, many view access to investment through funds with qualified investment professionals as a valuable diversification tool in the management of their investment portfolio that helps to mitigate the impact of economic cycles.
As a taxpayer and an investor, you should be informed about significant tax and nontax attributes of fund investments and manage your portfolio in a manner consistent with your understanding of those attributes. Taking time to understand the tax consequences of investing in a specific fund will help you produce a more tax efficient result overall. Thoughtful planning requires an understanding of a fund advisor’s investment strategy and how that may impact your personal tax situation, whether the investment fails or succeeds. This includes analyzing the tax treatment upon contribution of capital, evaluating the impact while you hold, and assessing the consequences upon sale or other disposition of the fund investment.

For example, before acquiring new fund investments, it is important for you to understand the character of the income that may be generated by the fund, as well as when you may recognize such income. Will the income or gains be subject to the highest ordinary income tax rates or will the income allocated to you be subject to preferential tax rates? Furthermore, you should discuss with your advisor whether you will receive a tax benefit from the expenses and losses that may be allocated to you. The deductibility of some fund level expenses may be limited by the itemized deduction phase-out provisions or added back under the alternative minimum tax (AMT) regime. Other expenses from a fund may directly offset income from fund or non-fund activities. Furthermore, losses may be disallowed in the current year if you are subject to the passive activity loss limitation rules.

Failing to understand the character of income and expenses that a fund will pass through to you can lead to unwelcome surprises when you receive the final tax information each year. In addition, fund investments may cause significant state implications and create foreign reporting requirements. Having a clear understanding of a fund’s strategy and the tax implications of investing in that fund allows you to make a more informed investment decision. To do so, let’s discuss the types of funds that exist, the character traits of each fund, and the tax consequences of investing in each type of fund.

As a taxpayer and an investor, you should be informed about significant tax and nontax attributes of fund investments and manage your portfolio in a manner consistent with your understanding of those attributes.
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- Private equity/venture capital
- Publicly traded partnerships
- Real estate funds
- Fund of funds

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- Passive versus non-passive income
- Separately stated activity (including PTPs)
- Qualified small business stock (QSBS)
- Unrelated business taxable income
- State tax reporting

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Tax implications of fund investing

What is an investment fund?

The popularity of funds continues to grow, and as of December 31, 2015, it was estimated that $3.65 trillion\(^1\) was invested globally into private equity and $2.8 trillion\(^2\) was invested into hedge funds.

Investment funds are types of investment companies that are typically organized as partnerships. An investment company invests the money it receives from investors on a collective basis, and each investor generally shares in the profits and losses in proportion to the investor’s interest in the investment company. The performance of the investment company will be based on (but it will not be identical to) the performance of the securities and other assets that the investment company owns.

The focus of this summary is on investment companies organized as partnerships, which are typically described as investment funds. These investment funds are typically structured as partnerships for tax purposes, either as limited partnerships (LPs) or limited liability companies (LLCs). The partnership tax structure is typically used by investment funds, rather than a corporate investment vehicle, to allow for the investment fund’s income to be taxed at the investor level and provide for flow-through treatment of income, expense, gains, and losses. Although mutual funds are a type of investment company, they are typically organized as corporations and will not be addressed in this summary.

Investors in investment funds include pension funds, sovereign wealth funds, endowment plans, family offices, high-net worth individuals, foundations, and insurance companies. Funds may be referred to as alternative investments and commonly include marketable security funds, hedge funds, private equity funds, and real estate funds. The popularity of funds continues to grow, and as of December 31, 2015, it was estimated that $3.65 trillion\(^1\) was invested globally into private equity and $2.8 trillion\(^2\) was invested into hedge funds. A more detailed discussion on the different types of funds available for investment follows.

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\(^1\) By Deloitte estimate, based on prorating the $3.5T figure from Preqin data as of June 2015, forward to December 2015. © 2016 Preqin Ltd. www.preqin.com. Note: Venture capital data are excluded from this number.

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Types of investment funds and income tax characteristics

The character of income and loss allocable to investors directly impacts after-tax returns on investments and can vary significantly between types of funds.

Marketable security funds

Marketable security funds (MSF) are investment funds that typically trade in stocks, bonds, and other marketable securities on the behalf of their partners. The purpose of these investments is to provide portfolio diversification by pooling capital from investors and investing in a broad base of investments. Many MSFs have an investment strategy targeted to a specific asset class such as small cap, large cap, international, or emerging markets, while other funds may look to invest more holistically across multiple strategies. Leverage is typically not utilized by MSFs.

Investments in MSFs are relatively liquid allowing investors to contribute cash or make withdrawals on a frequent basis such as monthly. Depending on whether a partner’s investment in the MSF is in an appreciated or depreciated state, compared to the partner’s tax basis in the MSF, many MSFs will allocate additional gains or losses to partners at the time they redeem some or all of their interest in a MSF in an effort to eliminate or limit this disparity.

Character of income considerations—MSF

The investment strategy of a MSF directly impacts the character of the income and loss generated by the fund. The character of income and loss allocable to investors directly impacts after-tax returns on investments and can vary significantly between types of funds. As a result, having a good expectation of this impact is important when making investments. MSFs typically invest in marketable securities and generate dividends, interest, tax-exempt interest, capital gains, foreign taxes, and expenses. Preferential income tax rates are available for qualified dividends and long-term capital gains. If a MSF is considered in the trade or business of trading securities (discussed further on page 58), the expenses can be tax effective and offset an investor’s ordinary income from other sources.

Additional information is available in the Individual Income Tax Planning section of the 2017 Essential Tax and Wealth Planning Guide regarding income tax rates, types of income, and planning considerations.

Hedge funds

Hedge funds (HF) are investment funds that can use one or more alternative investment strategies, including hedging against market downturns, investing in asset classes such as currencies or distressed securities, and utilizing return-enhancing tools such as leverage, derivatives, and arbitrage. Many, but not all, HF strategies tend to hedge against downturns in the markets being traded. HFs are flexible in their investment options (can use short selling, leverage, derivatives such as puts, calls, options, futures, etc.). There is typically broad discretion over investment objectives, asset classes, and investment vehicles.

Use of leverage

HFs typically utilize leverage to execute their investment strategy. Many HFs will buy securities on margin to increase the amount of exposure to a strategy. For example, if a HF received capital contributions from its investors of $10,000,000, by using leverage, it may be able to borrow $5,000,000 (buying on margin) so that it is able to invest $15,000,000. To the extent the HF can borrow assets to purchase more securities,

3 Per http://www.hedgefundassoc.org/about_hedge_funds
4 Per http://www.hedgefundassoc.org/about_hedge_funds
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There is greater opportunity for income and appreciation on those securities. It can also create additional risk on the downside to the extent the assets depreciate in value. Similar to buying on margin, lines of credit are another type of leverage that HFs utilize. HFs may also purchase financial instruments such as options, warrants, and convertible securities to increase leverage and potential upside.

Offshore blocker corporations

While most HFs are structured as LPs or LLCs, offshore blocker corporations are frequently offered as an alternative investment vehicle for US tax-exempt investors and foreign investors. While a partnership investment may be more tax efficient than an investment in a foreign corporation, a US tax-exempt investor and a foreign investor typically prefer to invest through the blocker corporation to limit the US income tax exposure and filing obligations related to investing in a HF. Additionally, tax-exempt investors and pension funds generally prefer to invest through the offshore blocker corporation to “block” the flow of unrelated business taxable income that would otherwise be allocated to them (see discussion on page 61). Generally, a non-US person who is allocated income from a HF that trades in stocks or securities in the United States is not treated as engaged in a US trade or business. This safe harbor exception applies to trading in stocks, securities, and options to buy or sell stocks and securities, including margin transactions and short sales. If the HF satisfies this safe harbor exception, it will not be treated as engaged in a US trade or business. However, if the HF does not satisfy the safe harbor exception, the fund would generate effectively connected income (ECI), and the fund would be required to withhold US taxes on the foreign investor’s share of ECI.

Even if the HF is not engaged in a US trade or business, it is still required to withhold taxes on fixed, determinable, annual, and periodical (FDAP) income that is US-sourced. Dividends and interest income (unless it meets an exception) are generally characterized as FDAP income. The HF must withhold taxes on a foreign person’s share of FDAP income at a 30% rate unless a treaty applies to reduce the withholding rate.

To the extent a foreign person is allocated either ECI or FDAP income, the foreign person has a US tax return filing obligation. Therefore, foreign investors would prefer to invest through a blocker corporation to avoid being allocated a share of the HF’s US income, which would obligate them to file a US tax return. While a US C corporation would generally be required to pay tax at the highest US tax rate, many...
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Foreign individuals and foreign trusts should understand the character of the income that will be generated by the HF so that they can identify the investment vehicle that would best satisfy their needs.

Character of income considerations—HFs

The income generated by an HF is often similar to the income generated by an MSF. In addition, HFs may also generate the following types of income:

- The HFs that trade in regulated futures contracts and/or foreign currency contracts will recognize income/loss taxed under the provisions of IRC §1256. To the extent IRC §1256 applies, the income/loss from these contracts will be recharacterized as follows: 60% classified as long-term capital gains/losses and 40% classified as short-term capital gains/losses.
- For HFs that have made an IRC §475 mark-to-market election, investments are marked up or down to their fair market value at the end of the year and ordinary income or loss is recognized to the extent of the mark. Many HFs with a trading strategy seeking to profit from swings in the daily market movements make an IRC §475 election. Losses are ordinary in nature and not subject to capital loss limitations. Also, because short-term capital gains and ordinary income are taxed at the same tax rate, there is no disadvantage because income is taxable at ordinary income rates.
- HFs typically invest in a variety of financial instruments. The instruments utilized by HFs include options, warrants, convertible securities, and joint venture agreements. The taxation of these instruments is complex and can vary by the type of investment.

Private equity and venture capital funds

Private equity funds (PEF) are investment funds that pool capital for investment in privately-owned businesses at different stages of development. PEFs invest in privately-owned C corporations and partnerships with the ultimate objective of long-term capital appreciation. The PEF will enhance the company’s value by working with the management team to increase revenue streams, reduce expenses, improve cash flow, and increase margins. The exit strategy for the PEF may include selling the investment to a strategic buyer, another PEF, or possibly taking the company public. The lifecycle of a PEF will be stated in the offering documents but is typically 7-13 years, depending on its investment strategy.
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The investment period of the PEF is typically closed to new investors 6-12 months after the initial closing. To the extent that investors acquire an interest in the fund after the first fund closing, they are often required to pay interest to the fund and the fund allocates this interest income to the investors who invested in the first closing. The general partner (GP) will require capital contributions to be made to the fund over a 3-5 year commitment period. The PEF calls capital commitments in stages as it identifies investment opportunities or as needed to fund management fees and other expenses. Capital contributions are made pro-rata by all partners in proportion to their capital commitments, with the limited partners committing most of the capital and the GP contributing a small portion of the capital.

Investments in PEFs are typically illiquid, as capital is locked-up for many years, with infrequent distributions until there is a liquidity event. Investors typically do not have an ability to withdraw their capital. The PEF’s profits and losses are allocated to the capital accounts of the partners as agreed upon in the partnership agreement. The PEF’s profits are typically distributed to all partners based on their respective capital contributions, with a preferred return allocable to the limited partners over the life of the fund primarily for the use of their capital. In most instances, the GP or a separate management company is paid an annual management fee. To the extent the PEF earns an aggregate return on its investment that exceeds the preferred return, management fees, and partnership expenses, the GP will be allocated a portion of the excess profit, referred to as the carried interest.

Some PEFs have started to use debt or lines of credit to help fund investments in portfolio companies for a period of time between when an opportunity is identified and when the capital can be called from investors. If implementing such a strategy, the PEF is generally able to increase the internal rate of returns to its investors, but this approach can create tax ramifications, specifically for tax-exempt investors, creating unrelated business taxable income (UBTI). See page 61 for additional information on UBTI.

Venture Capital Funds

A venture capital (VCF) is a type of PEF that typically focuses on providing equity and financing to start-up emerging businesses with a focus on providing its investors above-average returns. VCFs can be attractive to investors versus traditional PEFs because they typically invest in businesses that are less developed. If these less-developed businesses become successful, they may provide for higher growth opportunities. On the other hand, there is more risk on the downside because many of the less-developed businesses may ultimately not be successful. Another difference between VCFs and PEFs is that investments in VCFs are typically equity whereas investments in PEFs can be both equity and debt.
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Character of income considerations—PEF and VCF

Income generated from PEFs and VCFs is typically dependent on the type of investment. For many PEFs that are investing in businesses organized as partnerships, there will typically be operating income or losses flowing through to the investor which are subject to ordinary tax rates. For PEFs investing in businesses organized as corporations, any operating income from that business will not flow through to the PEF nor to the PEF’s investors.

Depending on the type of investments made by PEFs and VCFs, some funds may include alternative investment vehicles (AIV) in their fund structure. An AIV is simply a fund partnership typically created to allow tax sensitive investors to invest, side by side, with the main fund, for example, in a flow-through portfolio company. The AIV structure will typically have a blocker corporation as a limited partner in the AIV, through which tax-sensitive limited partners invest.

When a PEF or VCF disposes of a portfolio company structured as a corporation, the gain/loss is treated as short-or-long-term capital gain, depending on the time that the fund held the investment. When a PEF or VCF disposes of a portfolio company structured as a partnership, the ordinary income portion will be similar to the amount that would be recognized if the underlying operating business conducted by the portfolio company was sold. Such a disposition results in gain taxed as ordinary income (to the extent of ordinary deductions required to be recaptured or to the extent of gain attributable to assets the sale of which would be treated as ordinary income (e.g., inventory), with the remainder of the gain (if any) being taxed at the long-term capital gain rate. In some cases, if the underlying investments are in the energy industry, there may be unique tax treatment of certain items for those types of investments. Lastly, see the additional discussion on page 60 regarding qualified small business stock, which may apply for certain types of PEF or VCF investments.

As a PEF or VCF recognizes items of income, gain, loss, deduction, and credit, such items are allocated among its partners based upon the economic terms of the LP agreement. Such allocations take into consideration each partner’s rights under the economic terms set forth in the fund’s LP agreement. Generally speaking, the allocations will reflect each limited partner’s right to return of capital, preferred return, and an allocable share of upside gain on the disposition of an investment. In addition, the allocations will reflect the GP’s right to return of capital, carried interest, and upside gain on disposition of an investment. The character of any item of income, gain, loss, deduction, or credit allocated to the GP under the carried interest provisions of the LP agreement for a PEF or VCF is determined by the LP and retains its character when reported by the GP. Although a GP’s carried interest in many instances is not determined until late in a calendar year or after the calendar year end, the timing of when the items are incurred in the GP’s carried interest coincides with when the items are recognized by the PEF or VCF. For example, if the fund recognizes long-term capital gain on the sale of corporate stock in January, and such gain results in an allocation of gain to the GP under the carried interest provisions of the LP agreement, then such income is treated as allocated to the GP in the first quarter and should be taken into account for quarterly estimated tax purposes accordingly.
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Publicly traded partnerships (PTP)

A publicly traded partnership (PTP) is a partnership that is either traded on an established securities market or readily traded on a secondary market or the substantial equivalent of a secondary market. Partnerships that are publicly traded are classified as corporations for US federal income tax purposes unless at least 90% of the partnership’s gross income is from sources commonly considered to be passive or from certain types of businesses historically conducted in partnership form (qualifying income). PTPs that are structured as pass through entities pay no corporate level taxes and owners of a PTP are called unitholders.

In order to qualify as a PTP, the fund must satisfy specific income requirements to take advantage of these tax efficiencies. Taxes are not paid at the fund level but are paid by the partners at the partner’s individual rate on amounts reported to them by the fund on Schedule K-1. Periodic distributions received from PTP investments are generally not taxed and treated as a return of capital.

Note, the term master limited partnership (MLP) is used interchangeably to refer to a PTP, generally in the natural resource industries. An MLP often refers to a tiered limited partnership structure in which operations are conducted by lower-tier partnerships or other subsidiaries (often disregarded for tax purposes) held by the publicly traded MLP.

Character of income considerations—publicly traded partnerships

PTPs are statutorily required to be separately stated (see page 59 for an additional discussion on separately stated activities). This requirement can be time consuming, which creates additional administrative burden in tax return preparation. In addition, PTPs typically have activities in multiple state jurisdictions. Therefore, it is important to understand any additional state filing obligations that may be created upon making an investment directly in a PTP or indirectly through the use of a partnership.

Typically, PTPs can be efficient from a tax perspective because PTPs frequently produce losses (although one needs to consider the impact of the passive activity rules discussed more on page 58) due to accelerated depreciation. Once PTPs are sold, a portion of the gain/loss on disposition is taxable as ordinary income/loss and a portion is taxable as capital gain/loss. Also, PTPs commonly make quarterly distributions of operating cash flow, which are typically tax-free as long as there is basis in the investment.

It is important to understand any additional state filing obligations that may be created upon making an investment directly in a PTP or indirectly through the use of a partnership.
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Real estate funds
Real estate funds (REF) are investment funds that pool capital for investment in real estate (including direct investment in property, other real estate partnerships, real estate investment trusts (REITs) or real estate operating companies). Traditionally, REFs include US taxable (usually individuals), US tax-exempt, foreign taxable (generally individuals or corporations), and foreign tax-exempt investors. Similar to other funds operating as partnerships, income and loss flow through to the partners resulting in one level of tax at the partner level. Investors in REFs may also be subject to the Foreign Investment in Real Property Tax Act (FIRPTA) rules. REFs often operate similarly to private equity and venture capital funds from a capital commitment and liquidity perspective. Shares of REITs are often traded on public exchanges and encourage widespread passive investment in real estate by investors interested in liquidity. A REIT is a special entity for US federal income tax purposes that meets certain technical requirements and elects REIT status. The key difference between a regular US corporation and a REIT is that a REIT is allowed a tax deduction for dividends paid to its shareholders. In order to qualify for this special treatment, a REIT must, among many other requirements, distribute at least 90% of its taxable income (exclusive of capital gains) to its shareholders. As a result, REITs rarely pay federal income tax, but REIT shareholders will pay tax on amounts distributed as dividends, resulting in one level of income tax.

In many instances, REITs may be formed to facilitate investments by REFs. These REITs are frequently referred to as private or “baby” REITs. These REITs are frequently formed to reduce an investor’s exposure to state income taxes and attract foreign and tax-exempt investors.

Character of income considerations—real estate funds
Most REF investments generate taxable income or loss from the rental of properties to 3rd parties, and in those cases, rental real estate income is taxable as ordinary income. In many instances, real estate may operate at a loss as a result of depreciation and interest deductions. The deductibility of these losses may be deferred as a result of the application of the passive activity rules (discussed further in the passive versus non-passive section on page 58). Note, the passive activity rules apply to individuals and other entities, such as trusts, that are not considered real estate professionals that materially participate in the rental activity. Generally, gain or loss upon the sale of investment real property is taxed as IRC Section 1231 gain or loss. Gain is typically taxed at capital gain rates, except to the extent the gain is considered depreciation recapture. Loss is generally treated as ordinary loss. When REF investments are sold, typically any gain is going to be taxed at a 25% rate (to the extent ordinary deductions were taken for tax depreciation) with the remainder of the income being taxed at the long-term capital gain preferential rate of 20%.

FIRPTA requires foreign individual, trust, and corporate investors to treat gain or loss on the disposition of a US real property interest (“USRPI”) as if such gain or loss is ECI.

Real estate professionals must spend the majority of their time in the real estate property business and have a minimum of 750 hours a year.
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Fund of funds
The term fund of funds (FOF) refers to an investment fund with an investment strategy designed to hold a series of underlying fund investments versus directly owning stocks, bonds, operating entities, and other assets. FOFs are typically structured as LPs or LLCs.

FOF are typically organized by the type of underlying investment funds; for example, a hedge fund FOF, private equity FOF, real estate FOF, or publicly traded partnership FOF. Alternatively, it is possible for a FOF to be setup with investments across multiple types of investments, though this is less common. One benefit many find with a FOF structure is that FOFs provide access to funds investors may not be able to invest in directly. For example, many funds have contribution minimums for investors. If an investor can’t meet the contribution minimum, the investor may be able to gain exposure to the fund by commingling its capital with others in a FOF structure to be able to meet the contribution minimum and obtain access. Consideration should be given to the additional layer of management and performance fees at the FOF level, in addition to the fees that are being charged by the underlying investment funds.

Character of income considerations—fund of funds
The tax attributes of FOFs are similar to the aforementioned investment funds. Depending on the investments of FOFs, it can be similar to one or more types of investment funds.
Key tax attributes of investment funds include 1) the characteristics of the fund itself and 2) the character of income, expense, gain, loss, and credits generated by the fund (or allocable to the fund in a FOF setting) and how these amounts impact the investor’s tax liability. Taxpayers may invest in a wide variety of funds but may not be aware of how the investment strategy (e.g., holding securities short or long, trading through derivatives, buying dividend paying stocks, purchasing operating company investments, etc.) could impact the character of the income, losses, and deductions generated by the investment.

The below chart and discussion can assist you in understanding the attributes of funds and the character of income and expenses coming from the funds.

**Investment fund attributes**

*Entity characteristics, income/(expense) characteristics, and other considerations*

<table>
<thead>
<tr>
<th>Fund of funds*</th>
<th>Marketable security partnership</th>
<th>Hedge fund partnership</th>
<th>Private equity/ Venture Capital partnership</th>
<th>Publicly traded partnerships</th>
<th>Real estate partnerships</th>
</tr>
</thead>
<tbody>
<tr>
<td>Classified as a business trading securities</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Classified as an operating business</td>
<td>No</td>
<td>No</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
</tr>
<tr>
<td>Classified as an investor partnership</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
</tr>
<tr>
<td>State sourced income generated</td>
<td>No</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Frequently</td>
<td>Yes</td>
</tr>
<tr>
<td>PTP separately stated activities</td>
<td>No</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Non-PTP separately stated activities</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Sometimes</td>
<td>Yes</td>
</tr>
<tr>
<td>Qualified small business stock</td>
<td>No</td>
<td>Rarely</td>
<td>Sometimes</td>
<td>Rarely</td>
<td>Rarely</td>
</tr>
<tr>
<td>Operating business unrelated business taxable income</td>
<td>No</td>
<td>Sometimes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Debt financed unrelated business taxable income</td>
<td>No</td>
<td>Frequently</td>
<td>Yes</td>
<td>Sometimes</td>
<td>Yes</td>
</tr>
<tr>
<td>Foreign reporting requirements</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
</tr>
<tr>
<td>Capital commitments</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Usage of leverage</td>
<td>No</td>
<td>Frequently</td>
<td>Yes</td>
<td>Sometimes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

* Fund of funds can include multiple investment funds in one strategy (hedge funds for example) or can be across investment fund strategies (hedge fund, private equity, publicly traded partnerships, etc.)
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<table>
<thead>
<tr>
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<th>Hedge fund partnership</th>
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<th>Real estate partnerships</th>
</tr>
</thead>
<tbody>
<tr>
<td>Passive income/(losses)</td>
<td>No</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Preferential rate qualified dividends</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
</tr>
<tr>
<td>Long-term capital gains</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
</tr>
<tr>
<td>IRC Section 475 mark to market income</td>
<td>No</td>
<td>Sometimes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>IRC Section 1256 foreign currency contracts</td>
<td>No</td>
<td>Sometimes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Income subject to 3.8% NIIT tax</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Fund expenses subject to 2% limitation</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
</tr>
<tr>
<td>Fund expenses non-subject to 2% limitation</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
</tr>
<tr>
<td>Carried interest</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
<td>Sometimes</td>
</tr>
</tbody>
</table>

Other considerations

- Frequency of liquidity: Monthly/quarterly, Monthly/quarterly, No liquidity, Daily, No liquidity
- Typical fund life: Indefinite, Indefinite, 7.13 years, Indefinite, 7.13 years
- Foreign versus domestic: Generally domestic, Domestic & foreign, Domestic & foreign, Domestic, Domestic & foreign
- Typical entity type: Partnership, Partnership, Partnership, Partnership, Partnership
- Frequency of asset valuation: Monthly/quarterly, Monthly/quarterly, No liquidity, Daily, No liquidity
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Trader versus investor status

Typically, funds like MSFs and HFs will either be determined to be a trader (in the business of trading securities) or an investor (not in the trade or business of trading securities). This annual determination is based on the facts and circumstances of the fund surrounding frequency of trading, holding period, etc. There is no statutory definition of a trader vs. an investor, and the fund must complete an annual analysis to determine whether it is a trader or an investor for the current year. Typically, a trader is a taxpayer who buys and sells securities with reasonable frequency in an effort to catch swings in the market and profit thereby on a short-term basis. A trader can be engaged in a trade or business if the activity is conducted with continuity and regularity and with a primary purpose of producing economic income or profit. A fund that is classified as an investor typically has less trading activity and seeks to profit from more long-term investments.

If the fund qualifies as a trader, then its activities will be considered in the connection of a trade or business. Expenses such as management fees or fund expenses will be classified as trade or business expenses, fully available to offset an investor’s ordinary income from the trader, as well as other sources. Conversely, if the fund is considered to be an investor, any management fees or fund expenses will not be considered in connection with a trade or business and may be limited by the itemized deduction phase-out provisions or added back under the AMT regime.

Passive activity versus non-passive activity

Ordinary income or loss generated from fund investments is typically either passive or non-passive. Passive income and losses are often generated by a rental activity or an operating business in which the taxpayer does not materially participate. Items that are non-passive income include portfolio income such as interest, dividends, and gains on stocks and bonds. Investment activity from marketable security and hedge funds is almost always not considered passive income, either because it is portfolio income or because it is trading income.

Passive losses are only deductible by an investor to the extent of an investor’s overall passive income. If, in a given year, an investor has more passive losses than passive income, the excess passive losses can be carried forward indefinitely to future years. To the extent a taxpayer has carryforward losses from an investment and the investment is completely disposed of in a fully taxable transaction to an unrelated party, such losses are deductible in the year of the disposition regardless of whether the taxpayer has other passive income to offset the losses. The deductibility of carryover losses in the year of complete disposition is dependent upon how the investor has grouped its passive activities.
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If a taxpayer invests in a PEF or a REF and the taxpayer receives a current year tax estimate, consideration should be given regarding whether any loss estimates are currently deductible or whether they may be passive and the deduction is limited to the extent of projected passive income. Furthermore, to the extent you borrow to acquire an interest in a PEF or REF, you should evaluate whether the interest expense may be subject to the passive loss rules as well.

Separately stated activities—non PTPs

Many PEFs and REFS separately state the income and losses of each of their underlying passive activities. A taxpayer may decide to separately state the passive income and losses from a passive activity as it is reported on the Schedule K-1 or group two or more activities of similar nature together. By separately stating each passive activity, the investor may deduct any current or carryforward passive losses in a year of complete disposition of that activity.

Separately stated activities—PTPs

PTPs are unique because the passive activity limitations discussed above are applied separately on a PTP-by-PTP basis. Thus, a net passive loss from one PTP may not be utilized to offset passive income from another PTP or any other passive source. Rather, a passive loss from a PTP is suspended and carried forward to offset income in a future year from that same PTP. If the partner’s entire interest in the PTP is completely disposed of in a fully taxable transaction to an unrelated party, any unused losses are fully deductible in the year of disposition.

Care should be given when a taxpayer invests in a FOF that then invests in PTPs. Typically, the FOF will list the activity of each underlying PTP investment separately. Upon review of the underlying Schedule K-1, it may be determined that the taxpayer indirectly invested in the same PTP through multiple investment vehicles. To the extent this occurs, the taxpayer must aggregate the income and losses related to the PTP investment that is still held and may be recognized when the other PTP FOF disposes of the underlying PTP investment.
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PTP investments are typically held through an investor’s brokerage account. The monthly and year-end statements do not typically adjust the investor’s tax basis for the investor’s share of allocable income or loss from the PTP. Therefore, it is important for the taxpayer to track its tax basis in the PTP, so that the appropriate capital gain or loss can be calculated on disposition. It is important to note that the PTP fund will also provide details to the investor regarding the portion of the gain that will be recharacterized as ordinary in the year of disposition.

As you can see from the description above, the tax rules associated with holding PTP investments are complex and can create additional tax reporting requirements and administrative work. Therefore, when evaluating the rate of return related to PTP investments, consideration should be given to the incremental cost associated with the additional tracking and reporting requirements.

**Qualified small business stock (QSBS)**

Over the years, Congress has provided a variety of incentives to encourage investments in qualified small businesses. Congress believes that targeted relief for investors who risk their funds in new ventures, small businesses, and specialized small business investment companies will encourage investments in these enterprises. In the past several years, Congress has made these incentives even more generous for QSBS acquired after September 27, 2010, to the point where a complete exemption from federal income tax on gains from the sale of certain stock is possible. VC funds often make investments in companies that may qualify as a QSBS and having a good understanding of what investments may generate QSBS gains could generate significant tax savings.

The chart below summarizes the portion of the gain from the sale of QSBS that may be excluded from income depending on when the stock was purchased. The chart also outlines the effective regular and AMT rates associated with the sale of QSBS.

<table>
<thead>
<tr>
<th>Stock acquisition period</th>
<th>Section 1202 exclusion amount</th>
<th>AMT treatment</th>
<th>Effective regular tax rate</th>
<th>Effective AMT tax rate</th>
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</thead>
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<tr>
<td>Prior to February 18, 2009</td>
<td>50% of the realized gain</td>
<td>3.5% of the realized gain will be treated as an AMT preference item</td>
<td>14%</td>
<td>14.98%</td>
</tr>
<tr>
<td>After February 18, 2009 and on or before September 27, 2010</td>
<td>75% of the realized gain</td>
<td>5.25% of the realized gain will be treated as an AMT preference item</td>
<td>7%</td>
<td>8.47%</td>
</tr>
<tr>
<td>After September 27, 2010 and before January 1, 2015</td>
<td>100% of the realized gain</td>
<td>0.0% of the realized gain will be treated as an AMT preference item</td>
<td>0%</td>
<td>0%</td>
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- Hedge funds
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Below are some of the requirements in order for a stock to be considered QSBS.

Requirements
- The stock must be in a domestic C corporation (not an S corporation or LLC, etc.) and it must be a C corporation during substantially all the time the taxpayer holds the stock.
- The corporation may not have more than $50 million in assets as of the date the stock was issued and immediately after.
- The taxpayer’s stock must be acquired at its original issue (not from a secondary market).
- During substantially all the time the taxpayer held the stock, at least 80% of the value of the corporation's assets were used in the active conduct of one or more qualified businesses.

In contrast to being able to receive a full federal income tax exemption for QSBS acquired after September 27, 2010 (but before January 1, 2015), a second alternative is available to defer gain by rolling over gains into new QSBS investments. There are also planning considerations to increase the ability to take the exclusion to the extent the amount of the excludable gain exceeds the exclusion limitation.

Unrelated business taxable income

For tax-exempt investors considering a fund investment, it is important to understand the underlying investment strategy and income that will be generated by the fund. For example, foundations generally pay excise tax equal to 1% or 2% of the net investment income earned by the foundation during the year. However, if a foundation is allocated UBTI, such income is subject to a 35% income tax rate. Accordingly, tax-exempt organizations generally try to minimize acquiring investments that generate UBTI.

Even income that is otherwise not UBTI will be UBTI if the income is from debt-financed property. As described above, many HF's utilize leverage to execute the investment strategy, thus creating UBTI for tax-exempt investors. Therefore, depending on the anticipated amount of UBTI, many tax-exempt investors will proactively choose to invest through the offshore HF blocker corporations to effectively block any UBTI from flowing through. For tax-exempt investors, it may be prudent to weigh the cost of paying tax on UBTI by holding a direct interest in a partnership HF investment (which would flow through the UBTI to the taxpayer) versus the cost of investing directly in an offshore blocker corporation, which is subject to 30% withholding on FDAP income and 35% withholding on ECI. Another activity that causes UBTI is investments in operating businesses. Typically, income from operating businesses is considered UBTI. Many PEF's and REPIs generate operating income, and thus the income would be UBTI.

Ultimately, tax-exempt entities should weigh the expected appreciation and benefits of diversification that investing in underlying funds can offer against the incremental cost of paying 35% tax on UBTI.

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Many states with budget shortfalls recently have chosen to ramp up their tax collection efforts to help plug budget shortfalls. As a result, many states have become more aggressive and have developed enhanced systems to identify investors who have a requirement to file a tax return with the state. Therefore, when considering acquiring a fund, it is important to understand whether the fund is expected to generate state-sourced income.

Funds with state-sourced income generally disclose to each investor their allocable share of state sourced income by providing state K-1s or a footnote included with the federal K-1 with state specific information. As an investor, if there is state-sourced activity, it is important to understand whether the income creates a state tax filing obligation and potential liability. To the extent there might be a state filing obligation, it is helpful to quantify what the investor's liability might be and the cost associated with any additional filings that might be necessary.

If the fund anticipates that state-sourced income will be generated, you should inquire whether the fund will withhold nonresident taxes on your behalf or whether the fund will file an entity level return, referred to as a composite tax return. In many states, the fund can file a composite tax return and pay the investors' share of tax liability attributable to the share of income allocable to the state. By participating in a state's composite filing, an investor's tax filing obligation may be satisfied. Each state has its own specific rules on which types of investors (individual, grantor trust, complex trust, partnership, and corporation) can be included in a composite return and/or have withholding performed on their behalf. Therefore, understanding what the fund plans to do to address the investor's state filing obligations will be important for investors to evaluate the cost of investing in the fund.

MSFs often qualify under special investment partnership rules providing that their investment income is not sourced to a state. For REFs, the state-sourced income allocated to the investors is typically allocated to states where the property is located and where rental income is being received. Many PEFs also generate state-sourced income to the extent that the portfolio investments are directly in operating businesses organized as a partnership. Most resident states provide for credits for taxes paid to other states, so it is important to understand the rules of your state.

Additional state filings can be costly and increase an investor's tax exposure. Therefore, taking the time upfront to proactively analyze the incremental cost associated with additional state tax liabilities and filings will be important to quantify the potential after-tax return associated with a fund investment.
With a solid understanding of the various types of funds and how specific attributes of the funds impact your tax position and tax compliance obligations, you can make more informed investment decisions. Considering that the ordinary tax rate is currently 39.6%, the net investment income tax rate is 3.8%, and many states/localities have income taxes, it is not uncommon for investment returns to be potentially taxed as high as 50%.

Below are some actions you may consider taking and questions you may consider asking before making an investment:

- Review the investment strategy and tax consequences section of the offering documents or private placement memorandum.
- Understand the timing when periodic economic and tax information will be delivered.
- Ask for a sample prior year Schedule K-1. If the fund is new, ask for a representative Schedule K-1 from a similar fund.
- Understand the character of the income likely to be allocated from the investment.
- Assess how the income allocated from the investment impacts your facts and tax posture.
- If a tax-exempt investor is making the investment, what, if any, UBTI can be anticipated.
- Inquire whether the fund is a domestic fund or foreign fund to evaluate reporting requirements.
- Inquire about foreign filings and expected type and volume.
- For marketable security and hedge funds, understand provisions for being able to redeem capital.
- For private equity and real estate funds, understand anticipated timing of capital calls and estimated fund life.
- For private equity and real estate funds, understand whether the activities will be separately stated on Schedule K-1.

As taxpayers seek to diversify their portfolios, we anticipate that opportunities to invest through funds will continue to grow. Therefore, understanding the tax consequences associated with the investments will allow you to proactively plan and enhance your investments.
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In 2017

Family office  Globalization

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