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2017 essential tax and wealth planning guide

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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 edition presents sections on **Tax policy and elections, Individual income tax planning, Wealth transfer planning,** and **Unique investments**. With the election less than one month away, Republican presidential candidate Donald Trump and Democratic presidential candidate Hillary Clinton are making their final case to the voters, with their respective tax plans playing an important, if not always prominent, role. We offer a detailed summary that includes highlights of their tax proposals that may impact you.

A second edition, coming in early December, will provide a **Post-election update, Wealth transfer planning alternatives, 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 edition 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,

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In this issue

Coming in December

In 2017

Tax policy and elections

With the general election campaign now in high gear, Republican presidential candidate Donald Trump and Democratic presidential candidate Hillary Clinton have begun to make their final case to the voters, with their respective tax plans playing an important, if not always prominent, role.

Potential impact of the 2016 elections

Trump and Clinton have so far discussed taxes in broad strokes, without the technical detail necessary to explain how many of their specific proposals would operate. The information they have provided suggests that both are working within the current income tax rules rather than moving toward a consumption-based or other alternative system and both are largely following their respective party orthodoxies. Trump has adopted the traditionally Republican rate-lowering, base-broadening approach similar to past House GOP tax reform plans, while Clinton is following the Democratic model of using the federal tax code to address perceived income inequality and raise revenue for new spending and deficit reduction.

Highlights of their respective proposals affecting high net worth individuals appear below. Details of Trump's proposals are based on the tax plan he unveiled in late 2015, along with clarifications and revisions he released in conjunction with a speech at the Detroit Economic Club on August 8 and a speech at the Economic Club of New York on September 15. Details on Clinton's plan come from her campaign website and remarks at an economic address she gave in Warren, Michigan on August 11.

Ordinary income rates and incentives

Trump would compress the individual income tax rate brackets from seven under current law (top rate: 39.6 percent) to three—12 percent, 25 percent, and 33 percent—and increase the standard deduction to $30,000 for married filing jointly (MFJ) filers and $15,000 for individuals. He also would eliminate personal exemptions and the head-of-household filing status.

Potential impact of the 2016 elections

In a significant change from his original plan, the revised proposal Trump released in September calls for capping itemized deductions at $200,000 for MFJ filers and $100,000 for single filers. Trump originally proposed to phase out most itemized deductions, tighten the so-called "Pease" limitation, and keep the deductions for mortgage interest and charitable giving unchanged for all taxpayers.

Clinton proposes a series of tax increases on upper-income individuals to, among other goals, pay for new spending programs to make college affordable for middle-class families. Her plan would retain the seven existing income tax brackets and essentially create a new eighth bracket of 43.6 percent by imposing a 4 percent "fair share" tax on income over $5 million. Clinton also calls for a minimum tax rate of 30 percent on taxpayers earning $1 million or more (the "Buffett Rule"), a 28 percent cap on the tax value of most itemized deductions, and limits on contributions to certain tax-preferred retirement accounts with high balances.

Even as they propose to reduce or eliminate many individual tax deductions, both candidates have proposed new tax benefits targeted at families. Trump proposed a new family tax relief package in September that includes above-the-line deductions for taxpayers facing child care and elder care expenses (available to itemizers and nonitemizers alike with a maximum income of $500,000 for MFJ filers and $250,000 for single filers) as well as tax-preferred savings accounts to encourage families to set aside funds for caregiving expenses.

Clinton has proposed—without substantial elaboration—to assist families taking care of elderly relatives by creating a new tax credit of up to $1,200 for caregivers and to assist insured individuals facing high out-of-pocket costs for prescription drugs by creating a new refundable credit of up to $2,500 ($5,000 for families). She also has called for expanding the child tax credit for working families as part of a larger plan to limit the cost of child care to 10 percent of family income.

Potential impact of the 2016 elections

Passthrough income

Trump's position on the treatment of business passthrough income has been inconsistent over the course of the campaign and was unclear as this publication went to press. His original tax plan released in 2015 proposed to reduce the top rate on corporate and passthrough business income to 15 percent and offset the rate reductions in part by reducing or eliminating unspecified corporate tax preferences. A fact sheet the campaign initially released in conjunction with his September 15 speech in New York reaffirmed Trump's commitment to reducing the corporate tax rate to 15 percent, but was silent on the issue of passthrough income. An updated fact sheet released later on September 15 affirmatively states that the 15 percent rate would be "available to all businesses, both big and small, 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 original plan, dividends would be taxed at a top rate of 20 percent, and the 3.8 percent net investment income tax (NIIT) would be repealed.

The campaign also indicated that a Trump administration would work with Congress to develop anti-abuse rules to prevent passthrough business owners from recharacterizing wage income as more lightly taxed business income.

Certain small passthrough entities reportedly would be exempt from the second layer of tax, but the campaign did not elaborate on where that threshold would be set and by what measure (for example, assets or gross income). A campaign official indicated that those details would be worked out with Congress after the election.

Clinton thus far has not offered changes to the treatment of passthrough income, so absent further proposals, the top corporate rate would remain at 35 percent and passthrough owners would continue to be taxed on the individual side of the federal tax code. Based on her proposals regarding individual income taxes, however, Clinton's plan could result in a tax increase on wealthy passthrough owners.

Potential impact of the 2016 elections

Capital gains

Consistent with his original plan, Trump continues to call for a top capital gains rate of 20 percent and repeal of the 3.8 percent NIIT. He also would retain the current-law 20 percent rate on dividend income.

Clinton's plan would tax capital gains of certain wealthier individuals on a sliding scale at statutory rates ranging from 20 percent (for assets held over six years) to 39.6 percent (for assets held two years or less). Individuals subject to the 3.8 percent NIIT, the Buffett Rule, and the 4 percent "fair share" tax would face even higher effective tax rates.

Clinton has not thus far proposed changes to the tax rate on dividend income.

Carried interests

Both candidates would tax carried interest income as ordinary rather than capital gain; however, the impact of that change would be more severe under Clinton's plan (which calls for a top individual rate of 43.6 percent) than under Trump's plan (which calls for a top rate of 33 percent).

Estate and gift tax

Trump has consistently called for repealing the estate, gift, and generation-skipping transfer taxes. However, in a significant change from the original plan, his September 15 fact sheet states that he would tax capital gains on appreciated assets held at death to the extent such gains exceed $10 million. The fact sheet does not specify whether the $10 million threshold would apply per person or per "couple." Without elaborating, the document also states that, in order to prevent abuse, "contributions

Politics of policymaking

As the campaign continues, the media's focus when it comes to tax policy will be directed primarily at the presidential candidates. But getting tax code changes enacted into law in the next administration—whether at the margins or as a comprehensive reform package—will require active engagement by and cooperation between Congress and the new president.

If the election places one party in control of the House, the Senate, and the Oval Office, the path forward for tax reform potentially becomes less difficult. But even then, problems could arise: for example, if the minority party in the Senate holds 40 or more seats, it can use procedural means to block legislation it does not support.

If Congress is controlled by one party and the White House by another or if control of the House and Senate is split between Republicans and Democrats—two scenarios we have witnessed in recent years—there will be greater opportunities for gridlock on tax legislation and, indeed, on most significant legislative proposals.

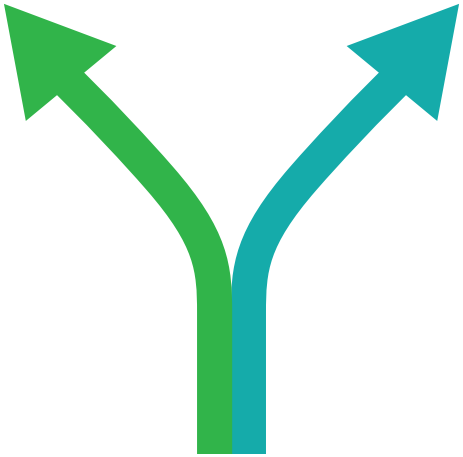
Potential impact of the 2016 elections

of appreciated assets into a private charity established by the decedent or the decedent's relatives will be disallowed."

Clinton's original tax plan, unveiled earlier this year, proposed to return the estate tax to the parameters in effect in 2009—that is, a top rate of 45 percent and an exemption of $3.5 million per person—as well as establish a $1 million lifetime gift tax exemption and require consistency in valuation for transfer tax and income tax purposes.

In an announcement on September 22, Clinton expanded her proposal by calling for increased taxes on the largest estates. According to her campaign website, Clinton's latest proposal would impose "higher rates as values rise," culminating in a top rate of 65 percent on estates larger than $500 million per person ($1 billion per couple). Other news sources, citing details provided by the Clinton campaign to the Center for a Responsible Federal Budget, have reported two intervening rate thresholds—a 50 percent rate on estates over $10 million per person and a 55 percent rate on estates over $50 million per person. For 2016, a federal estate tax of 40 percent applies after an exemption of $5.45 million per person.

In addition to the new rate structure, Clinton proposes to eliminate the basis step-up for capital gains at death. She also proposes to "limit the tax benefits of like-kind exchanges" as part of a larger effort to "prevent high-income taxpayers from misclassifying income as capital gains or avoiding paying tax on some income at all."



The new provisions reportedly are intended to offset the cost of Clinton's proposals to simplify the tax code for small businesses and expand the child tax credit to help working families cover the cost of child care.

Patient Protection and Affordable Care Act (PPACA)

Trump proposes to repeal the PPACA and, presumably, the taxes enacted under that legislation, including the 0.9 percent Federal Insurance Contributions Act Hospital Insurance (commonly known as Medicare Hospital Insurance or FICA-HI) tax on wage income and the 3.8 percent NIIT, both of which are imposed on individual filers with adjusted gross income (AGI) over $200,000 and MFJ filers with AGI over $250,000.

Clinton would retain the PPACA and related individual taxes.

How the Clinton and Trump tax proposals stack up

The table below provides a high-level overview of how selected provisions affecting high net worth individuals in the Clinton and Trump tax plans compare with each other and with proposals in the House Republican tax reform blueprint released on June 24.

Overview of selected provisions affecting high net worth individuals

Issue	Clinton	Trump	House GOP blueprint
Tax brackets	• Retain the seven current-law brackets and essentially create a new eighth bracket of 43.6% by imposing a 4% "fair share" surcharge on income over $5 million • Implement Buffett Rule: Minimum 30% rate on those earning $1 million or more • Presumably retain current-law 0.9% FICA-HI tax on high-income taxpayers	• Three brackets: 12%, 25%, and 33% • Repeal 0.9% FICA-HI tax	• Three brackets: 12%, 25%, and 33% • Repeal 0.9% FICA-HI tax*
Passthrough income	• No changes specified (although the wealthiest passthrough owners would be subject to Clinton's proposed new top ordinary rate of 43.6% on income over $5 million)	September 15 proposal calls for a 15% rate "available to all businesses, both big and small, that want to retain the profits within the business" Trump campaign has since indicated that: • Passthrough businesses may elect to be taxed at the 15% corporate rate or under the individual side of the tax code • Large passthroughs electing the 15% rate would be subject to second-level tax on dividends, but small ones would not (no details on threshold for determining when or how second-level tax would apply)	• Top rate of 25% will apply to active business income of sole proprietorships and passthrough entities, such as partnerships, limited liability companies (LLCs), and S corporations • Passthrough entities will pay or be treated as having paid reasonable compensation to their owner-operators, which will be deductible by the business and will be subject to tax at the graduated individual income tax rates

* Provisions included in the health care reform blueprint that House Republicans released on June 22.

How the Clinton and Trump tax proposals stack up

Issue	Clinton	Trump	House GOP blueprint
Passthrough income (cont.)		• 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 (2015 proposal called for 15% top rate for all passthroughs)	
Capital gains/ Dividend rate	• For taxpayers in top two income tax brackets: Top statutory capital gain rate of 39.6% (assets held ≤2 years), gradually reduced to 20% (assets held >6 years) • Presumably retain current-law 3.8% NIIT • No changes specified for dividend rate	• Retain current-law capital gain structure with top rate of 20% • Repeal 3.8% NIIT • No changes specified for dividend rate	• Taxed at ordinary rates with 50% exclusion (effective tax rates of 6%, 12.5%, and 16.5%) • Exclusion also applies to interest, which is currently taxed as ordinary income • Repeal 3.8% NIIT*
Carried interest	• Tax as ordinary income (maximum rate: 43.6%)	• Tax as ordinary income (maximum rate: 33%)	• Follows proposed treatment of capital gain (*i.e.*, taxed at ordinary rates but with 50% exclusion for a maximum effective rate of 16.5%)
Itemized deductions	• Cap tax value of most itemized deductions at 28% for wealthier individuals (exception would apply for charitable giving deduction) • Cap may also apply to some items of income currently excluded from tax	• Cap itemized deductions at $200,000 for MFJ filers and $100,000 for single filers	• Retain deductions for mortgage interest and charitable giving; eliminate most others
Standard deduction and personal exemptions; other credits	• No specific proposals to change current-law deductions or exemptions	• Increase standard deduction to $15,000 for individuals and $30,000 for MFJ filers • Eliminate personal exemptions and head-of-household filing status	• 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 MFJ filers

How the Clinton and Trump tax proposals stack up

Issue	Clinton	Trump	House GOP blueprint
Standard deduction and personal exemptions; other credits (cont.)	• Expand child tax credit; create new tax credit for caregivers; create new refundable credit to assist insured individuals facing high out-of-pocket costs for prescription drugs	• Create new above-the-line tax deductions for child care and elder care expenses and new tax-preferred savings accounts to encourage families to set aside funds for those expenses	• Consolidate personal exemption for children and child tax credit into a single $1,500 credit, $1,000 of which is refundable
Estate tax	• Return to 2009 parameters: 45% top rate and $3.5 million exemption per spouse • Implement tiered rate structure for larger estates; top rate: 65% on estates larger than $500 million per person ($1 billion per couple) • Eliminate basis step-up of capital gains at death	• Repeal, but tax capital gains on appreciated assets held at death 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
Treatment of asset sales/ transfers	• Limit tax benefits of like-kind exchanges	• No changes specified	• No changes specified
Patient Protection and Affordable Care Act	• Retain	• Repeal	• Repeal*

Clinton's and Trump's proposed individual rate brackets: Ordinary income

The following table compares the proposed marginal rates on ordinary income under the Trump and Clinton plans—and the income thresholds at which those rates would apply—with current-law brackets and the inflation-adjusted income thresholds in effect for 2016. The House GOP tax reform blueprint, like the Trump plan, calls for three rate brackets of 12 percent, 25 percent, and 33 percent; but the blueprint does not supply beginning and ending points for the rate brackets and is not included in this comparison.

Tax rate on ordinary income[1]	Single			MFJ		
	Current law	Clinton	Trump	Current law	Clinton	Trump
10%	$0 – $9,275	$0 – $9,275	—	$0 – $18,550	$0 – $18,550	—
12%	—	—	$0 – $37,500	—	—	$0 – $75,000
15%	$9,276 – $37,650	$9,276 – $37,650	—	$18,551 – $75,300	$18,551 – $75,300	—
25%	$37,651 – $91,150	$37,651 – $91,150	$37,501 – $112,500	$75,301 – $151,900	$75,301 – $151,900	$75,001 – $225,000
28%	$91,151 – $190,150	$91,151 – $190,150	—	$151,901 – $231,450	$151,901 – $231,450	—
33%	$190,151 – $413,350	$190,151 – $413,350	$112,501 and above	$231,451 – $413,350	$231,451 – $413,350	$225,001 and above
35%	$413,351 – $415,050	$413,351 – $415,050	—	$413,351 – $466,950	$413,351 – $466,950	—
39.6%	$415,051 and above	$415,051 up to $5 million	—	$466,951 and above	$466,951 up to $5 million	—
43.6%[2]	—	$5 million and above	—	—	$5 million and above	—

Notes

[1] Current law imposes an additional 0.9 percent Medicare Hospital Insurance tax on certain upper-income individuals. This tax would be retained under the Clinton plan but would be repealed under the Trump plan.

[2] Rate reflects Clinton's proposed 4 percent "fair share" surcharge on income of $5 million and above.

Sources: Inflation-adjusted brackets in effect for 2016 listed in Internal Revenue Service (IRS) Revenue Procedure 2015-53. Clinton data assumes income thresholds for current-law brackets would remain in effect under her plan. Trump data from the candidate's website.

Clinton's and Trump's proposed individual rate brackets: Capital gain income

The following table compares the proposed marginal rates on capital gain income under the Trump and Clinton plans—and the income thresholds at which those rates would apply—with current-law brackets and the inflation-adjusted income thresholds in effect for 2016. The House GOP tax reform blueprint calls for taxing capital gain income at ordinary rates with a 50 percent exclusion; however, the blueprint does not supply beginning and ending points for the rate brackets and is not included in this comparison.

	Single			MFJ		
Bracket[1]	**Current law**	**Clinton**	**Trump**	**Current law**	**Clinton**	**Trump**
0%	$0 – $37,650	$0 – $37,650	$0 – $37,500	$0 – $75,300	$0 – $75,300	$0 – $75,000
15%	$37,651 – $415,050	$37,651 – $415,050	$37,501 – $112,500	$75,301 – $466,950	$75,301 – $466,950	$75,001 – $225,000
20%	$415,051 and above	—	$112,501 and above	$466,951 and above	—	$225,001 and above
20–39.6%[2]	—	$415,051 and above	—	—	$466,951 and above	—

Notes

[1] Rates shown in this table do not reflect the 3.8 percent NIIT imposed on certain high net worth individuals that is in effect under current law and would be retained under the Clinton plan. The NIIT would be repealed under the Trump plan.

[2] For taxpayers in the 39.6 percent and 43.4 percent income tax brackets, Clinton would tax realized gains on a sliding scale—at statutory rates ranging from 20 percent to 39.6 percent—based on the asset's holding period. The lowest rate would apply to assets held longer than six years and the highest would be imposed on assets held for two years or less. The additional 3.8 percent NIIT also would apply, as would any applicable Buffett Rule and "fair share" taxes. See the table on the following page for additional details.

Source: Current-law rates from IRS Publication 17 (2015), *Your Federal Income Tax*; inflation-adjusted brackets for 2016 from IRS Revenue Procedure 2015-53. Clinton data assumes income thresholds for capital gains tax brackets follow current law. Trump data from the candidate's website.

A closer look at Clinton's proposed top capital gain rates

For individuals in the top two income tax brackets under the Clinton plan,[1] realized capital gains would be taxed on a sliding scale—at statutory rates ranging from 20 percent to 39.6 percent—based on the asset's holding period. The lowest rate would apply to assets held six years or longer and the highest would be imposed on assets held for less than two years. The additional current-law 3.8 percent NIIT also would apply, resulting in top effective tax rates ranging from 23.8 percent to 43.4 percent. The top rate on dividend income presumably would remain subject to the current-law rate of 23.8 percent (inclusive of the 3.8 percent NIIT).

The table below shows how the top capital gains rates under the Clinton plan compare with current law, with the Trump tax plan and with the House GOP blueprint.

Top capital gain rates

Asset holding period (Years)	Current law (Statutory Rate + NIIT)	Clinton plan (Statutory Rate + NIIT)[2]	Trump plan (NIIT Repealed)	House GOP blueprint (NIIT Repealed)
Less than 1	39.6% + 3.8% = **43.4%**	39.6% + 3.8% = **43.4%**	33%[3]	Presumably 33%[3]
1–2	20% + 3.8% = **23.8%**	39.6% + 3.8% = **43.4%**	20%	16.5%[4]
2–3	20% + 3.8% = **23.8%**	36% + 3.8% = **39.8%**	20%	16.5%[4]
3–4	20% + 3.8% = **23.8%**	32% + 3.8% = **35.8%**	20%	16.5%[4]
4–5	20% + 3.8% = **23.8%**	28% + 3.8% = **31.8%**	20%	16.5%[4]
5–6	20% + 3.8% = **23.8%**	24% + 3.8% = **27.8%**	20%	16.5%[4]
More than 6	20% + 3.8% = **23.8%**	20% + 3.8% = **23.8%**	20%	16.5%[4]

Notes

[1] Under Clinton's plan, the top two income tax brackets would be 39.6 percent and 43.6 percent. The 39.6 percent bracket would apply to income ranging from $415,051 up to $5 million for single filers and $466,951 up to $5 million for MFJ filers. The 43.6 percent bracket would apply to income over $5 million for single and MFJ filers.

[2] Rates shown do not reflect the 30 percent Buffet Rule tax that Clinton would impose on income over $1 million or the 4 percent fair share tax on income above $5 million.

[3] Neither the Trump plan nor the House GOP blueprint specifies whether a separate tax rate would apply to short-term capital gains. Presumably, both will follow current law and tax short-term gains at the maximum rate for ordinary income, resulting in a short-term capital gains rate of 33 percent.

[4] Long-term capital gain rates under the House GOP blueprint reflect the proposed top ordinary income rate of 33 percent with a 50 percent exclusion.

Source: Clinton and Trump data from the Tax Policy Center. House GOP blueprint data from *A Better Way—Our Vision for a Confident America: Tax,* published by the House Republican Tax Reform Task Force on June 24, 2016 (http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf).

Individual income tax planning

While opening the door to income tax planning is an important step to take throughout your life, many individuals see the myriad of taxes and the complicated rules behind them as a barrier to planning. We encourage you to not let this be the case for you. Your overall tax burden undoubtedly consumes a large percentage of your income. We believe that investing the time to understand the character of income that your activities and investments produce and the different taxes associated with those activities will lead you down the path to realizing a more tax-efficient result.

Individual income tax planning

Today's increased tax rate environment

Before we discuss tax rates, it is important to briefly discuss how complex tax policy has evolved in recent years and led us to today's increased tax rate environment. We will discuss how we arrived at our current graduated income tax rate structure and also some of the additional taxes that may be assessed on your income.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) brought sweeping changes to the tax landscape in the early days of President George W. Bush's first term. The changes generally brought a reduction in tax rates that were to be phased in over nine years. Subsequently, the Jobs and Growth Tax Relief Reconciliation Act of 2003 accelerated the phase-in of those reductions. However, an original "sunset" provision of EGTRRA provided that the reduced rates would end on January 1, 2011, and revert back to their pre-EGTRRA levels. The sunset was included to ensure the legislation complied with certain parliamentary rules governing the budget reconciliation process under which EGTRRA was passed, specifically a rule that prevented the bill from increasing the deficit beyond the ten-year budget window.

The potential for the expiration of the reduced rates, as well as the reintroduction of various phase-outs that were gradually repealed under EGTRRA (*e.g.*, the "Pease" limitation on itemized deductions and the Personal Exemption Phase-out or "PEP"), loomed for years. This environment caused uncertainty for long-term income tax planning.

In 2010, Congress passed, and President Obama signed, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which extended the fully phased-in EGTRRA rate reductions and repealed phase-out provisions for two additional years, through 2012. Finally, in early January of 2013, Congress settled the issue by passing the American Taxpayer Relief Act of 2012 (ATRA). ATRA permanently extended the reduced tax rates for lower-and-middle-income taxpayers, but allowed the top tax rates to increase and return to pre-EGTRRA levels for upper-income taxpayers. ATRA also brought back, in permanent form, the Pease and PEP limitations for single taxpayers with adjusted gross income (AGI) over $250,000, or $300,000 for married filing jointly (MFJ) filers.

After periods of significant uncertainty and change, the individual income tax rates have remained static post-ATRA. However, the price of stability is today's increased tax rate environment.

Today's increased tax rate environment

2016 and 2017 federal income tax brackets

Tax rate on ordinary income	Single				Tax rate on qualified dividends and long-term capital gains
	2016		2017		
	over	to	over	to	
10%	$0	$9,275	$0	$9,325	0%
15%	$9,275	$37,650	$9,325	$37,950	0%
25%	$37,650	$91,150	$37,950	$91,900	15%
28%	$91,150	$190,150	$91,900	$191,650	15%
33%	$190,150	$413,350	$191,650	$416,700	15%
35%	$413,350	$415,050	$416,700	$418,400	15%
39.6%	$415,050		$418,400		20%

Tax rate on ordinary income	MFJ/Qualifying widow or widower				Tax rate on qualified dividends and long-term capital gains
	2016		2017		
	over	to	over	to	
10%	$0	$18,550	$0	$18,650	0%
15%	$18,550	$75,300	$18,650	$75,900	0%
25%	$75,300	$151,900	$75,900	$153,100	15%
28%	$151,900	$231,450	$153,100	$233,350	15%
33%	$231,450	$413,350	$233,350	$416,700	15%
35%	$413,350	$466,950	$416,700	$470,700	15%
39.6%	$466,950		$470,700		20%

Individual income tax planning

Today's increased tax rate environment

While relative stability was created for income tax rates, the Patient Protection and Affordable Care Act (PPACA), enacted in 2010, created two additional taxes to be assessed on individuals. The PPACA imposed the following taxes, effective as of January 1, 2013:

(1) A 3.8 percent net investment income tax (NIIT) on the net investment income of individuals, estates, and trusts, and

(2) A Federal Insurance Contributions Act Hospital Insurance (commonly known as Medicare Hospital Insurance or FICA-HI) tax that increased the employee share of Medicare taxes by 0.9 percent from 1.45 percent to 2.35 percent for wages received.

These additional taxes created great complexity and uncertainty. Although the law was passed in 2010, the Treasury Department did not issue proposed regulations until late 2012 and did not finalize those regulations until late in 2013. Given the issuance of the regulations, over time the application of these complicated statutory and regulatory provisions has become clearer, thus allowing individuals to better plan for these new taxes.

Despite potential changes or uncertainty in tax policy, we believe you should always be aware of and carefully analyze tax planning considerations. However, to the extent that change and uncertainty were an impediment to planning, now is the time to move forward given that we are in the midst of a relatively stable tax environment that may not last indefinitely. Presidential or Congressional changes could again create a period of uncertainty in the short or long term. We encourage you to take advantage of today's period of calm before that potential storm arrives by committing to thoughtful tax planning now.

Individual income tax rates by type of income

Categories of income	Categories of tax
Ordinary income	Income tax
Qualified dividends	Self-employment
Capital gains	Alternative Minimum Tax (AMT)
	Health care taxes
	State and foreign taxes

Ordinary income tax rates. If your primary source of income comes from employment, then you will generate ordinary income in the form of wages, salaries, tips, commissions, bonuses, and other types of compensation. Other investments may also generate ordinary income in the form of interest, nonqualified dividends, net income from a sole proprietorship, partnership or limited liability company (LLC), rents, royalties, or gambling winnings. For 2016 (and 2017), the top marginal ordinary income tax rate is 39.6 percent for single taxpayers with income more than $415,050 ($418,400) and married taxpayers with income more than $466,950 ($470,700). Ordinary tax rates continue to range from 10 percent to 39.6 percent and will remain in place permanently until further reform.

Tax rates on qualified dividends. We will refer to qualified dividend income as tax preferential income since the top qualified dividend rate is 20 percent for taxpayers in the top 39.6 percent bracket. This contrasts to the 39.6 percent top rate assessed on ordinary income. For taxpayers in the 25 percent through 35 percent ordinary income tax brackets, the top rate on their qualified dividend income is 15 percent, and for those taxpayers in the two lowest ordinary income tax brackets, their qualified dividend rate is zero percent. Note that in addition to these rates, qualified dividends may also be subject to the 3.8 percent NIIT.

Long-term capital gains tax rates. If you have invested in a capital asset, then the gain on the sale or exchange of such an asset results in capital gain. The long-term capital gains tax rate, assessed on capital assets held for greater than one year, is 20 percent for taxpayers in the top 39.6 percent tax bracket, 15 percent for taxpayers in the 25 percent through 35 percent tax brackets, and zero percent for those taxpayers in the two lowest tax brackets. Given the reduced rates on long-term capital gains, we will also refer to this income as tax preferential income.

2016 (and 2017) long-term capital gains rates

Taxable income less than threshold
$37,650 ($37,950) single;
$75,300 ($75,900) for MFJ

Taxable income
Over $37,650 ($37,950), but less than $415,050 ($418,400) single; over $75,300 ($75,900), but less than $466,950 ($470,700) for MFJ

Taxable income greater than or equal to threshold
$415,050 ($418,400) single;
$466,950 ($470,700) for MFJ

Individual income tax rates by type of income

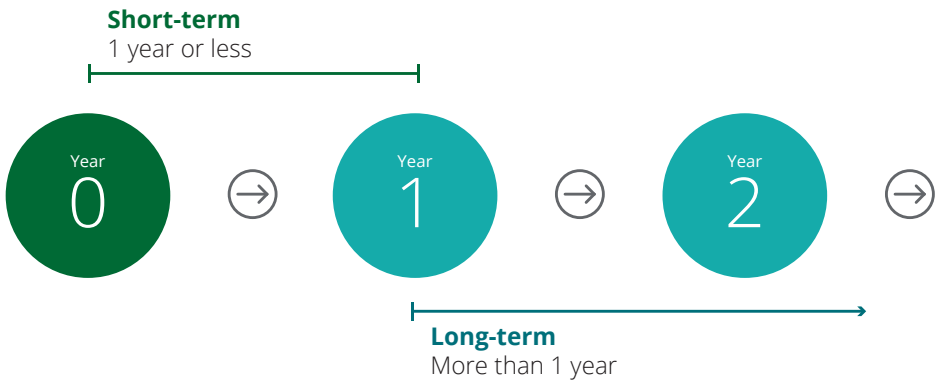
Given the tax preferential nature of long-term capital gain income, special attention should be given to the holding period of an asset to take full advantage of the long-term capital gain rates.

Certain sales of capital assets do not qualify for the lower capital gains rate. A "short-term capital gain"—or gain on the sale of an asset held for one year or less—is still a capital gain, but is taxed at ordinary income tax rates. Although short-term capital gains are taxed at the same rate as ordinary income, a benefit to short-term capital gains is that they can be offset with capital losses since an individual will net his or her capital gains and losses in arriving at their total capital gain income. Note that if capital losses exceed capital gains, a taxpayer can only deduct up to $3,000 of net capital losses against other income—the balance of their net capital loss is to be carried forward to future years.

Gains from installment sales are taxed at the rate in effect on the date an installment payment is received. Collectibles remain subject to a 28 percent maximum rate.

It is important to remember that more than one type of tax may apply to the same character of income. Therefore, we will now discuss additional taxes that may apply, including employment taxes, AMT, and NIIT.

Holding period



Self-employment tax

If your income is generated by operating a business as a sole proprietor, a partner in a partnership, or a member of a multi-member LLC, you usually are also subject to self-employment tax in addition to your ordinary income tax. The self-employment tax rate is 12.4 percent for social security tax on self-employment income up to $118,500 for 2016 ($127,200 for 2017) and 2.9 percent for Medicare taxes on all self-employment income. These taxes are in addition to the FICA-HI tax. Once self-employment tax has been calculated, then half of that amount is deductible when calculating overall AGI for that year.

FICA taxes

FICA	2016 base	2017 base	Employee rate	Employer rate	Total
Social Security	$118,500	$127,200	6.20%	6.20%	12.40%
Medicare	**Unlimited**	**Unlimited**	**1.45%**	**1.45%**	**2.90%**
FICA-HI	$200,000 Single $250,000 MFJ	$200,000 Single $250,000 MFJ	0.90%	N/A	0.90%
Total			8.55%	7.65%	16.20%

Alternative minimum tax (AMT)

The AMT has evolved into an unwieldy system that continues to ensnare millions of unsuspecting taxpayers. AMT is imposed at a nearly flat rate on an adjusted amount of taxable income above a certain threshold, which is also known as an exemption. The exemption is substantially higher than the exemption from regular income tax. The AMT exemption is indexed for inflation and phased out as taxpayers reach higher levels of AMT income. For 2016 (and 2017), the AMT exemption amount for single filers is $53,900 ($54,300) and begins to phase out at $119,700 ($120,700) . It is $83,800 ($84,500) for MFJ filers, for whom the exemption begins to phase out at $159,700 ($160,900).

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

Now that the difference between the highest ordinary income tax rate and the highest AMT rate has increased, as has the AMT exemption, it is likely that fewer taxpayers will be subject to AMT going forward. Still, in order to navigate the AMT, taxpayers must be especially mindful of year-end cash payments, such as fourth quarter state income taxes (especially in states with high rates), prepayment of investment and tax advisor fees, and charitable contributions. Falling victim to AMT has many possible causes, but you may be particularly prone to AMT if you have any of the following circumstances:

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

Current-year planning around timing of the payment of expenses that constitute itemized deductions not deductible under the AMT system is certainly important, but it may not be enough. In addition, projecting taxable income from hedge and private equity funds, as well as managing private activity bonds, are among activities that take on special significance. More than ever, meaningful AMT planning requires examining multi-year scenarios.

Health care taxes

As we have previously discussed the creation of the heath care taxes, it is now important to put the taxes in the context of how they apply to particular types of income. Note that each of these taxes are in addition to other taxes that are assessed on these types of income.

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

NIIT

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

Net investment income

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

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

Does **NOT** apply to:

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

FICA-HI tax. An additional 0.9 percent FICA-HI tax applies to earnings of self-employed individuals or wages of an employee received in excess of $200,000 ($250,000 if MFJ). Self-employed individuals will not be permitted to deduct any portion of the additional tax. If a self-employed individual also has wage income, then the threshold above which the additional tax is imposed will be reduced by the amount of wages taken into account in determining the taxpayer's liability.

FICA-HI Tax

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

MFJ	Married filing separately	Single
$250,000	**$125,000**	**$200,000**

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

This change does not change the employer hospital insurance contribution.

State and foreign taxes

Now having worked our way through the various federal taxes that can be assessed, there are still income taxes from other jurisdictions to be addressed. While a thorough discussion of all possible taxes imposed by states or foreign countries is not the purpose here, no income tax planning exercise is complete without considering the potential for taxes from all possible jurisdictions.

States such as Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not have individual income taxes, but most states do—with California having the highest rate of more than 13 percent. If an individual is subject to income taxes in multiple states, it may be possible to generate a state tax credit in the resident state to reduce the overall tax burden.

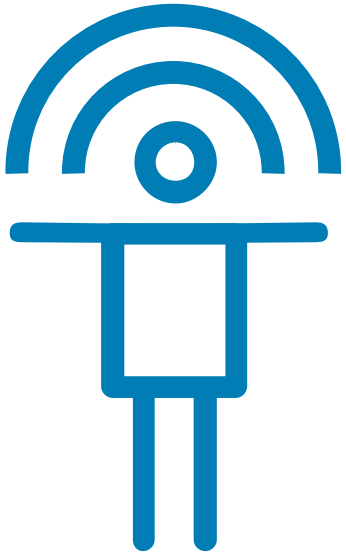
Individual consumers may also be subject to sales and use taxes. When the governing body collects the tax at the point of purchase, it is called a sales tax. Alternatively, when a tax on goods or services is paid to a governing body directly by a consumer, it is usually called a use tax. The imposition of these taxes may be an important consideration when an investment is a commodity, such as an airplane or art.

Finally, if income is earned in a foreign jurisdiction, then it may be subject to foreign taxes. Similar to the state tax credit, a foreign tax credit may be available when income is subject to tax in multiple jurisdictions.

Year-round personalized planning

With a solid understanding of the various taxes that may be assessed on your income and an understanding of the importance of planning for this meaningful liability, you are now equipped to consider the issues that are presented to you based on your personal tax situation. When we say considerations, we like to think of those as levers that you can engage.

What lever can you pull that may position you for a potentially more tax-efficient result?



Maybe your lever is to take steps to defer income to a subsequent year, or maybe it is to accelerate a deduction or expense into the current year. Either way, think of these levers as tools within your control that you can use to affect your tax result. By implementing a long-term commitment to holistic tax planning, you likely will identify many different levers to consider each year and position yourself to navigate today's increased tax rate environment more efficiently.

To be more effective in your efforts, it is best to not think of your tax situation based on the income you expect to realize or the deductions you expect to incur. To only think of income planning approaches or deduction planning strategies is to think in a vacuum. That is not the way that it works when you file your taxes—everything is taken into consideration when calculating your tax bill. So we encourage you to think of planning here as a year-round process, taking into consideration all the levers you can pull, be they income or deduction decisions—to create a more efficient tax result.

As you think about this, keep in mind that the levers you will consider will be different than levers someone else would consider because each of us has a unique tax posture and different goals and objectives.

There is no one-size-fits-all approach that applies to everybody. You should focus on your planning based on your own specific fact pattern and objectives. Even if your income posture is identical to someone else's, maybe you are charitably inclined and they are not. Perhaps both of you are charitably inclined, but you plan to fund your charitable donations soon whereas the other person plans to fund his or her donations as part of an estate plan. So your levers become very specific and unique to you based on your tax posture and your personal goals and objectives. Understanding this is critical in tax planning because it shines a direct light on specific considerations for tax efficiencies for you and facilitates the pursuit of your goals and objectives.

As part of your long-term commitment to holistic tax planning, recognize that each year may present different issues based on that specific year's activity. For example, maybe this year you have a significant ordinary income event, but you expect a significant long-term capital gain event next year. Maybe this year you expect an operating loss from your business enterprise, but next year you project the business to turn around and be highly profitable. The likelihood of anticipated legislative changes will also need to be

Year-round personalized planning

considered. As a result, steps you would take in one year compared to the next year to create an efficient tax result may vary greatly. For example, the levers you will consider in years with large amounts of tax preferential, low-rate income will likely need to be vastly different than the levers you would consider in years where you expect significant levels of high-rate ordinary income. Similarly, the levers you will pull if you expect tax rates to increase or decrease in future years will cause you to consider pulling levers that you will not otherwise consider.

To start to think about this in more detail, we encourage you to consider the character and the timing of your income and your deductions, as not all items of income or deductions are equal. As reviewed earlier, some income is subject to ordinary tax rates as high as 39.6 percent, like wages, whereas some income, like long-term capital gains or qualified dividend income, is subject to tax preferential rates that only go as high as 20 percent. Some items of income are more easily controllable when you recognize the income event, for example, when to realize the long-term capital gain that is currently in your portfolio. Other items of income may be less controllable by you, such as the amount and timing of your company bonus.

The issue is even more complex for your deductions. Some deductions are easily controllable in terms of their timing, like your charitable contributions, but may still carry an array of tax issues, such as the funding of that charitable donation (cash versus stock versus other assets), let alone the optimal year to fund the donation. Some deductions are less controllable, like interest expense and real estate taxes, as you generally pay those when they become due. If that is not enough, consider that some deductions may provide significant value if you are not subject to the AMT, but those same deductions may provide no benefit if you are subject to AMT. Just because you are in AMT this year does not mean you will be in next year. Your deduction may reduce your taxes by 39.6 percent if it offsets ordinary income, only 20 percent if it offsets long-term capital gains, or absolutely zero percent if you are in AMT. As you digest this, you can begin to see that controllability is a significant lever for you to consider for both income and deduction items.

Year-round personalized planning

Putting all of this into perspective may be easier when you consider these important points:

1. Items that are controllable provide flexibility for determining the more optimal time for tax recognition of that item. This is equally applicable to items of income as it is to items of deduction.

2. Some items are automatically going to occur—you will pay your real estate taxes when they are due (or face a penalty for not doing so), and you will earn your wages when they are earned. Often these automatic events lay the foundation of your planning. In essence, enhance the efficiency you can gain from your controllable events against the backdrop of your noncontrollable events.

3. Controllable deductions may be one of your biggest levers. Again, an example would be when and how do you want to fund your charitable gifts. Will you use securities or an alternative asset? Recognizing that there are more efficient ways to fund these deductions—both in terms of the when and the how—allows you to reach a greater level of tax efficiency.

4. Your personal tax situation will afford you some additional considerations today, in future years, and in some instances, even prior years. Making sure you review it holistically and commit to thoughtful tax planning is likely to position you to realize a greater degree of tax efficiency than you otherwise might expect.

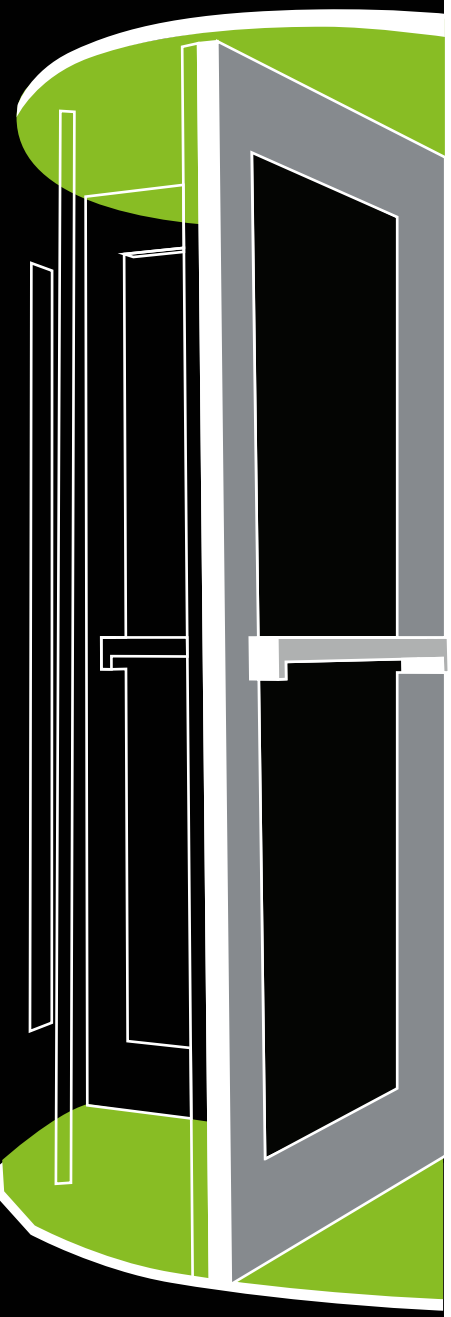
5. Do not lose sight of the fact that if you are an owner of, or invest in, passthrough entities, the more thoughtful planning that you may need to undertake to position yourself for an efficient tax result may be planning within those entities as opposed to planning by you directly. Failing to coordinate tax planning between a flow-through entity and the owners of that flow-through entity will likely undercut tax efficiency.

6. Before acquiring new investments, take time to understand the character of the income that will be generated by the investment as well as when you will recognize the income. Furthermore, analyze whether you will benefit from the expenses and losses allocated to you. The deduction for some expenses may be limited by the itemized deduction phaseout provisions or added back under the AMT regime. Furthermore, losses may be disallowed in the current year if you are subject to the passive loss rules. Failing to understand the character of income and expenses that the passthrough entity will pass through to you may lead to unwelcome surprises when you receive the final tax information.

This guide is meant to help you apply these considerations to your unique goals and objectives and open the door to tax-efficient planning with your advisor.

Wealth transfer planning

Planning to leave your legacy to your heirs (including charity) can be complex and difficult to face. There is no easy way to say it—anticipating your death is an uncomfortable topic. The issues that need to be confronted are far easier to avoid than to address. Yet effective wealth transfer planning may lessen the likelihood of family conflict, preserve wealth, reduce estate costs, and reduce taxes.



Wealth transfer planning

Open the door to planning

When it comes to wealth transfer planning, establishing who gets what, how they get it, and when they get it are, as a general rule, personal matters—but these decisions can have significant financial implications. While it is human nature to procrastinate on such issues, the entire family benefits if these matters are addressed sooner rather than later. Addressing your estate plan now puts you in a position to monitor its progress while you are living and make adjustments as circumstances evolve. In addition, planning now provides peace of mind that decisive action has been taken. Finally, planning will, in most cases, provide your family with a tax-efficient plan to address the disposition of assets, while providing for their long-term needs. If you are willing to start the dialogue today, you will learn how much more tax efficient it is to transfer assets while you are alive rather than waiting to transfer assets once you have passed.

Wealth transfer planning determines how you will "slice up the pie" and encompasses the many activities necessary to confirm that your affairs are in order and that your assets will be directed as you intend.

You can't take it with you—so where do you want your wealth to go?

There are three places your assets can go at your death: to your family and friends, to charity, or to the government in the form of taxes. Wealth transfer planning determines how you will "slice up the pie" and encompasses the many activities necessary to confirm that your affairs are in order and that your assets will be directed as you intend. For wealthy individuals subject to high estate taxes, effective wealth transfer planning may direct more wealth to family and charity—and less to the government in the form of taxes.

What a wealth transfer plan entails

All estate plans should cover the basics, including having in place a current will, powers of attorney for property and health care (these documents will vary from state to state and may also include a health care directives or living wills), and revocable trusts (if applicable). In addition, planning should provide for guardians for minor children and confirm that assets are titled properly and beneficiary designations are up to date so that assets pass as intended at death.

For wealthy individuals, the estate plan must do much more as it becomes the roadmap from which a legacy will be established and implemented. Effective planning may reduce the likelihood of family conflict as well as the possible administrative and tax costs associated with your passing.

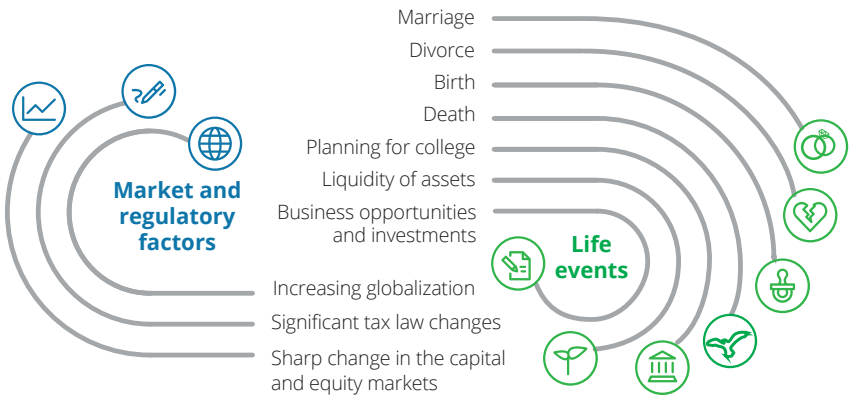
Establishing your wealth transfer planning goals

"Don't let perfect be the enemy of good"

The old adage "don't let perfect be the enemy of good" applies to all planning—your wealth transfer plan included. Your wealth transfer plan, like every other plan, anticipates the probability of future events in the face of imperfect knowledge. Consequently, it will never be perfect—it will always remain a work in progress requiring periodic updates as anticipated events occur (or not), as market and regulatory developments occur (or not), and as new planning considerations arise (or not). For your part, retaining competent advisors to help you select from the sheer variety of effective planning considerations and to navigate you through the wealth transfer planning process is essential. You should work with your advisors to articulate your current wealth transfer planning goals. Although your goals may evolve over time, the goals you identify today will serve as the foundation that guides the planning steps you choose to implement. And as you execute wealth transfer strategies, you should develop a periodic review and analysis process to compare your accomplishments to your originally defined goals.

The wealth transfer planning process

Life events, as well as market and regulatory factors, can impact the wealth transfer planning process. It is important for your wealth transfer plan to remain flexible, and be revisited and adjusted periodically.



1 **What is important to you?**

- Identify your needs
- Quantify your aspirations
- Define your goals

2 **How do you plan?**

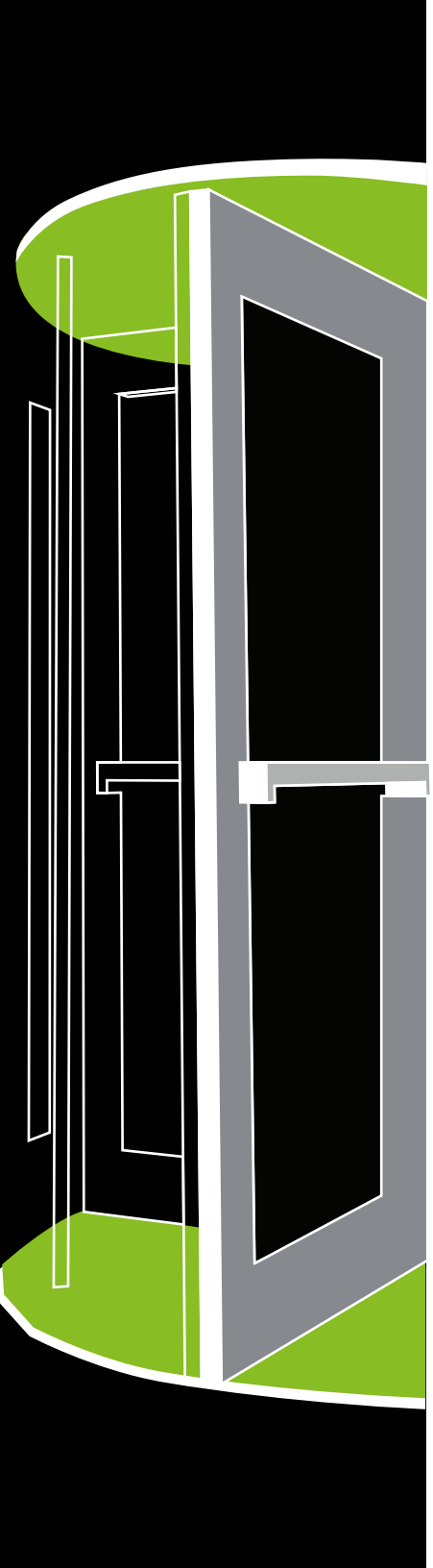
- Determine risk tolerance
- Collaborate with advisors
- Develop a wealth and tax approach
- Identify asset protection plans

3 **How will you distribute your wealth?**

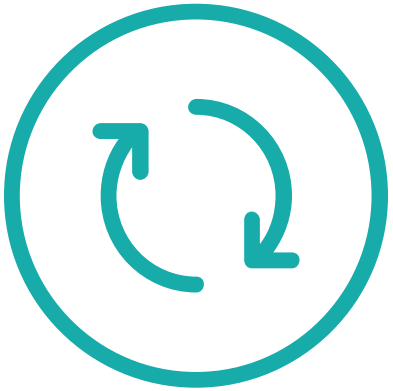
- Determine to whom, when, and under what circumstances
- Evaluate wealth transfer plans
- Implement and monitor the chosen plans

4 **How do you stay in check?**

- Perform regular performance reviews
- Adjust planning in light of life events and market conditions



The planning process for your wealth transfer plan



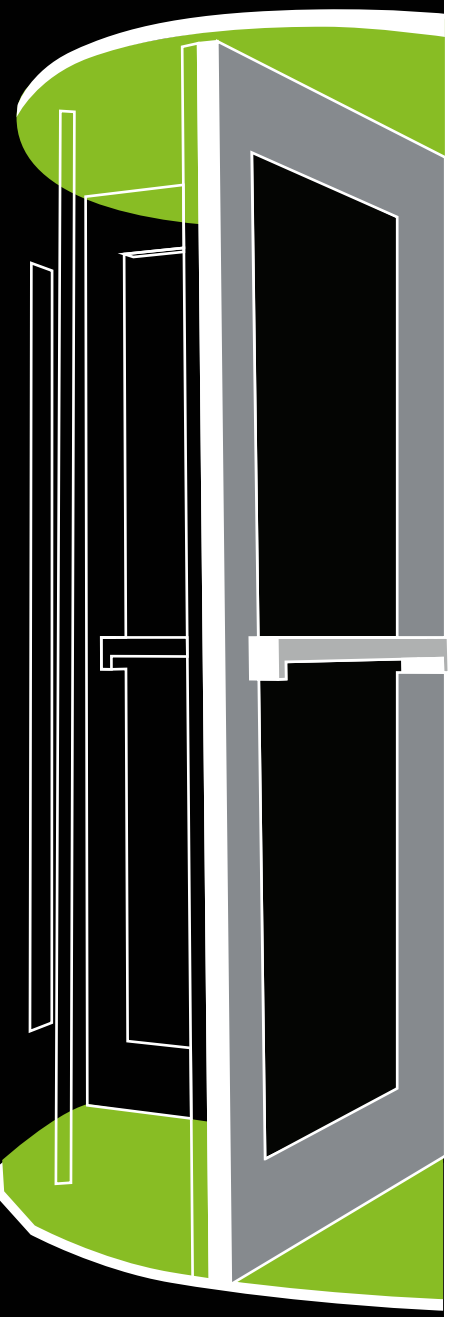
However you choose to approach your wealth transfer plan, the following four considerations must receive appropriate attention:

1 What is important to you?

Upon your passing, your assets must be distributed to your family and friends, philanthropy, or to the government in the form of taxes. If you proactively plan, over time there will likely be more assets transferred to family, friends, and/or the charities of your choice. The first step is to determine to what extent that is important to you and what limits, if any, might be important to impose. For example, is there a limit to the wealth you wish to leave for family? Second, must your plan accommodate your heirs' special considerations—for example, special needs family members for whom long-term care is important? There are trusts specially designed to address these concerns. How much to endow these trusts with can be objectively determined. Third, does the nature of your wealth require special considerations? Whether to retain a successful business enterprise or see to its orderly disposition should not be ignored. If the business is particularly sensitive to your unique contributions, its monetization during your lifetime must be considered. Fourth, are you passionate about a specific charity? Many individuals have a strong desire to leave a portion of their wealth to one or more charities where they were actively involved or were otherwise passionate about the cause. Your testamentary documents become particularly important if you have a closely-held business and anticipate that the residue of your estate will pass to charity.

Most people can paint the landscape above in broad strokes, but struggle with the details. That's not a problem. Clear articulation of detailed goals is not required to get started—instead, start by taking incremental but meaningful steps employed through flexible structures to address the goals you can identify now.

If you proactively plan, over time there will likely be more assets transferred to family, friends, and/or the charities of your choice.



Wealth transfer planning

The planning process for your wealth transfer plan

2 How do you plan?

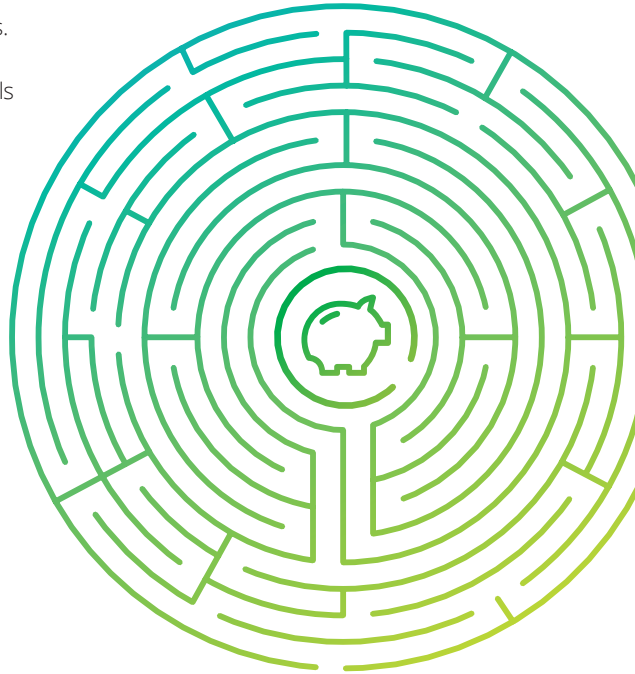
Flexible planning increases complexity. More complex transfer planning options can often provide greater flexibility and the ability to transfer more wealth and appreciation at a lower transfer tax cost to you. However, prior to implementing such options, two considerations should be addressed. First, should you have an infrastructure in place that will help you navigate the complexity (for example, a family office)? Second, you need to appreciate your level of risk tolerance because certain options may attract greater scrutiny by federal or state tax authorities. Your team of advisors is there to help you asses these considerations and select the right tool(s) for the identified task.

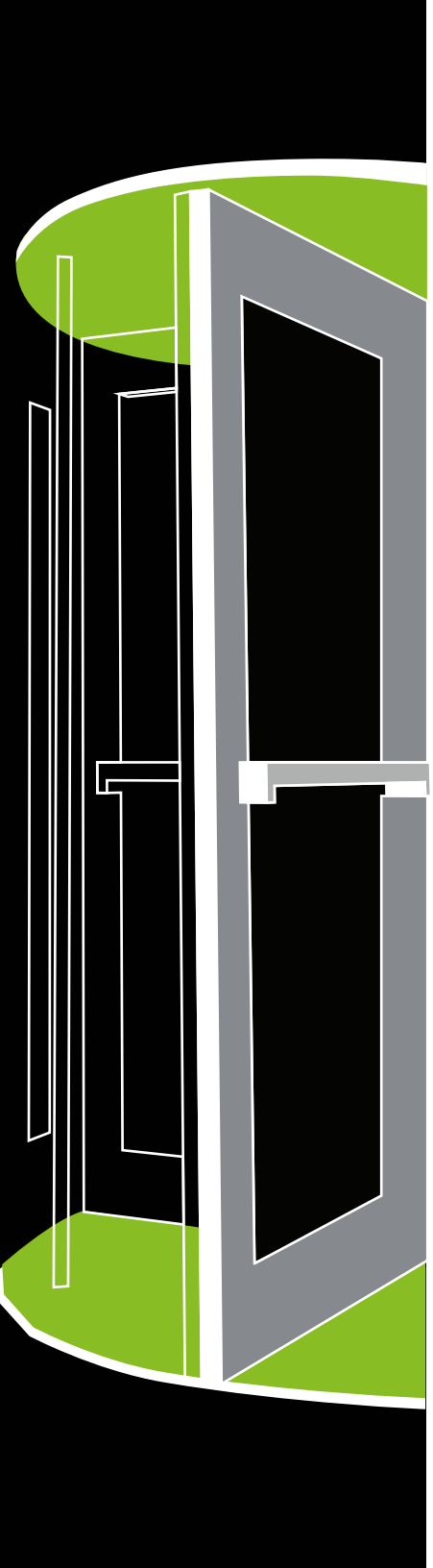
3 How will you distribute your wealth?

In some instances you may want your heirs or charity to have immediate access, control, and enjoyment of the assets you transferred to them. In other instances, you may consider placing constraints on your heirs' ability to access wealth. Many individuals transfer assets to trusts so that a third party (either an individual, corporate trustee, or private trust company) can oversee the access to wealth of the trust beneficiaries. Establishing trusts to hold, manage, and invest assets, rather than giving individuals complete control over assets, is almost universally the key to maintaining family wealth for generations to come.

Remember that when you transfer assets to a trust or an individual, you no longer have control over or access to those assets if you intend for them to be removed from your taxable estate. Consequently, it is paramount that you assess, with your advisors, the wealth required to maintain the lifestyle you desire before transferring large amounts of wealth beyond your control.

Establishing trusts to hold, manage, and invest assets, rather than giving individuals complete control over assets, is almost universally the key to maintaining family wealth for generations to come.





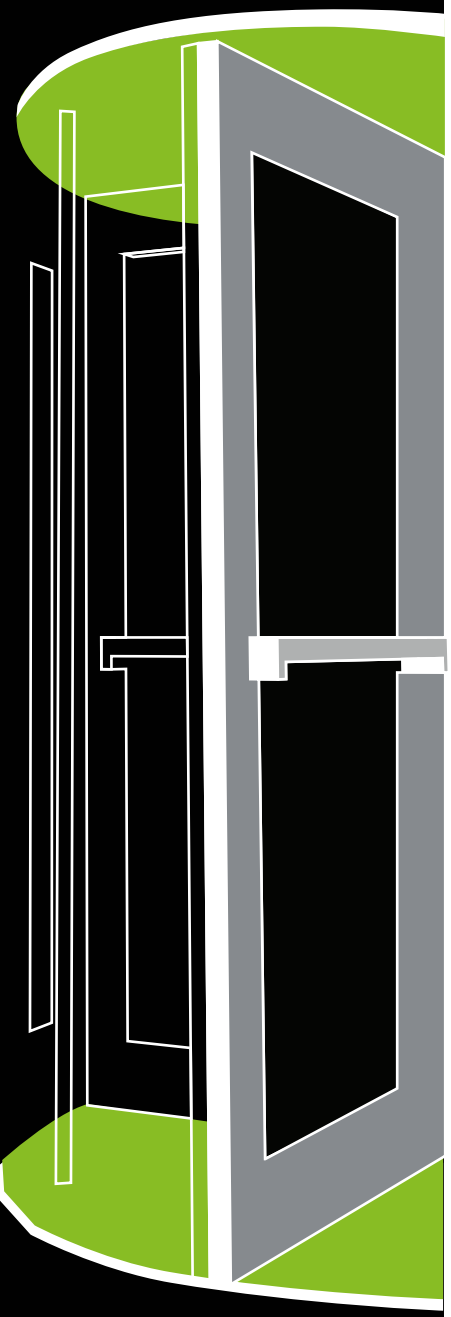
The planning process for your wealth transfer plan

4 How do you stay in check?

Once you have a plan in place, it is a leading practice to review your plan with your advisors on a regular basis. There will be market and regulatory factors and life events that will occur, some with little or no warning. Such events may require that you reevaluate your plan, determine whether and to what extent your goals have changed, and may suggest actions required to address the change in goals, much like where we started at Step 1.

Exercising a little discipline with respect to your wealth transfer plan will yield significant results relative to the goals you have identified—particularly if you start early.

Once you have a plan in place, it is a leading practice to review your plan with your advisors on a regular basis.



Wealth transfer planning

The transfer tax system—a primer

A well-constructed wealth transfer plan considers tax-efficiency as part of the overall plan. After all, increasing tax efficiency can provide for greater wealth transfer to heirs and/or charity.

The transfer tax system includes three separate taxes: the gift tax, the estate tax, and the generation-skipping transfer (GST) tax. While politically sensitive in the current environment, given the considerable debate over these taxes during the last 20 years, it is safe to conclude at this time that these taxes are here to stay.

Gift tax basics

Most uncompensated transfers of property during life are subject to the federal gift tax. The gift tax is computed based on the fair market value of the property transferred. For 2016 and 2017, the top gift tax rate is 40 percent.

Not all transfers generate transfer tax

The following transfers are excluded in determining the total amount of gifts that are subject to tax:

- Gifts utilizing the lifetime gift tax exclusion
- Gifts that qualify for the gift tax annual exclusion
- Certain education and medical gifts
- Certain gifts to your spouse
- Gifts to qualified charitable organizations
- Transfers to certain qualifying organizations (including some political organizations) that have been granted a specific status by the Internal Revenue Service (IRS)
- Non-gift transactions

The lifetime gift tax exclusion

The amount of property that each person can transfer tax-free is referred to as the applicable exclusion amount. The applicable exclusion amount is used to calculate the credit available to offset the gift tax calculated for current-year transfers. The applicable exclusion amount, which has been indexed for inflation annually since 2012, is currently $5.45 million in 2016 and will increase to $5.49 million in 2017.

The transfer tax system—a primer

Gift tax annual exclusion

In addition to the lifetime gift tax exclusion amount, each individual taxpayer is allowed an annual exclusion from gift tax for certain gifts valued up to $14,000 per recipient, which is also indexed for inflation, but only in increments of $1,000. To qualify for the gift tax annual exclusion, gifts must be of a present interest. A present interest implies that the beneficiary has a substantial present economic benefit arising from the gift property.

Many outright transfers qualify for the annual exclusion, including gifts of cash, marketable securities, and income-producing real estate. Transfers under the Uniform Transfer to Minors Act and funds contributed to section 529 educational savings plans qualify as present interest gifts by statute. However, most transfers involving restricted access to the transferred assets will not qualify. For example, most transfers in trust cannot qualify as a present interest unless the beneficiary is given the immediate right to withdraw the value of some or all of such transfer out of the trust. Similarly, transfers of interests in certain family investment entities, which do not consistently distribute earnings to their owners, may not qualify for the annual exclusion.

The power of annual gifting

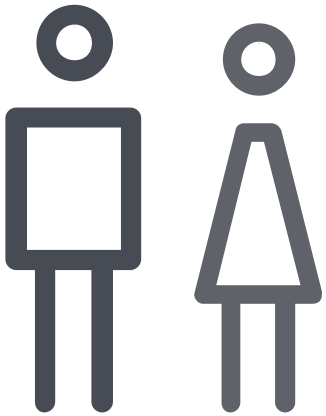
Assume a couple has three children. In 2017, this couple can transfer up to $28,000 per child, or $84,000 to all three children. If each child has a spouse, the maximum amount that can be given to the children and their spouses is $168,000 without utilizing any of the couple's combined $10.98 million applicable exclusion amounts. If the couple has grandchildren, the ability to further reduce their taxable estates through annual gifts expands.

Education and medical gift exceptions

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

Gifts to your spouse

Outright gifts to your spouse, assuming the spouse is a US citizen, qualify for an unlimited marital deduction and are not subject to gift tax. Gifts to non-citizen spouses are instead subject to an annual exclusion limitation ($148,000 and $149,000 for 2016 and 2017, respectively).



The transfer tax system—a primer

Gifts to qualified charitable and other tax-exempt organizations

Certain gifts to qualified charitable organizations qualify for the gift tax charitable deduction and are not subject to gift tax. This includes transfers to donor advised funds. For gifts after December 19, 2015, the gift tax also does not apply to transfers to certain qualifying organizations (including some political organizations) that have been granted a specific status by the IRS.

Non-gift transactions

Non-gift transactions may include such transfers as a sale of property between family members for full and adequate consideration, or an intra-family loan arrangement that provides for adequate interest. Other more sophisticated techniques, including the use of the classic zeroed-out grantor retained annuity trust (GRAT), can also result in a non-gift transaction. In many cases, although the transfer results in no gift, it is prudent to nonetheless adequately disclose the transaction on the transferor's gift tax return in order to start the statute of limitations on that transfer.

Estate Tax Basics

The estate tax is imposed on the fair market value of all assets includible in your estate at the time of your death less debts and expenses and what remains of the applicable exclusion amount. The only permitted reductions to the taxable estate are the value of assets passing in a qualified manner to one's spouse and the value of qualified assets passing to qualified charities. Generally, the estate tax exemption is what remains of the applicable exclusion amount not utilized through gift transfers. The applicable exclusion amount for 2016 is $5.45 million, increasing to $5.49 million for 2017. Generally, if the total of one's gross estate and prior gifts exceeds the applicable exclusion amount, the excess is taxed at the top marginal transfer tax rate of 40 percent in 2016 and 2017.

Transfers to a spouse who is a US citizen are covered by the unlimited marital deduction, so such transfers may be made totally free from estate tax. Thus, with proper planning, the estate transfer tax for married individuals can be deferred until the death of the surviving spouse. However, leaving all of your assets to your surviving spouse does not eliminate the need to develop an estate plan for the entire family, nor is it necessarily tax efficient. Most transfers to qualified charities are covered by an unlimited charitable deduction.

The estate tax is imposed on the fair market value of all assets includible in your estate at the time of your death less debts and expenses and what remains of the applicable exclusion amount.

Generally, upon the death of an individual, the assets included in the estate of a decedent receive a "step up" in basis. The heirs of the estate receive a basis in the assets equal to the fair market value at the date of death. Thus, except with respect to specific exceptions, any inherent income or gain in appreciated assets at the date of death is extinguished.

The transfer tax system—a primer

A note on portability

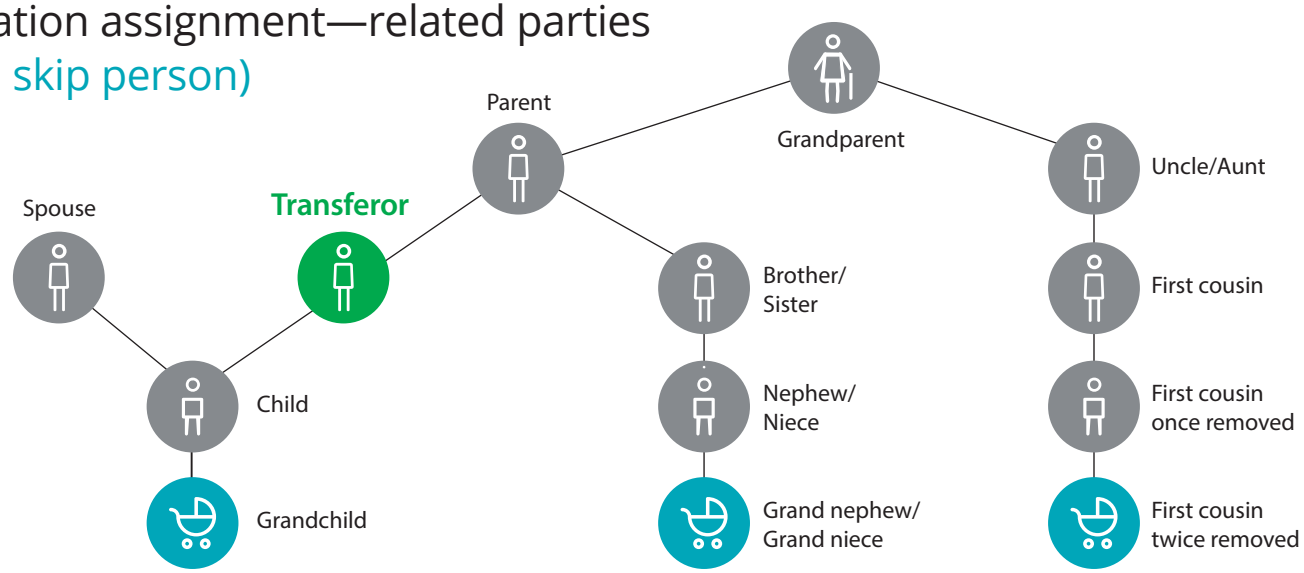
Beginning in 2011, a surviving spouse can use his or her own basic exclusion amount ($5.45 million in 2016, $5.49 million in 2017) plus the unused exclusion amount of his or her most recent deceased spouse to offset the tax on the survivor's subsequent gifts or to offset his or her estate. The deceased spouse's unused exclusion amount will not be available to the surviving spouse unless the executor of the deceased spouse's estate makes a portability election by filing an estate tax return and computes the amount to which the surviving spouse is entitled. Note that the GST tax exemption is not portable.

As favorable as the potential simplicity promised by portability is, it is not an effective replacement for good estate planning, particularly for high net worth families. Family wealth may likely be better preserved where both spouses each have wealth equal to at least their basic exclusion amount and affirmatively plan its use.

GST tax basics

The GST tax is imposed in addition to the gift and estate tax on transfers or bequests made to a "skip person"—a recipient who is at least two generations younger than the donor or decedent, such as a grandchild. If there was no GST tax, a transfer to a grandchild would be subject to the gift or estate tax once, while a gift to a child who then gifts or bequeaths those assets to a their child would be subject to transfer tax twice. The GST tax is intended to tax the gift or bequest to the grandchild twice at the time it is made (through both the gift/estate tax and the GST tax), to compensate for the otherwise skipped level of tax. Furthermore, with respect to a taxable gift, the cash used to pay the GST tax is also subject to gift tax.

Generation assignment—related parties (blue = skip person)



The transfer tax system—a primer

For GST tax purposes, when a gift or bequest is made within a family, the focus is on the relationship of the transferor and the transferee and not their age difference. The age difference is important only for non-relatives.

The GST tax exemption amount permits the transfer of that amount of assets free of current and subsequent GST tax. The GST tax exemption in 2016 is $5.45 million, increasing to $5.49 million in 2017, coinciding with the gift and estate tax applicable amount. It, too, is inflation adjusted. The GST tax rate is equal to the maximum federal estate tax rate (40 percent in 2016 and 2017) for the year that the skip person receives or becomes permanently vested in assets.

There is also an annual exclusion amount available for transfers subject to GST tax. The GST tax annual exclusion amount, like the gift tax annual exclusion amount, is $14,000 for transfers made in 2016 and 2017. Unlike the gift tax annual exclusion, however, the GST tax annual exclusion is very limited for gifts to trusts.

Generation assignment—unrelated parties (blue = skip person)

Transferor

Non-Family Member
up to 37.5 years younger

Non-Family Member
> 37.5 years younger

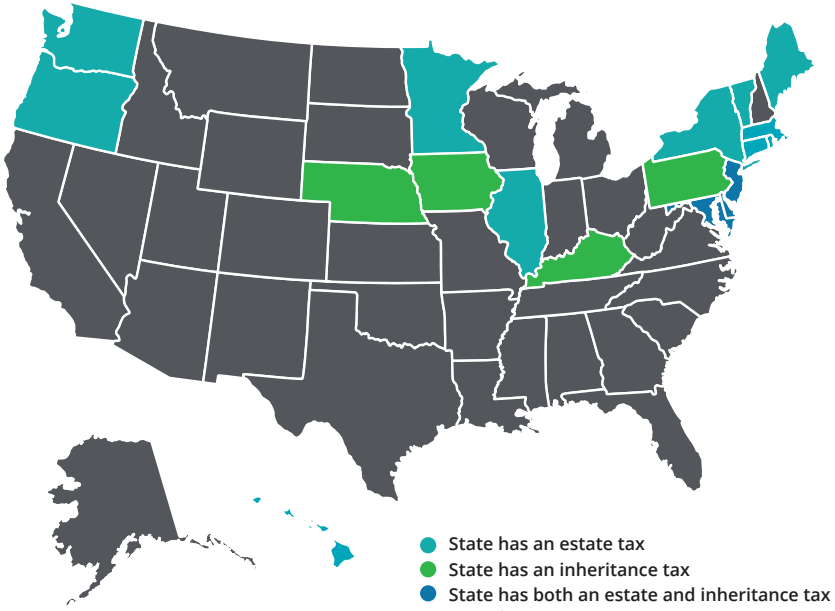
The transfer tax system—a primer

State transfer taxes

One benefit of wealth transfer planning during life—compared to death—may be the avoidance of state transfer taxes. As of January 2016, Connecticut is the only state that has a gift tax. Thus, for many wealthy taxpayers, lifetime transfers may only result in a federal tax, but transfers at death may result in both a federal and state transfer tax.

Many state transfer taxes are patterned after the federal transfer tax system; however, there are differences, and state taxes may be incurred even in situations in which there is no federal tax. As of January 2016, fourteen states and the District of Columbia impose an estate tax while six states have an inheritance tax. Maryland and New Jersey have both.

State estate and inheritance tax rate and exemptions in 2016



State	Inheritance tax	Estate tax
Connecticut		$2M; **7.2%-12%**
Delaware		$5.45M; **0.8%-16%**
Hawaii		$5.45M; **0.8%-16%**
Iowa	**0%-15%**	
Illinois		$4M; **0.8%-16%**
Kentucky	**0%-16%**	
Maine		$5.45M; **8%-16%**
Maryland	**0%-10%**	$2M; **0%-10%**
Massachusettes		$1M; **0.8%-16%**
Minnesota		$1.6M; **9%-16%**
Nebraska	**1%-15%**	
New Jersey	**0%-16%**	$675K; **0.8%-16%**
New York		$3.125M; **3.06%-16%**
Oregon		$1M; **10%-16%**
Pennsylvania	**0%-15%**	
Rhode Island		$1.5M; **0.8%-16%**
Vermont		$2.75M; **0.8%-16%**
Washington		$2.078M; **0%-20%**
District of Columbia		$1M; **0.8%-16%**

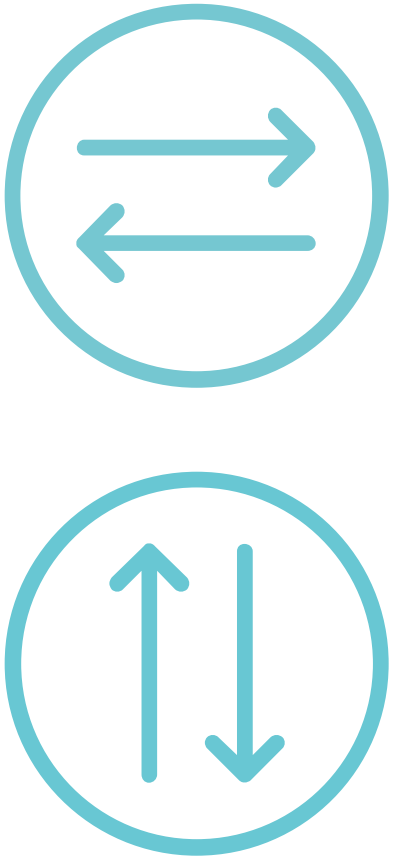
Note: Exemption amounts are shown for state estate taxes only. Inheritance taxes are levied on the posthumous transfer of assets based on the relationship to the descendent; different rates and exemptions apply depending on the relationship.

The transfer tax system—a primer

Of note, only two states with an estate tax (Delaware and Hawaii) have an exclusion equal to the federal exclusion amount and index the exclusion for inflation. Consequently, in the states that do not conform to the federal estate tax rules, an immediate state estate/inheritance tax may arise where the corresponding state applicable exclusion amount is less than the federal applicable exclusion amount and the testamentary plan is built upon the federal exclusion amount.

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

The disparity in state tax rules requires transfer tax planning efforts focused by one's state of legal domicile.



Fundamentals of effective wealth transfer planning

Armed with a basic understanding of the wealth transfer tax system, let's consider some fundamental components of effective wealth transfer planning.

The tax efficiency of transferring assets during life

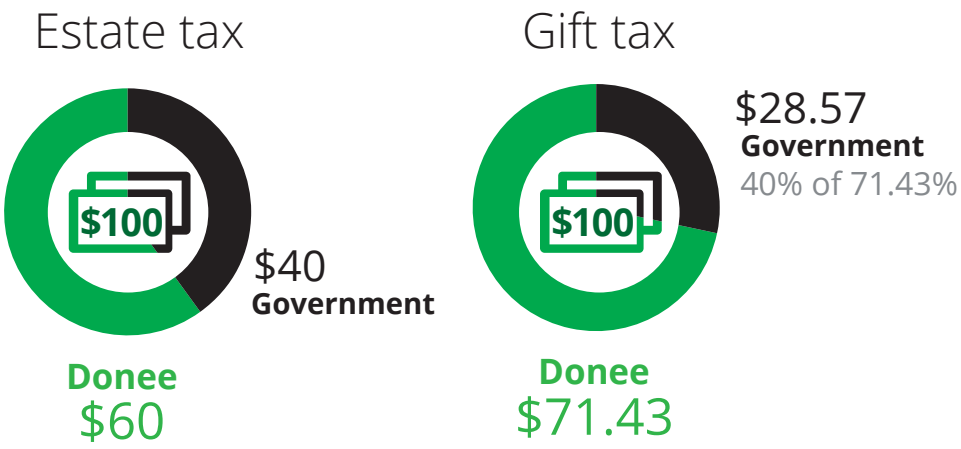
Family wealth is preserved when it is taxed at the lowest possible effective tax rate. The gift tax is assessed only on the value of the property transferred whereas the estate tax is assessed on the aggregate value of all of the decedent's wealth including the funds with which the estate tax will be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

Thus, the "tax exclusive" nature of the gift tax makes taxable gifts a generally more efficient method of transferring wealth. Federal and state governments, aware of this advantage, generally require the gift taxes paid with respect to any gifts made within three years of death be added back to the gross estate. Doing so recaptures the "tax exclusion" benefit and thereby discourages so-called "death bed transfers."

Consider this simple example:
You die with $100 and are subject to a 40 percent estate tax rate. In this case, $40 will go to the government to cover your estate tax liability, and $60 will go to your heirs.

As an alternative, let's say you elected to make a gift (and satisfy the related gift tax) of the same $100 during your lifetime. Because the gift tax is an "exclusive" tax, the amount subject to gift tax is only the amount transferred.

Assuming the same $100 is available for distribution and the gift tax rate is 40 percent, you can transfer $71.43 of the $100 to the donee, and only $28.57 (40 percent of the $71.43 transferred) would be remitted to the government to satisfy your gift tax liability. This increased transfer opportunity—$71.43 versus $60 in our example—demonstrates how much more efficient it is to transfer assets during lifetime rather than at death. This conclusion remains true even taking into account the time value of money.



Fundamentals of effective wealth transfer planning

The effective use of trusts

Trusts have been used by wealthy families for generations to protect, oversee and manage wealth, passing it from one generation to the next. Trusts regulate access to assets by beneficiaries (typically younger family members or those without the legal or mental capacity to own assets outright).

Almost any dispositive scheme imaginable can be accomplished with a trust. This requires a skilled draftsman because once the trust becomes irrevocable, changes, while possible, are problematic. Moreover, trusts follow state law which can limit both the trust's duration and a trustee's conduct. Thus, choosing the governing state law is an important consideration.

Whether a trust is regarded for income and transfer tax purposes depends upon, among other things, the participation of the settlor (*i.e.*, the person who created the trust). Complications may arise if the settlor retains either an economic interest in or broad powers over trust assets, or when the grantor's spouse is a beneficiary of the trust. For example, a revocable trust, while legally binding, has no tax significance at all. In contrast, an intentionally defective irrevocable trust (IDIT) is legally binding and should be regarded for estate tax purposes; but, due to the settlor's retained powers, may be disregarded for income tax purposes. Accordingly, care must be exercised in these situations that the trust agreement support the intended result—because the result can be very meaningful for wealth transfer tax purposes.

An IDIT can be excludible from the grantor's estate. However, the grantor recognizes and pays income tax annually on the trust's taxable income. As such, the trust does not consume its own assets to pay taxes and the grantor is in essence making tax-free gifts to the trust with the payment of such taxes.

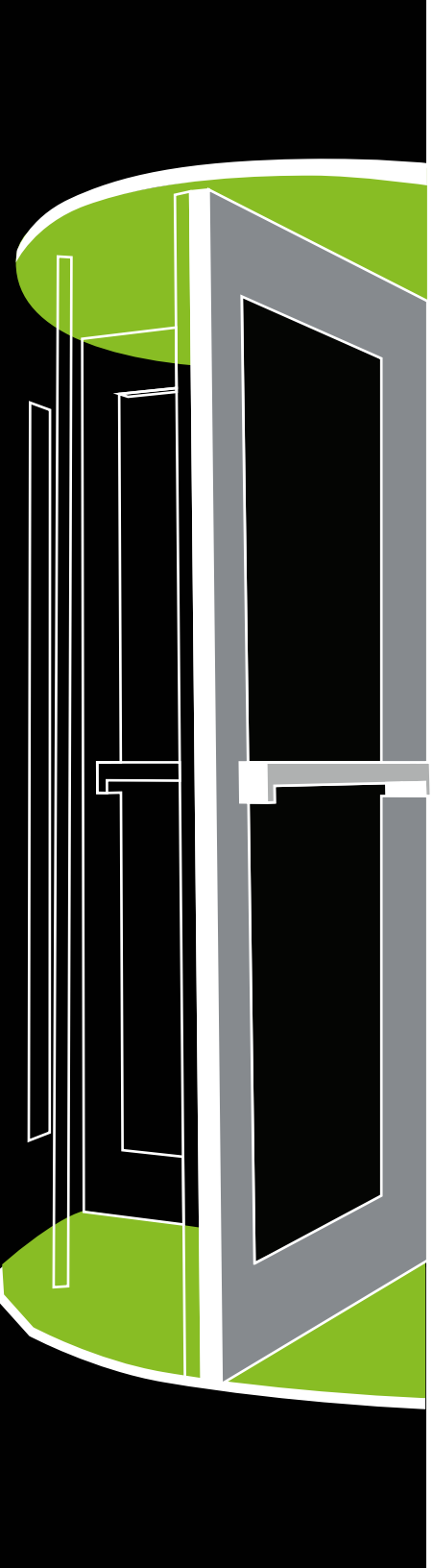
The importance of valuation

For many wealthy taxpayers, the $5.49 million exclusion ($10.98 million per couple) for gifts made in 2017 is more than enough to cover their wealth transfer goals—thus reducing the need for more complicated wealth transfer transactions.

Others may decide to gift minority interests in closely-held businesses, fractional interests in real estate, interests in private equity funds, or in other investment entities, such as family investment partnerships or limited liability companies. Traditionally, a minority interest in a closely-held family enterprise are valued at less than its proportionate share of going concern value (for a business enterprise) or net asset value (for an investment entity) due to valuation discounts applied for lack of control and/or marketability. Such discounts allow for more effective wealth transfers, as interests in these family owned enterprises may be passed at a relatively lower transfer tax value.

Proposed regulations under section 2704

On August 4, 2016, the Treasury Department and the IRS published proposed regulations under section 2704. If the proposed regulations remain unaltered and unchallenged, they may significantly reduce minority and marketability discounts when determining gift and/or estate tax values of interests in family-controlled entities. If, and then when, these regulations are finalized, while they will not affect how wealth transfer planning is undertaken, they will require such planning to consider relatively higher values for affected assets than is currently the case.



Fundamentals of effective wealth transfer planning

The family uses of leverage

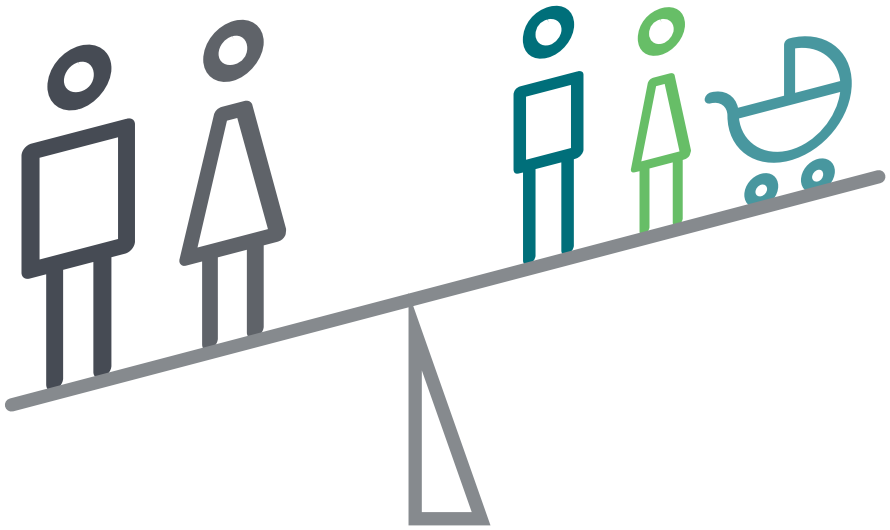
Parents can loan money to their children, trusts for their children (especially grantor trusts) or entities owned by their children and charge interest at the IRS-prescribed applicable federal rate (AFR), the minimum rate required to be charged between related parties. In today's interest rate environment, the AFR is significantly lower than the rate at which most individuals would be able to borrow from a bank.

The borrowed funds would be invested in assets (perhaps assets acquired from the grantor) anticipated to earn a rate of return greater than the interest rate being charged by the lender. If the asset performs as predicted, the child, trust or business will accumulate wealth without a transfer tax being imposed on the parent. Of course, there may be gift tax consequences if the asset does not perform as predicted. The advantage of lending and selling assets to a grantor trust is that the grantor (who is also the lender) will not need to report or be taxed on interest income related to the loan or gain related to the sale of assets.

Transferring value can be independent from transferring control

Many wealthy individuals are reluctant to make lifetime transfers of wealth because they feel that they will lose their ability to manage or control the assets. This fear of relinquishing control can often delay or completely derail the implementation of effective wealth planning.

One's gross estate also includes assets to which the decedent once held title but transferred without full compensation, in a manner where he or she continued to enjoy the assets, their income, or had the power to determine who would enjoy the assets or their income. The classic example is a revocable trust holding title to assets held for the benefit of the grantor—the assets of such a trust are included in the gross estate at their date of death value.



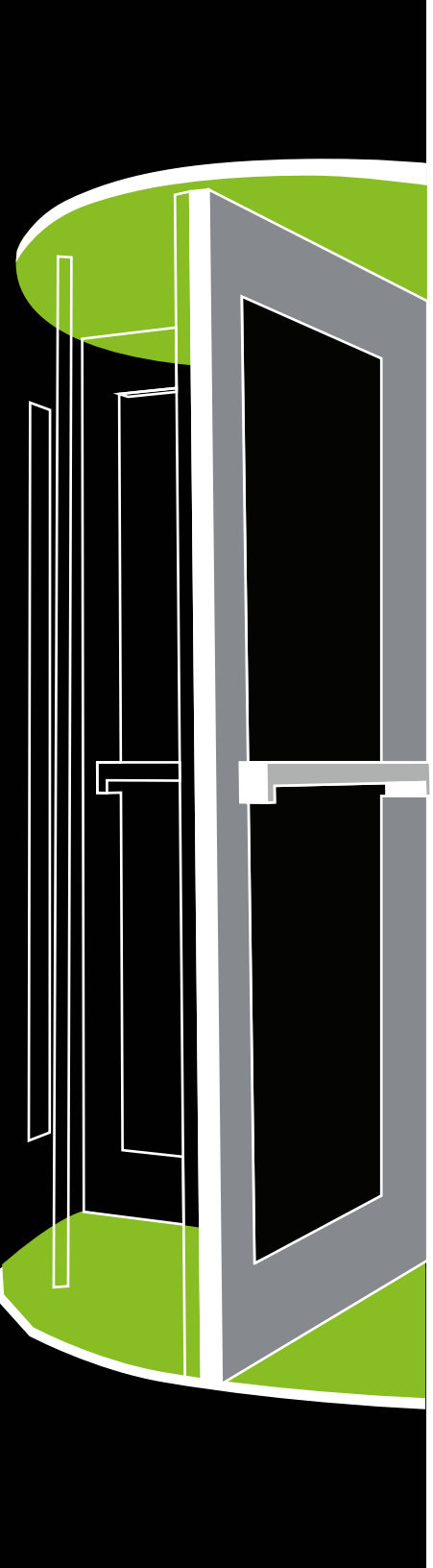
Fundamentals of effective wealth transfer planning

Transfer tax planning will be effective only where the decedent relinquished both the economic benefits of the transferred property and the control of those benefits.

This treatment, however, has been extended to trusts for the benefit of others and to partnerships and corporations to which the decedent contributed assets in exchange for an equity interest. If the decedent was found to have retained too much control, the value of the transferred assets at the date of death will be included in the gross estate, not the value of the equity interest. Consequently, transfer tax planning will be effective only where the decedent relinquished both the economic benefits of the transferred property and the control of those benefits. Given these complications, it is highly recommended that a strong governance structure be established to monitor the transferor's relationship to the transferred property in order to mitigate the estate inclusion risk.

A related but separate concern is that lifetime transfers will result in unproductive heirs. Many wealthy individuals believe that their children are unaware of the family's wealth and that lifetime transfers of wealth will act as a disincentive, permitting the children to pursue an unacceptable lifestyle.

Effective planning can address these issues—but it requires striking a fine balance in order to satisfy the senior generation's concerns with the ability to achieve the desired financial and nonfinancial goals. For example, where a family business is included in a family's holdings and the senior generation seeks to maintain decision-making authority, value may be transferred to junior generation family members through the use of nonvoting (or low-voting) interests. Further, assets transferred to the junior generation are often placed in trust, and the dispositive terms of those trusts can be thoughtfully crafted to address a particular family's goals and objectives. However, as indicated above, at some future point transfers of interests in these entities may be subject to valuation under section 2704.



Wealth transfer planning

Moving forward

A critical and often overlooked element of wealth planning is keeping plans and directives up to date, particularly as assets grow or relationships change.

Assembling your planning team

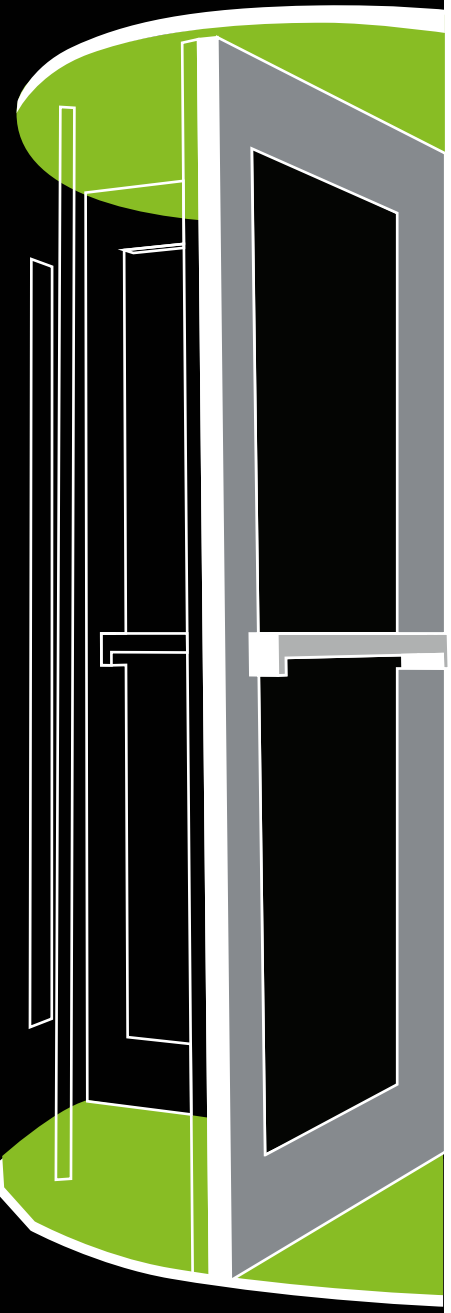
The more wealth involved, the more complex the relationships and the more people typically involved. The more input, the more ideas that may result—but in the wrong situation it may also produce more pressure. At a minimum, planning should involve a married couple—hopefully on the same page—as well as an attorney and tax and investment advisors. It is not uncommon for attorneys to interview both individuals separately to validate that they are both able to express their views and interests openly. Beyond that, you will need to consider family dynamics and relationships. At the appropriate time, you will need to involve the next generation and others in a position of trust—such as designated fiduciaries (executors, personal representatives, trustees, agents, etc.)—to communicate and confirm their understanding of your wishes and expectations.

As with many aspects of estate planning, there is no one-size-fits-all formula for choosing the right fiduciary; much depends on the size and complexity of your estate. Many wealthy families opt for a combined corporate/individual approach to serve as fiduciary—including an individual who understands the family dynamics and interests, such as the need to treat a certain child's bequest differently from others, and a corporation that professionally approaches trust administration. Having one capable individual who may fulfill both roles offers some advantages, but keep in mind that when one family member is in a position of making decisions on behalf of others, there may be conflicts. In these cases, plans may be drafted to help reduce personal fiduciary liability for issues related to conflicts of interest.

Reviewing and updating your plans

A critical and often overlooked element of wealth planning is keeping plans and directives up to date, particularly as assets grow or relationships change. While life events such as marriages, divorces, deaths, or births should prompt an analysis of plans, so too should certain market factors—for example, substantial increases or declines in asset values, sharp changes in the interest rate environment, or significant tax law changes.

For example, many individuals have taken the step to quantify the estate tax liability due if the individual should unexpectedly pass today, based on the existing estate plan. Such an analysis will test the written word in the estate plan against the mathematical computation necessary to determine the estate tax due. From the review, it is likely that additional considerations may be identified and ambiguities in the wealth transfer plan will be encountered, both of which may require further clarification. Thereafter, regular analysis provides the opportunity to monitor your plans and your progress in prefunding wealth-transfer strategies in light of a changing regulatory environment and a volatile economy. In addition, the review allows you to verify that these strategies remain relevant to your goals and objectives.



Wealth transfer planning

Now it's your turn

The success you've already enjoyed has required vision, creativity, planning, edification and perseverance, as all great endeavors do. Why should your legacy planning be different? The same focus can serve a great purpose—planning for your legacy and, indirectly, your family's financial future. Most people wait outside this door too long—open the door, sit down with your advisors and start the dialogue. You'll be grateful you did.

Unique investments

Individuals, family offices, and asset managers are increasingly interested in diversification tools for investment portfolios. Examples of these may include art, airplanes, and yachts. Each of these unique investment classes presents specific tax issues, in addition to practical and personal considerations.

Art

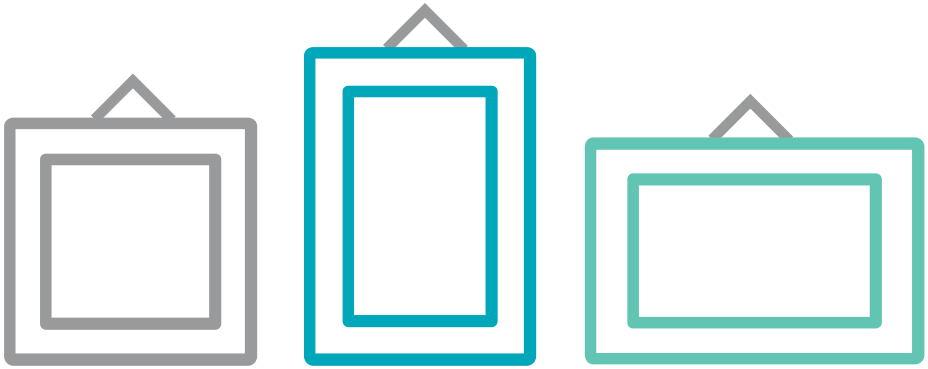
Gift and estate tax planning

For individuals and families who maintain an art collection as a substantial portion of their wealth, gift and estate tax planning can be particularly important. The illiquid and hard-to-value nature of artwork makes it a special asset for planning purposes. Examples of considerations include structuring lifetime gifts or bequests at death. These transfers may occur in specialized situations, from simple transfers to heirs to more complex transactions, including partnerships, dynasty trusts, and split-interest trusts. If the decedent transfers these assets to family members upon death, the estate plan should consider how the taxes attributable to the art collection will be paid, given the illiquid nature of the assets.

Philanthropy and charitable planning

Individual donors may be able to take advantage of significant income, estate, and gift tax deductions for charitable donations of art to cultural institutions. 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 for charitably inclined taxpayers may include more complex gifts, including fractional donations and charitable remainder trusts.

For art and other tangible personal property with a long-term holding period, the charitable deduction is the asset's fair market value only if the property will be put to a use related to the exempt purpose of the donee charity. If the art is not used by the charity in its exempt function (*i.e.*, related use) for three years after donation, then the donor must recognize income equal to the difference between the fair market value deduction taken and the basis of the property at the time of donation. This recapture can be avoided if the donor obtains a letter from the charity stating that the property was in fact used in the exempt function, how it was used, and certifies that such use has become impossible or infeasible. There is a special penalty of $10,000 imposed on charities who inappropriately and fraudulently certify property as being "related-use property."



Art

Fractional gifts of art

Taxpayers should also be aware of the tax issues related to fractional gifts of art. Prior to the Tax Reform Act of 1969, it was possible to donate artwork to a museum, retain the life estate, and receive an immediate income tax deduction. Congress was concerned that art donors were benefiting from the increase in value as the art was on display in a museum setting. As the value increased, donors would donate additional, more valuable fractions with the hope that the value of the deduction would increase over time. The Pension Protection Act of 2006 established two restrictions as follows:

- **Time limitation:** Art must be completely donated by the earlier of 10 years or the death of the donor, or the income tax deduction will be recaptured and a 10 percent penalty tax will be imposed
- **Value limitation:** Value of subsequent fractional gifts based on the value on the date of the first fractional donation (only subsequent depreciation, not appreciation, is considered)

Fractional donations of art are still a very attractive charitable planning alternative, allowing one to spread a gift over a number of years to reduce the limitations on the charitable deduction allowed. However, taxpayers should be aware that there is no longer an enhanced income tax deduction for subsequent donations.

Valuation considerations

If an executor is tasked with selling a collection through a private sale or public auction, then the executor must plan for the income and transfer tax implications. In any estate or gift-planning situation, valuation will be an important consideration, as will auxiliary costs of insurance, storage, and shipping. Very rarely will clients leave a bequest to sell their art and distribute the proceeds to their children. An executor's biggest worry is getting the art into the right auction, at the right auction house to maximize proceeds. The Internal Revenue Service (IRS) is likely to accept the selling prices as the value for the estate tax return and the selling costs will be allowed as an estate tax deduction. Most clients will leave their art to their heirs—valuation is likely to be the major issue between the IRS and the executor. The IRS can challenge deductions for insurance, storage, and shipping if it appears the expenses were for the convenience of the heirs, rather than falling clearly within estate administration costs.

The IRS has established the Art Advisory Panel, which includes up to 25 renowned art experts. If a taxpayer's individual, gift, or estate tax return is audited and the value of the art reported on the return exceeds $50,000, the IRS will refer the case to its Art Appraisal Services Group. This group will then leverage the Art Advisory Panel to review and assess the valuation used to determine the value reported on the return. Alternatively, taxpayers can proactively request that the IRS review the appraisal prior to filing an income, gift, or estate tax return. Following the review, the IRS will issue a statement of value and the taxpayer can report the agreed-upon value on the return to avoid possible penalties from being assessed on gift and estate tax returns.

Art

The bottom line is that if the art is expensive, or the estate is that of the actual artist, the estate should retain the foremost valuation expert in the particular artist. There is a strong likelihood that the IRS will review the values claimed for the art on the income, gift, or estate tax return, and the IRS may challenge the values reported if the taxpayer does not obtain a statement of value.

Import and export considerations

In some instances, obtaining artwork, collector's pieces, antiques, or cultural property may involve exporting the item from one country and importing it into another. In such cases, it is important to consider both the departure and arrival countries' export and import laws and restrictions prior to acquiring and transporting the item across borders. For example, certain types of art, artifacts, and antiquities may be restricted or prohibited from export and/or import based on cultural property laws, international agreements, restrictions on materials, formalities on documentation, and other complexities. The assessment of customs duties depends on the proper tariff classification of the item, as determined by factors, such as the detailed characteristics of the item, its age, the circumstances of how it was made, and/or whether the item is a functional object or a collectible as defined by the customs authorities. In some cases, items may be eligible for duty-free treatment. Finally, the proper valuation of the item for export and import purposes must be considered.

The investor must analyze these issues and effectively navigate the complex, global import and export regulations that govern the cross-border movement of artwork, collector's pieces, antiques, and cultural property to identify possible duty reduction planning.

Art

Value added tax (VAT) and goods and services tax (GST)

There are potential VAT/GST consequences to consider where art is sold, purchased, leased, donated, or simply moved across borders in today's increasingly globalized economy. More than 150 countries in the world have some kind of VAT/GST system. With VAT/GST rates ranging up to 27 percent, it is important to fully understand the applicable rules in order to take steps to manage VAT/GST to limit significant additional costs. In the art world, in particular, there are often special tax regimes and complex VAT rules that can apply where goods are sold by auction or donated/loaned to institutions, making it even more important to plan in advance and take steps to correctly understand the position. Consideration should be given to navigating the complex VAT/GST world to mitigate the risk of unnecessary VAT costs to the investor personally or to a business.

US sales and use tax

In the United States, 45 states and the District of Columbia impose some sort of sales or use tax with differing exemptions and procedures. As a result, owners, dealers, and collectors will need to consider the potential sales or use tax consequences on purchases and/or delivery within the continental United States.

Tax planning, tax compliance, and tax controversy services related to purchases or interstate movement of artwork and other collectibles are all important considerations. With each state—and with certain cities within those states—having unique tax laws, factors, such as origin, status of seller, initial delivery locations, storage, and final destination of the artwork, all impact the tax planning and compliance process. It is important to identify potential issues and tax-saving considerations up front and before the transactions have occurred, so sales and use taxes do not become an unwanted additional expense or surprise.

Unique investments

Airplanes

Every private flyer is looking for the most efficient way to fly at the best possible price. Whether you are a wealthy individual, a closely-held business owner, an entrepreneur, or any other type of aircraft user, the issues involved in flying private are complex.

The decision to purchase

In situations where it is difficult to predict usage, it usually makes sense to start out by chartering an aircraft or purchasing a flight card until you have a better understanding of how often, how far, and how many people will be flying with you. Especially, if passenger loads will tend to vary widely from trip to trip, the flexibility of charter and flight cards may be advantageous, as they allow you to size the aircraft to meet each flight's requirements.

You may not need to actually buy a plane to fly private. The truth is that the costs and responsibilities of such a large purchase may not match the investment. For the majority of those who need private aircraft, there are attractive partial ownership options.

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Option	Description	How many passengers per trip	Advantages	Disadvantages
Full ownership	You or your entity owns the plane	Your choice, within your aircraft's seating capacity limits	• Full control over every aspect of the plane: crew, maintenance, inspections, hours flown, and passengers • Depreciation benefits	• Full liability • Equipment wear and tear, which affects residual value • Variable operating costs • Bears direct cost of repositioning the plane
Fractional ownership	You or your entity typically owns 1/16 to 1/2 of an aircraft through a third party (a fractional share provider)	Can be scaled to the specific trip needs	• Lower up-front capital outlay • Guaranteed plane availability • Depreciation benefits • Choice of plane size • Planes are professionally managed and maintained • No charges (generally) for deadheading or repositioning costs • Possibility of guaranteed plane buyback	• Can be relatively expensive to use per hour • Planes are used more heavily • There are limits on peak flying dates • Liability could be high, depending on whether the owner or operator is in operational control
Joint ownership	You sign an FAA-sanctioned agreement to share the cost of operating an aircraft	Limited to the size of the plane purchased specifically by the joint owners	• More cost effective per hour than fractional ownership • Depreciation benefits	• Less flexible • Finding a responsible partner • Aircraft availability
Chartering	You contract for services on a trip-by-trip basis or use the services of a charter broker	Can be scaled to the specific trip needs	• Flexible • Cost effective • Less liability • Ideal when flight usage is sporadic or difficult to predict	• Inconsistency in service experience and costs • Less convenient or less consistent as other choices • Additional advanced notice needed to schedule flights • Competition for peak usage periods • Fuel surcharges, pilot wait charges, landing fees and deadhead hour charges
Flight cards	You purchase either a block of flight hours or a specific dollar balance	Can be scaled to the specific trip needs	• Price competitive with charters • Allows family members to fly to multiple destinations at the same time using different aircraft	• No benefits of depreciation • More expensive per flight hour than fractional ownership hours

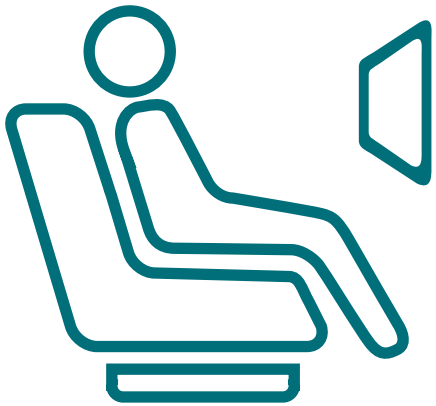
Airplanes

Ownership structure

Understanding the tax implications of flying private can help you choose the ownership structure that appropriately addresses your specific needs and circumstances. The immediate instinct of most aircraft buyers is to put the plane in a separate legal entity instead of placing it directly in an operating business in order to protect the owners from legal liability. Unfortunately, this can create significant tax problems. Payments between related entities can attract federal excise taxes, which are imposed on "air transportation." It also may create a captive charter company, which may subject it to certain Federal Aviation Administration rules applicable to operators that "carry passengers for hire." Generally, providing air transportation and carrying passengers for hire occurs when there is a single payment to one entity for both the provision of the aircraft itself as well as the provision of pilots. Individuals and families should always consult competent legal counsel and tax professionals when structuring the ownership of an aircraft.

Sales and use taxes on aircraft purchases

Many states provide exemptions from sales and use tax for the purchase of an aircraft, such as an exemption for aircraft used in interstate commerce and an exemption for leased aircraft (although the future lease payments may be subject to sales/use tax). It is important, however, to understand if one of these exceptions is met (and continues to be met for the period of the aircraft's use). The determining factor in concluding which state's taxability rules to apply is the principal hanger location for the aircraft and/or where the aircraft will be located. Individuals who are considering the acquisition of private aircraft should assess whether any sales and use tax exemptions apply prior to taking possession of the aircraft so that the proper paperwork is executed in a timely manner.



Airplanes

Deductible business expenses

One of the most important questions that must be addressed is when the cost of private aviation is considered an ordinary and necessary business expense. If business is typically conducted locally or business travel is between major cities that are regularly served by the major airlines, it may be difficult to justify the cost of private air travel as an ordinary and necessary expense of the business. A better argument exists when the business requires flights to out-of-the-way locations without ready commercial air service, the timing and duration of business flights is unpredictable, or personal security is a significant concern.

Once the ordinary and necessary requirement is met, the next issue is to determine which costs are deductible and which are not. If the aircraft is owned by an entity (other than a single member limited liability company (SMLLC) owned by an individual), costs need to be apportioned to each passenger on each flight and then allocated between business and personal (which includes personal nonentertainment and personal entertainment). If the aircraft is owned by an individual or through a SMLLC, there is a different allocation methodology to determine any expenses that may not be deductible. For purposes of determining the expenses allocated to entertainment air travel of a specified individual, a taxpayer must use either the occupied seat hours or miles, or the flight-by-flight method. A taxpayer must use the chosen method for all flights of all aircraft for the taxable year. Taxpayers should quantify the deductible costs under all allowed methodologies each year to identify the maximum business deductions allowed.

Personal travel using private aircraft

Many people start out believing they will use a private aircraft strictly for business. Once they try it for personal travel, however, they often increase personal usage steadily. This change creates tax effects that are important to understand. The American Jobs Creation Act of 2004 and its related subsequent regulations have put limitations on the deductibility of aircraft use.

Taxpayers should quantify the deductible costs under all allowed methodologies each year to identify the maximum business deductions allowed.

Airplanes

Generally speaking, aircraft use is deductible for business purposes, but it may not be deductible when flown for personal use, depending on the category of the flight. Personal aircraft usage breaks down into two categories—personal nonentertainment and personal entertainment.

Personal travel is also considered a fringe benefit provided to the employee or owner in which income needs to be imputed to the individual, or reimbursed, for use of the aircraft. Most companies, when imputing income to an executive for personal use of an aircraft, utilize the Standard Industry Fare Level (SIFL) tables. SIFL tables can require an amount of income to be imputed to the individual that is less than the actual cost of operating the aircraft. As long as the executive has compensation imputed to him or her for the flight, or reimburses the company an appropriate amount, personal nonentertainment flights can generally be fully deductible by the company.

For example, commuting is considered personal nonentertainment, but is not specifically defined in current guidance. Generally speaking, travel constitutes commuting any time you are traveling from a personal residence (defined as a residence used personally more than 10 percent of the time or for more than 14 days per annum) to your principal place of business. Accordingly, a regular pattern of travel between your place of employment and a personal residence can constitute commuting, making it a personal nonentertainment flight, allowing the company to deduct the entire cost as long as there is proper imputation of income to the individual.

If a specified individual (generally defined as an owner, shareholder, or officer of a company) flies for personal entertainment purposes, the cost of the flight is only deductible to the extent compensation has been imputed to the individual for the flight or the specified individual reimbursed the company for the cost of the flight. Personal entertainment is broadly defined and generally includes all personal travel that is not otherwise categorized as personal nonentertainment.

Additionally, spousal travel is not deductible, unless the spouse is an employee of the company and is also traveling for business purposes. However, if the spouse's travel can be considered personal nonentertainment travel (*i.e.*, they are traveling as a companion to a business event where spouses are expected/encouraged to attend), income related to the spouse's travel would be imputed to the executive, which could then (in limited circumstances) make the full cost of the travel deductible.

Selling your aircraft

Gain or loss on a disposition of an aircraft can be difficult to calculate, as there are differing methodologies for calculating basis on a disposition. The applicable methodology for calculating basis not only affects taxable dispositions of aircraft, but also affects the results of like-kind exchanges. It is important that taxpayers understand the various authorities regarding how basis of an aircraft is affected by personal use before finalizing the gain/loss calculations on a disposition of an aircraft.

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Yachts

Another asset which presents unique tax consideration is a yacht.

Yacht financing

Many of the yachts built in the United States are constructed in Louisiana and Mississippi. Yacht construction resembles home construction in some regard, but there are income tax issues related to construction loan interest that should be considered.

Generally, interest on personal use property is not capitalized. A yacht may qualify as the taxpayer's personal residence and the loan may be secured by the yacht itself. If so, the interest on a construction loan of a personal residence can be mortgage interest for up to 24 months of the construction phase. In that case, interest deductibility is limited to the same personal residence limitations and is nondeductible for alternative minimum tax purposes.

State tax issues

Title to a yacht transfers when it is delivered to a taxpayer after construction is complete and the yacht passes "sea trials." The seller of the yacht has nexus for state sales and use tax in the state(s) where it has physical presence. However, many "yacht-friendly" states have sales and use tax exemptions for sales of vessels with certain load displacements (*e.g.*, 50 tons or more). Although the "selling state" may have an exemption, if the yacht were to cruise in US waters, other states could impose a use tax at their ports if one had not yet been imposed. One possible approach, assuming the taxpayer properly qualifies, is to register the yacht in a state with a low tax to reduce a challenge to impose a sales or use tax by another state. An alternative solution is to become a foreign-flagged vessel (FFV) with a US cruising license.

FFVs

There are advantages and disadvantages to becoming a FFV with a US cruising license. Some believe that they may be safer in international waters by not flying the US flag. Also, it may allow for insulation against sales and use taxes imposed by other states. However, care should be given in selecting the proper jurisdiction (for example, Cayman Islands, Panama, Bahamas, etc.). Taxpayers should understand the initial and annual maintenance fees of a foreign registry, which may include registration fees, tonnage fees, company formation, document recording, inspection tariffs, etc. Additionally, it may be seen as detrimental that in order to enter and operate in US waters for pleasure, an FFV must obtain a cruising license and important restrictions will apply.

Operating costs

Yacht operation is typically handled through a management company. For a fee, the management company will handle the crew, maintenance, books and records, and compliance with applicable rules and laws. Yacht operating costs are significant with annual operating costs typically running 10 percent or more of the acquisition cost.

Chartering activities

Chartering may become a very appealing option to offset the costs of owning a yacht. Chartering income typically may be offset by a portion of operating and maintenance costs, as well as depreciation. The management company would handle the details, but it would also take a commission. For an FFV, the yacht can only be chartered and operated outside of US waters.

Yachts

Finally, there are special considerations for the income tax treatment of a yacht that is operated for both personal and charter purposes ("mixed use property"). Determining the portion of yacht expenses that are deductible is a complicated calculation. The taxpayer should engage tax advisors familiar with these rules to reduce the potential challenges by the IRS of the deductibility of costs.

Dispositions of yachts

Ultimately, if the investor chooses to dispose of the yacht, then there are additional unique income tax considerations. If the yacht is chartered, a portion of the related gain, if applicable, is ordinary income to the extent of prior depreciation allowed or allowable. Also, based upon the extent of historical personal use, any prior suspended losses may not be utilized to offset any gain upon sale and are lost. Additionally, any loss realized on the sale of the yacht cannot be recognized. If the restrictions for a personal use vessel do not apply, then any passive losses may be "freed up" upon disposition of the activity. It should be noted that an FFV cannot be offered for sale in the United States.

Yacht operation—income tax treatment of mixed use property

Chartering

Does the high net worth individual charter the yacht to unrelated persons?

Multiple courts have treated yachts as an "entertainment facility" under section 274. As such, expenses are non-deductible.

Exception applies for "operating a pleasure cruise ship as a business". Treas. Reg. § 1.274-2(f)(2)(ix). Chartering will permit an allocable share of expenses to be deductible.

Personal Use

Does the high net worth individual use the yacht for the greater of 14 days or 10% of the days chartered?

Chartering activity is a section 162 activity but could be subject to the passive activity loss rules under section 469 and may be susceptible to the hobby loss rules under section 183.

Yacht classified as section 280(A) property. Allocable expenses ***in excess*** of charter income not deductible—carried forward to offset income in future years.

Resources

Private wealth	Private Wealth: Sustain, enhance and protect your wealth
Tax policy and elections	Tax News and Views
Individual income tax planning	Private wealth tax controversies: Deep experience navigating interactions with taxing authorities
	US Estate and gift tax rules for resident and nonresident aliens
Wealth transfer planning	Wealth Planning: securing your legacy
	Private Foundations: Establishing a vehicle for your charitable vision
Unique investments	Art & Finance: Art is your passion...Tax is ours
	Private aircraft: Flying private makes sense for those with the right information

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