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Trust UPDATE

Stillman BANK

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Year-end planning in the shadow of tax reform

Tax and portfolio planning as each year draws to a close always involves some guesswork about the future, about one's income fluctuations, about the state of the financial markets. This year we have one additional variable: Will the tax code itself be overhauled? How might that alter the calculus?

The "Uniform Framework for Fixing Our Broken Tax Code," released by the Trump administration at the end of September, promised tax relief for middle-class families. If one can be confident that taxes will be lower in the future, the normal course is to defer income and accelerate deductions. But it will be hard to have such confidence, given the information at hand.

The proposal calls for a consolidation of today's seven tax brackets into just three: 12%, 25%, and 35%. There is no indication of the bracket boundaries, but presumably they will move higher. However, the proposal leaves the door open to a fourth bracket for the highest-income taxpayers. Just how high that fourth rate might be is unknown, but many observers expect it to be at least 40%.

If enacted, the proposal would eliminate the need for year-end tax planning for many taxpayers. It would achieve this by a doubling of the standard deduction, which is already taken by a majority of taxpayers. However, the personal exemption would be eliminated, so this change is not so generous as one might first suppose. For families, the loss of a personal exemption for children would be offset by a new child tax credit, details as yet unknown.

Under the framework the Alternative Minimum Tax would be eliminated. For individual taxpayers, the AMT may be the single greatest source of tax complexity, and its elimination would be most welcome. The AMT "no longer serves its intended purpose," according to the report.

For investors, the most important element of the September tax reform outline was the dog that was not barking—the tax treatment of capital gains and losses was not mentioned.

Retirement plans

Major changes are not proposed for the tax incentives for saving for retirement or education, but legislators are "encouraged to simplify these benefits to improve their efficiency and effectiveness." However, there are two items to watch out for. Each might be tapped to "pay for" other tax changes.

• ***Elimination of "stretch IRAs."*** There has been considerable support in the Senate Finance Committee for requiring the distribution of an inherited IRA over five years, instead of over the life of the beneficiary. The rule would likely not apply to a surviving spouse. It also would likely apply only prospectively.

• ***"Rothification" of employer retirement plans.*** Some 401(k) plans already include a Roth option; that is, current deferrals are subject to income tax, and future distributions are tax free. A proposal to put more employer plans on this basis would accelerate near-term tax collections,

while lowering them in the longer term. A change along these lines might help the legislation meet budget targets.

Itemized deductions

Most itemized deductions would be eliminated under the framework. "Tax incentives" would be retained for the home mortgage deduction and for charitable contributions. However, the incentives may no longer be simple deductions. They may be capped, or the benefit could be limited, perhaps to no more than 25% of the expense.

The loss of the state and local tax deduction could hit some taxpayers in high-tax states hard, but for much of the country the doubling of the standard deduction would more than offset the loss.

A taxpayer who lives in a high-tax state may want to consider accelerating payments and deductions for state and local taxes. However, that runs the risk of triggering the AMT.

Charitable contributions may be worth more this year than next year, for taxpayers whose marginal rate will be going down.

Prospects for tax reform

By late October, Republican Congressional leaders were expressing the hope that tax reform legislation would be completed by Christmas this year. Given the failure of Republicans to enact health insurance legislation of any kind, many observers believe that getting something done on tax reform has become essential. Passage of a budget by the Senate that allowed for $1.5 trillion in tax cuts over the next ten years kept the dream for tax reform alive.

Still, there were hints from President Trump and Treasury Secretary Mnuchin that the timeline might slip into early 2018.

We may not know the outcome of the process until it becomes too late for taxpayer action. Congress has been known to pass tax legislation as late as the early hours of January 1—it happened in 2013, to head off tax changes that had been scheduled to occur after December 31, 2012. ☐

Estate planning angles

The framework for tax reform calls for the repeal of the federal estate tax and the federal generation-skipping transfer tax. Estate tax repeal will be resisted fiercely by most Democrats, so it may not happen. But even if it does, estate planning may not be greatly simplified.

The future of gift taxes. The framework does not mention federal gift taxes. These may be retained so as to inhibit the intrafamily transfer of appreciated assets in order to minimize capital gains taxes. However, if the current lifetime exemption from gift taxes of $5 million (plus inflation adjustments) is retained, there still will be quite a bit of room for such strategies. Some observers question the efficiency of keeping the gift tax in place if the objective isn't really to collect gift taxes, but to bar income tax avoidance techniques.

Longevity planning. It appears that tax reform may be temporary, following the path established by the tax cuts under President Bush enacted in 2001. That is, to meet budget requirements the tax changes must expire after 10 years, unless they are made permanent in the intervening years. A taxpayer who is 95 may expect to die within 10 years and rely on the absence of an estate tax; one who is 55 probably should not. What's more, estate taxes could return at any time, with a change of administration. Accordingly, death tax considerations likely will remain an essential prong of many estate plans.

What about basis? Under current law, inherited assets receive a step-up in basis to fair market value at the owner's death. This forgiveness of capital gains taxes has a large revenue cost, and it is not expected to be retained if the estate tax is repealed. During his campaign President Trump suggested that the basis step-up would be denied to estates larger than $10 million. Does that mean we will have a carryover basis, so that heirs would inherit a built-in tax liability on a lifetime of asset appreciation? Or might we adopt the Canadian system and make death a recognition event for unrealized capital gains, as a "deemed disposition"? Should that approach be taken, larger estates may need to have plenty of cash on hand to meet tax obligations.

Dynasty trust planning. A dynasty trust is one that is expected to last for several generations or, perhaps, in perpetuity in states where that is allowed for private trusts. Some dynasty trusts have been created to take advantage of the exemption from the generation-skipping transfer tax. Once created, such a trust avoids future gift and estate taxes as well. Should the generation-skipping transfer tax be repealed on a temporary basis, there could be an unlimited opportunity for the funding of dynasty trusts.

Incentive trusts

According to a report from tmz.com, Britney Spears had her will redrafted last summer. Her old will divided her assets among her children once they reach age 18. The new will creates trusts for her kids and phases in ownership of her assets—full ownership is delayed until age 35.

That approach is undoubtedly superior to turning over an entire fortune to an 18-year-old, who may not have the financial maturity for it. Still, there are plenty of folks in their 30s who remain financially irresponsible—predictions are hard, especially about the future! Who is to say which child will have the necessary money management skills at any particular age?

Many affluent families are exploring an idea that has been around for quite a while, which may be termed an *incentive trust.* In addition to providing financial security for heirs, they hope to promote responsible behavior and instill family values. They achieve this by having the trust recognize and reward the meeting of goals.

Is a trust of this sort an attempt to "rule from the grave"? That depends upon the level of specificity of the incentives. One needs to be especially cautious about trust provisions that touch upon religion, sexual orientation, or ethnicity, as these may run into public policy limitations. Rewards for good behavior won't be problematic. See "Ideas for incentive trust provisions" for strategies that have been successful.

Besides, who is to say that ruling from beyond the grave is such a bad thing? The assets belong to the person creating the trust, not the beneficiaries.

Another point to consider for Ms. Spears. Unless she meets with a horrible accident, her children are likely to be more than 35 years old by the time that her will is submitted to probate, hopefully decades from now. Distributions tied to goals may prove more durably effective than those tied to the simple attainment of an age.

A charitable incentive

There are many cases of non-charitable incentive trusts that permit distributions to charities, private foundations, or donor-advised funds. In those situations, family members may be actively involved with the distribution decisions, guiding the ways in which trust assets will be used to further the family's philanthropic goals.

Another twist sometimes employed is that if a beneficiary fails to meet specified goals or performance standards, a distribution will be diverted from that beneficiary to a charity.

The trust boomlet

Over the next 30 to 40 years, the baby-boom generation is expected to transfer $30 trillion to $40 trillion to their heirs. In many cases, that much capital deserves professional supervision for its care and feeding. That may be one reason why the use of trusts has grown over the years. It's been estimated that in 1995 some 12.5% of estate plans used one or more trusts in furtherance of planning objectives. Today that figure is estimated at 40%.

Incentive trusts are poised to become as standard in future estate plans as marital deduction trusts have been in the past. To learn more about how trusts may be incorporated into your wealth management strategies, please arrange to speak with one of our trust professionals soon. ☐

Ideas for incentive trust provisions

- ★ Education costs for the family in perpetuity
- ★ Lump sum received at college graduation or for advanced degrees
- ★ A clause to encourage descendants to marry
- ★ Medical costs for the family in perpetuity
- ★ To help fund the purchase of a home
- ★ Deny trust benefits unless the beneficiary has a prenuptial agreement
- ★ Divorce protection
- ★ Family bank, to provide loans for family members
- ★ Denial of distributions for drug test failure
- ★ No-conflict clause—benefits denied to beneficiaries who challenge trust terms
- ★ Monthly stipend to stay-at-home parent
- ★ Monthly stipend to adult child caring for elderly relative
- ★ Supplement income for certain professions—artist, musician, or teacher, for example.

Reprieve for family businesses

In 2016, by some accounts, the IRS declared war on family-owned businesses. The chosen instrument was a proposal to stem "abuses" and the creation of "artificial" discounts for family businesses. Proposed regulations normally are clarifications of the law, not revenue raisers, but this proposal was projected to raise a whopping $18 billion over ten years. We know this because similar ideas were included with revenue projections in President Obama's budget proposal in 2013.

Valuing privately held companies always has been difficult. The standard is: What would a willing buyer pay, and what would a willing seller accept, if neither were under any requirement to buy or sell? In particular, with closely held firms the issue of control becomes paramount. If one shareholder controls the enterprise, his or her share may command a premium, while the minority shareholders' interest will be discounted. The minority interest may get an additional discount if there are restrictions on selling it, as is usually the case.

These principles of tax law are nothing new. By employing discounts for illiquidity and lack of control, the transfer tax costs (gift taxes or estate taxes) could be reduced significantly for family businesses. The IRS was particularly unhappy when the new legal entity was essentially a repository for a portfolio of marketable securities.

Accordingly, the IRS proposed a new set of regulations requiring that some transfer restrictions be ignored for valuing transfers within a family (but not for sales to outsiders). The proposal was not limited to LLCs owning a securities portfolio, but also would have hit active businesses with family ownership.

The proposal was seen as a game changer by estate planning experts, and the owners of family businesses were furious. A public hearing on the proposal in December 2017 lasted six hours, and some 28,000 comments were received.

In April President Trump signed an executive order instructing the Treasury Department to review all regulations issued in 2016 to identify any regs. that impose an undue financial burden on U.S. taxpayers or add undue complexity to the federal tax laws. On October 2 Treasury Secretary Steven Mnuchin released his report on eight regulatory projects. The conclusion for the family business regulation:

"After reviewing these comments, Treasury and the IRS now believe that the proposed regulations' approach to the problem of artificial valuation discounts is unworkable. In particular, Treasury and the IRS currently agree with commenters that taxpayers, their advisors, the IRS, and the courts would not, as a practical matter, be able to determine the value of an entity interest based on the fanciful assumption of a world where no legal authority exists." The proposed Regs. were withdrawn by the Treasury on October 4. ☐

Investment management isn't a one-person job.

Put our Investment and Trust team to work for you and your family.

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