CHILTON TRUST

Tax Bulletin:
2017 Year-End Tax Planning Considerations

PAUL F. NAPOLEON, *Senior Vice President & Head of Tax Services*

On December 2, 2017, the full Senate passed its amended version of the Tax Cuts and Jobs Act. This Bill now goes to a joint committee (conference committee) of House and Senate members who will try to reconcile the differences in the House and Senate bills and arrive at a compromised version. Republican legislators from high-tax states, however, have some concerns and may be looking for more concessions (e.g., concerns about the repeal of the state and local income tax deduction). The compromised version of the Bill, if any, will then be sent to both chambers of Congress for approval. It is difficult to predict when (or if) the Bill will be finalized, but the goal is to pass the final version of the Bill before the holiday recess. If Congress passes the Bill, it then goes to President Trump for signature.

Given that tax reform is likely, now is the time to finalize year-end planning strategies that could help to minimize your 2017 tax liability. Please note that this is for informational purposes only and is intended to provide you with some general year-end tax planning considerations and strategies. It is not intended to be used as a substitute for individualized professional tax advice. Any questions regarding the applicability or effectiveness of anything discussed herein should be discussed with your legal and tax professionals.

1. **Review Estate Planning Documents** – You should confirm that your estate planning and insurance documents engender an outcome consistent with your objectives; if not, engage your team of professional advisors to amend documents as needed. For example, review any credit shelter trusts to determine applicability, review how property is owned; designate or change beneficiaries; review your will, health-care proxy, and durable power of attorney as well as the guardians for minor children, if applicable, to ensure consistency with the overall goals of your estate plan. Consider revising your Will or estate documents if your family circumstances have changed, such as for a birth, death or divorce. If you have changed state residency since you last executed your Will, consider executing a new Will to reflect your new state of domicile.

2. **Annual Exclusion Gifts** – The most commonly used method for tax-free giving (non-charitable gifts) is the annual gift tax exclusion, which for 2017, allows a person to give up to $14,000 to each donee without reducing the donor's estate and lifetime gift tax exclusion amount (see below). The annual exclusion amount for 2018 has increased to $15,000. If you decide to make annual exclusion gifts, you should take action now to ensure that the transfer is considered completed for gift tax purposes before the end of the year, i.e., if you are making a gift by check, be sure the donee deposits the check in 2017. Generally, it is better to make these gifts at the beginning of each year rather than at year-end, since the principal and earnings would have a longer time to compound. You should note that the $14,000 per donee annual exclusion applies to present interest gifts only. A gift is considered a present

interest if the donee has all immediate rights to the use, possession, and enjoyment of the property or income from the property. Additionally, for a gift in trust (e.g., Irrevocable Life Insurance Trust), each beneficiary of the trust is treated as a separate donee for purposes of the $14,000 annual exclusion. To the extent that you are making annual exclusion gifts via trust or through a 529 plan, please be sure that you are not "doubling up" on such gifts outside of those vehicles. Finally, there is an unlimited gift and GST tax exclusion for any tuition paid **directly** to a school or for medical care payments made **directly** to a healthcare provider on someone else's behalf. Moreover, note that this unlimited exclusion would NOT apply if you gave the funds to the student or patient who then, in turn, uses the funds to pay for tuition or medical services. Lastly, note that the educational exclusion does not apply for non-tuition items such as room and board, books, fees, etc. Payment of such items would utilize the $14,000 annual exclusion (to the extent not already consumed for the year) and then, any excess would utilize a portion of the gift tax exclusion amount.

3. **Gift Tax Exclusion** – The gift (and estate) tax applicable exclusion and Generation Skipping Transfer ("GST") tax exclusion for 2017 is $5,490,000. For 2018, the applicable exclusion is expected to increase to $5,600,000. In addition, the highest transfer tax rate (gift, GST, & estate) on taxable transfers remains at 40%, applied after the utilization of the gift tax exclusion. *However, note that if the proposed tax legislation is enacted, the applicable exclusion amount would double to $11,200,000 per donee, starting in 2018.*

4. **Grantor Retained Annuity Trusts ("GRAT")** – In addition to using your annual exclusion gifts and gift tax applicable exclusion, consider a more advanced planning strategy by making gift-tax free transfers using a GRAT. A GRAT is an irrevocable trust through which the grantor retains an annuity interest for a brief term of years (generally, 2 – 5 years), after which the remainder of the trust is payable to named beneficiaries of the trust (usually, children or trusts for their benefit). The IRS establishes a "hurdle rate" (2.6% December 2017) for a GRAT's asset appreciation and any excess value over the "hurdle rate" at the end of the annuity term will be transferred to the GRAT beneficiaries gift tax free and would be excluded from the grantor's estate. If the grantor passes away during the term of the trust, the assets will not be excluded from his/her estate. In cases where the GRAT does not exceed the "hurdle rate", the assets are simply returned to the grantor as part of the annuity payments. GRATs work best with assets that are likely to appreciate rapidly and when interest rates (which are used in determining the hurdle rate) are low. Note that there have been budget proposals to limit the benefits of a GRAT by imposing a minimum trust term of 10 years, and requiring the trust to have a remainder interest greater than zero. Therefore, if you are interested in taking advantage of a GRAT, you should be encouraged to do so before any potential legislative action curtails the use of this strategy as it currently exists.

5. **Intentionally Defective Grantor Trust ("IDGT")** – An intentionally defective grantor trust is an irrevocable and complete transfer (i.e., a taxable gift using a portion of the grantor's lifetime gift tax exclusion) to a trust for estate and gift tax purposes but is an incomplete (defective) transfer for income tax purposes. To make the trust irrevocable for estate and gift tax purposes, the grantor cannot retain any powers that would cause estate tax inclusion (e.g., rights to income or principal or powers to determine beneficial enjoyment of the trust property). Hence, the IDGT

should be distinguished from the GRAT discussed above, where the grantor can retain a beneficial interest in the trust for a term of years. The benefit to the IDGT, however, is that the value of the assets transferred (plus future appreciation) is removed from the grantor's estate on the date of the gift to the IDGT. Therefore, the IDGT removes the mortality risk inherent in the GRAT strategy. To make the trust "defective" for income tax purposes, the grantor retains certain limited powers that cause the trust to be treated as a grantor trust for income tax purposes. As a result, the grantor (not the beneficiary) pays the tax on the income generated by the trust. This is a significant benefit in that the payment of income tax by the grantor will not be regarded as a taxable gift by the grantor to the trust beneficiaries who are directly benefited by the payment. The income tax payment also reduces the grantor's taxable estate. Furthermore, because the grantor pays the income taxes incurred by the IDGT, the value of the trust assets is not diminished by the taxes, thus allowing a greater value to pass to the remainder beneficiaries. IDGTs can also be a very effective way to accomplish multi-generational planning by making use of the donor's generation-skipping transfer ("GST") tax exemption. By allocating a portion of the donor's GST exemption equal to the value of the assets used to fund the IDGT, the trust assets and any appreciation can pass estate, gift and GST tax free to future generations.

6. **Qualified Personal Residence Trust ("QPRT")** – A QPRT is an irrevocable trust that holds the principal residence or vacation home of the grantor with the goal of transferring the home to the trust's beneficiaries at a discount from the home's current fair market value. The grantor reserves the right to occupy the residence for a term of years specified in the trust agreement (the "QPRT term"). Upon expiration of the QPRT term, ownership of the residence will pass to the remainder beneficiaries of the trust. At that time, the grantor can make an agreement with the beneficiaries to rent the home at fair market value. This is an excellent way to further reduce the grantor's estate. However, if the grantor passes away during the QPRT term, the value of the residence will not be excluded from his/her estate. Note that only the value of the remainder interest in the QPRT constitutes a taxable gift to the trust.

7. **Intra-Family Loans or Sales** – Intra-family loans can be an efficient way to lend money or sell assets to a family member, or to a trust for their benefit (such as an IDGT), in exchange for a promissory note bearing interest at the applicable federal rate ("AFR"). The grantor could structure this transaction in a manner that may result in no gift tax cost if (a) the value of the promissory note equals the value of the sold assets and (b) the promissory note bears an interest rate sufficient to avoid an imputed gift to the borrower, i.e., the interest rate should be at least equal to the AFR for the type and term of the note. Any appreciation of the sold assets exceeding the interest rate on the note passes to the holders free of gift or estate tax. It is important to document any intra-family loans or sales with a written agreement between the parties and those records are kept of all interest and principal payments by the borrower/purchaser. Furthermore, if the loan is used to purchase or improve a primary residence of the borrower, the note should be recorded as a mortgage so that the borrower may deduct any interest payments as qualified mortgage interest.

8. **Capital Gains/Losses** – A couple of strategies to consider this year, depending upon the gains or losses already realized in your portfolio, include (1) the possibility of utilizing carryforward losses from 2016 by recognizing gains to the extent of the available carryforwards, preferably short-term gains, if any, since they are taxed at the ordinary income rates, and or (2) if

appropriate available, harvesting capital losses to offset realized capital gains, if it makes sense and is congruent with the taxpayer's investment strategy to dispose of those assets in 2017. Take note of the "wash sale rule" which prohibits the loss on sale of stock or securities if, within 30 days before or after the sale, the taxpayer acquires substantially identical stock or securities. However, the wash sale rule does not apply to the sale of securities at a gain, thus, you can sell a security and realize the gain to be used against a carryforward loss, and then repurchase the same position and receive a step-up in tax basis. Again, any decision to sell should be driven by economics and not by taxes alone. In addition, be sure to balance transaction costs with the amount of tax savings that may be achieved. *Note that if the Senate's version of the tax bill is enacted, then starting after December 31, 2017, the cost of any specified security sold, exchanged, or otherwise disposed of would be determined on a first-in-first-out (FIFO) basis, except to the extent the average cost basis method is allowable (as in the case of stock of a regulated investment company). Consequently, the specific identification method may not be permissible after 2017, if the bill is enacted, hence this could be the last opportunity for taxpayers to utilize this method of selecting share lots of securities with a cost basis that could reduce or offset capital gains from the sale of such securities*.

9. **Deferring Income/Accelerating Deductions** – When your income and corresponding income tax rates are stable from year to year, the standard methodology is to accelerate deductions into the current tax year (2017) and defer income into the next year (2018). Some examples of deferring/reducing current income include, deferring bonuses and stock options, taking only the required minimum distribution from retirement plans/IRAs, utilizing installment sales or like-kind exchange opportunities, and harvesting capital losses to offset capital gains. Conversely, consider accelerating itemized deductions into 2017 when you expect to receive a tax benefit from said deductions, i.e., not projected to be in the alternative minimum tax ("AMT") for the current year. *Given the likely repeal of the popular state and local income tax deduction, it may make sense to accelerate the payment of your fourth quarter state estimated income tax obligation to this year (2017), even if you are in the AMT. This is because you would still receive a tax benefit for net investment income tax purposes. It is critically important to crunch the numbers to ascertain the tax benefit prior to making any payments.*

10. **Charitable Gifts:**

    a. Consider making charitable gifts of <u>appreciated long-term capital gain property</u>, e.g., stock, units in a mutual fund, etc., to a public charity. As a general rule, gifts of long-term capital gain property are deductible at their fair market value on the date of contribution, subject to adjusted gross income ("AGI") limitations, i.e., 30% of AGI. Essentially, you escape paying capital gains tax on the unrealized gain and receive a deduction at fair market value. You should always obtain the required documentation for qualified charitable contributions over $250 <u>before</u> you file your tax return. *Note that the FIFO rule under the Senate bill appears also to affect gifts of appreciated stock. Consequently, tax year 2017 may be the last year an individual can specifically identify the lots of a stock that can be used as a charitable gift.*

    b. If you are charitably-inclined but are still concerned about maintaining your annual cash flow, you might

consider donating appreciated long-term capital gain property to a Charitable Remainder Trust ("CRT"). By doing so, you may receive a fixed annuity percentage (not less than 5% and no more than 50%) from the donated assets for life or specified term up to 20 years with the remainder of assets going to a charitable beneficiary (subject to a 10% minimum). Because a CRT is a tax-exempt entity, the sale of long-term capital gain property by the trust would not result in an immediate capital gain tax. Rather, any income taxes would be payable by the non-charitable annuitant as the annuity is received over time, thus, creating opportunities for capital gain tax deferral. With the exception of annuity payments you receive back from the trust, assets in the charitable remainder trust would be removed from your estate. You may also receive a charitable income tax deduction (subject to income limitations) for the actuarial value of the charitable remainder interest upon funding the trust.

c. If you are charitably-inclined and do not need the current income from a particular asset(s), you might consider establishing a Charitable Lead Trust ("CLT") and funding it with highly appreciating assets. The CLT can be set up as a grantor trust (referred to as a qualified CLT) thereby providing the donor with an immediate income tax deduction for the present value of the charity's annuity stream. However, the donor (grantor) must report the income earned by the trust even though it is paid to the charity in the form of an annuity. Note that the estate tax rules must be taken into account if the grantor trust option is chosen. Certain administrative powers are often used to obtain classification as a grantor trust for income tax purposes. The powers must be carefully chosen or limited, or the assets of the charitable lead trust could be included in the donor's estate. Alternatively, the CLT can be established as a non-grantor trust (referred to as a nonqualified CLT), in which case the grantor will not receive a charitable income tax deduction and will not be required to include the income of the CLT on his/her own tax return. Charitable Lead Annuity Trusts are particularly appealing in a low interest rate environment. There can be significant tax benefits to creating a CLT, however, the donor should be aware of the potential ramifications of the generation skipping transfer ("GST") tax. Thus, care should be taken if remainder beneficiaries could potentially be the donor's grandchildren or other skip persons.

d. The law permanently extended the Qualified Charitable Distribution ("QCD") provision as of December 2015, which allows for individuals aged 70 1/2 and older to make tax-free distributions of up to $100,000 from individual retirement accounts **directly** to a qualified charity. By utilizing a QCD strategy, the charitable distribution would not qualify for a deduction on your individual tax return, but it would automatically satisfy, in part or in whole, your annual required minimum distribution. In effect, the QCD can remove up to $100,000 of income from your adjusted gross income ("AGI") (if filing jointly with your spouse, you may make a QCD from **each of your individual IRAs**, resulting in up to a $200,000 reduction of income from your AGI). Note that QCDs are not subject to the AGI limitations that other charitable contributions are subject to, i.e. a 50% AGI limitation for cash contributions. If you believe that this could be a good avenue to complete your charitable giving plans for 2017 and beyond, please consult your IRA plan administrator and tax adviser, as there are special procedures that must be undertaken to qualify. QCDs can still be made through December 31, 2017 in order to qualify for your 2017 tax return.

11. **Tax Planning Ideas for NIIT**: Listed below are some considerations you can use to plan efficiently for the Net Investment Income Tax:

a. Make investments that are tax efficient for regular tax purposes, and they often will be tax efficient for NIIT as well. Some investments include municipal bonds (excluded from both regular tax & NIIT, tax deferred annuities (tax is deferred until withdrawn), rental real estate (depreciation deductions typically shelter cash flow), oil & gas investments (depletion and intangible drilling cost deductions are allowed for NII), growth stocks, life insurance, etc.

b. Maximize contributions to qualified plans – this will reduce regular tax in the year of contribution and defer the tax on earnings until withdrawn. Notably, retirement distributions are not subject to NIIT, although they do increase your modified adjusted gross income that is used to determine whether the NII threshold has been met.

c. Make a Roth Conversion – income on the conversion will be subject to regular tax, but is excluded from NII. Future growth will be excluded from NII and regular income tax when distributions are withdrawn, if certain requirements are met. See below for further discussion on Roth conversions.

d. Income shifting for children's taxes – "kiddie tax" results in taxation at the parent's marginal tax rate for regular tax, but for the NIIT, each child's separate tax return stands on its own. For example, if each child that files a tax return has modified AGI below the $200,000 threshold, no NIIT would be assessed. However, if children's income is included on the parents return via Form 8814, that income would be subject to NIIT.

e. Distribution strategies for trusts & estates – since trust and estates are subject to NIIT on undistributed income above the $12,500 threshold for 2017, it could be beneficial to distribute the excess income to the beneficiaries if their AGI is below the individual threshold of $200,000 for single or $250,000 for married taxpayers. Additionally, fiduciaries should consider using the "**65-Day Rule**", which allows the fiduciary to treat a distribution to a beneficiary made within 65 days of the end of the tax year as having been paid or credited on the last day of the preceding tax year. The 65-day election gives fiduciaries additional time to make more informed decisions related to trust distributions that might minimize the trust's or estate's tax liability.

f. Installment sales – if your gains will be subject to the 3.8% surtax, consider an installment sale, especially if your AGI without including the gain will be below the thresholds.

g. Consider funding a Charitable Remainder Trust ("CRT") (see discussion above) – trusts that are exempt from income tax, such as a CRT, are not subject to NIIT. Although annuity distributions from the CRT to non-charitable beneficiaries may be subject to NIIT to the extent such distributions consist of net investment income in the hands of the beneficiary, any undistributed amounts retained by the CRT are not subject to NIIT.

12. **Alternative Minimum Tax ("AMT") Planning** – In general, for higher income taxpayers who are in the AMT, it is usually an effective strategy to accelerate ordinary income and defer certain deductions to the break-even point where the taxpayer's regular tax and AMT are approximately equal. Essentially, it changes your tax rate. This is a very complex area of the tax code due to the interrelationship of the AMT and regular tax systems. We can assist you by analyzing your year-end tax projection to determine whether it is tax effective to accelerate/defer income and/or deductions into 2017 or 2018.

13. **Roth Conversions** – Roth conversions can become a valuable estate planning vehicle for a client that does not need to tap into their IRA. As opposed to Traditional IRAs which are subject to required minimum distribution rules starting at age 70 ½, a Roth IRA may grow tax free until death, at which point it will become part of the owner's gross estate and potentially subject to estate tax. Consider making the Roth conversion in a year when you have beneficial tax attributes available to offset any conversion income, such as net operating losses or charitable contribution carryforwards. In addition, it's more advantageous to make the conversion when the IRA asset values are depressed, e.g., during a market correction. In the event asset values decline significantly from the conversion date, the law permits you to undo a Roth conversion (recharacterization) up to October 15th of the year following the conversion. Drawbacks associated with Roth conversions include the current cash flow hit for payment of tax as well as the possibility of a decrease in future tax rates. *Note that the proposed tax reform bill eliminates the taxpayer's ability to recharacterize a Roth IRA back to a Traditional IRA.*

Chilton Trust

New York	Palm Beach*	Stamford
300 Park Avenue	396 Royal Palm Way	1290 East Main Street
New York, NY 10022	Palm Beach, FL 33480	Stamford, CT 06902
Phone: (212) 843-6882	Phone: (561) 598-6330	Phone: (212) 843-6882

Paul F. Napoleon, CPA, CFP®, CTFA is a Senior Vice President & Head of Tax Services. Paul Napoleon, CPA, CFP®, is an accomplished tax professional with over twenty-five years of tax and accounting experience, serving as a trusted tax advisor to high net worth individual clients. He specializes in designing strategies to preserve and enhance his clients' wealth and helps them build value and manage risk. He provides income, trust, and gift tax consulting and compliance services, which include equity based compensation, investment, charitable giving, and retirement planning strategies to wealthy families. Prior to joining Chilton Trust, Mr. Napoleon spent twelve years at PricewaterhouseCoopers LLP in its Personal Financial Services practice. As a tax director at PwC, Mr. Napoleon has worked extensively with high net worth individuals, family groups, closely held businesses, and corporate executives. He has significant individual, trust, and gift tax compliance and tax planning experience. Mr. Napoleon is a Certified Financial Planner, Certified Trust and Financial Advisor, and a member of the American Institute of Certified Public Accountants and the New York State Society of CPAs. He has been a speaker on individual tax matters and has authored several articles on individual tax issues for PricewaterhouseCoopers' events and newsletters.

www.ChiltonTrustCompany.com

* Fiduciary services may only be offered through the Palm Beach office.