2016 YEAR-END TAX AND WEALTH TRANSFER PLANNING

Proactive year-end planning

Suzanne L. Shier,
Wealth Planning Practice Executive and Chief Tax Strategist/Tax Counsel

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In 2016, we continued to experience a period of relative certainty and stability in our income and wealth transfer tax systems. With the American Taxpayer Relief Act of 2012 (ATRA) now firmly in our rearview mirror, individuals have become accustomed to higher income tax rates and lower interest rates, and have diligently updated their tax and wealth transfer planning strategies for the current environment. Although tax reform remains a hot topic in the upcoming Presidential election, significant changes are not expected before 2017. Still, it is important that you stay actively involved in your tax planning through year-end so that you can maximize tax savings and stay on track to meet your wealth planning goals for the short- and long-term. At this point we can only plan for uncertainty, maintaining needed flexibility and agility.

In this *Insights on…Wealth Planning*, we discuss several planning techniques that you may want to consider before 2016 comes to an end and your near-term options become more limited. As a reminder, each individual's tax situation is unique and should be evaluated with the guidance of your trusted legal and tax advisors.

YEAR-END INCOME TAX PLANNING

In the current post-ATRA pre-year-end planning environment, income tax planning is an increasingly essential part of an overall effective tax and wealth transfer plan. In 2016, less than 1 in 500 Americans are subject to federal gift, estate and generation-skipping transfer (GST) taxes (transfer taxes) due to the current generous gift and estate tax exclusion amount of $5.45 million (up to $10.9 million for married couples) and the GST tax exemption of $5.45 million, and a historically low maximum 40% federal transfer tax rate for taxable transfers in excess of these amounts.[1] Given the limited scope of transfer taxes and the convergence of the combined federal and state income tax rates and the transfer tax rates, many individuals can shift their focus to strategies that reduce income taxes and increase the tax basis of transferred assets.

YEAR-END INCOME TAX PLANNING ACTION ITEMS

- Accelerate deductions to 2016, defer income to 2017
- Contribute to retirement accounts
- Take RMDs from IRA and 401(k) plans
- Make tax-wise charitable contributions
- Review estimated tax payments
- Proactively plan for AMT consequences

In 2016, taxpayers are subject to the top marginal federal income tax rate of 39.6% on taxable income over $415,050 for single filers, $466,950 for married joint filers and $12,400 for trusts and estates, and subject to the 3.8% net investment income tax (NIIT) on net investment income upon reaching thresholds of $200,000, $250,000 and $12,400, respectively. Net investment income includes interest, capital gains, annuities, royalties and income from businesses in which the taxpayer does not actively participate, but does not include distributions from qualified retirement plans and IRAs. Taxpayers in the 39.6% income tax bracket are also subject to the top 20% long-term capital gains tax rate. Additionally, 44 states levy individual income taxes with top marginal rates ranging from Pennsylvania's 3.07% to California's 13.3%. As a result, many taxpayers face income tax rates exceeding 50%.

Taxpayer	Taxable Income to Which the 39.6% Rate Applies in 2016	Taxable Income to Which the 39.6% Rate Applies in 2017
Single Filers	Over $415,050	Over $418,400
Heads of Households	Over $441,000	Over $444,550
Married Filing Jointly and Surviving Spouses	Over $466,950	Over $470,700
Married Filing Separately	Over $233,475	Over $235,350
Estates and Trusts	Over $12,400	Over $12,500

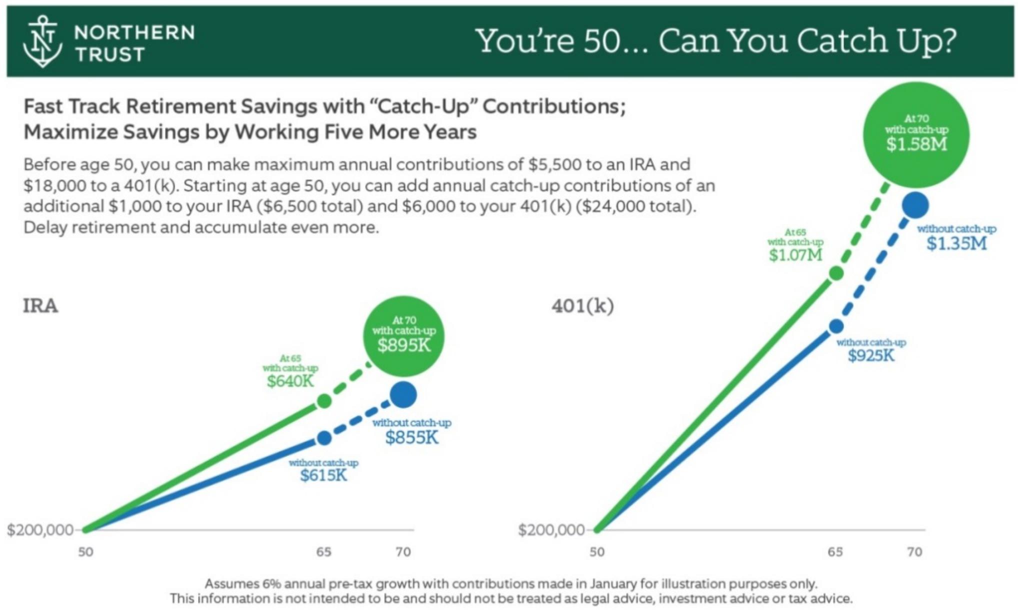
Ordinary Income Tax Bracket	Long-Term Capital Gain and Qualified Dividend Tax Rates
10%, 15%	0%
25%, 28%, 33%, 35%	15%
39.6%	20%

Accelerate Deductions, Defer Income

When possible, defer income and accelerate losses and deductions for potential tax savings. Tax reform proposals from both sides of the aisle are taking aim at the itemized deductions claimed by "high income" taxpayers, so use them before you lose them. Consider prepaying property taxes or deductible medical expenses in December instead of waiting until January 2017. Remember, itemized deductions are subject to phase-out beginning at adjusted gross income (AGI) of $259,400 for single filers and $311,300 for married joint filers. Decisions with respect to timing should take into consideration the Alternative Minimum Tax (AMT) as well as the effect of future spikes in income as a result of current deferral.

Contribute to Retirement Accounts

Year-end is an ideal time to review and reevaluate your plan for retirement to help make sure you stay on track. The average 65-year-old retiree will live an additional 19.3 years in retirement. If you haven't saved enough, there may still be time. If you are turning age 50 in 2016, you may make an additional catch-up contribution of $6,000 (for a total of $24,000) to your 401(k) and an additional $1,000 (for a total of $6,500) to your individual retirement account (IRA). However, you cannot make contributions to your traditional IRA in the year you reach age 70½ or thereafter. Contributions to your IRA may be tax-deductible depending on your income level, and 2016 IRA (not 401(k)) contributions may be made by April 17, 2017. Making additional catch-up contributions to your IRA or 401(k) can have a significant effect on your retirement savings, as illustrated below.



Take Your RMD to Avoid Penalties

If you have a traditional IRA or 401(k),[2] you must withdraw your required minimum distribution (RMD) by December 31, or a 50% penalty may apply. If you turned age 70½ in 2016, you may be able to defer your first RMD (for 2016) to April 1, 2017 (but you will have to withdraw two RMDs in 2017). RMDs are subject to tax as ordinary income, but are not subject to the 3.8% NIIT.

Make Tax-Wise Charitable Contributions

For those who are charitably inclined and desire to obtain the current income tax benefit of a charitable contribution, there are many tax-wise options to consider before year-end. One simple option is to make a cash (or check or credit card charge) contribution to your charity of choice, as cash contributions are always appreciated.

Donate *appreciated* marketable securities that you have held for more than one year to a public charity to avoid recognizing the taxable gain for income tax purposes and for a potential full fair market value income tax deduction. If instead you sell the appreciated marketable securities and donate the after-tax proceeds, both you and the charity will receive less of a benefit, as illustrated below.

	SCENARIO 1 Sell appreciated marketable stock held for more than 1 year with $0 basis and donate cash proceeds to charity	**SCENARIO 2** Donate appreciated marketable stock held for more than 1 year with $0 basis directly to charity
Fair market value	$100,000	$100,000
Federal capital gains tax paid	$100,000 appreciation x 23.8% = $23,800	$0 ($23,800 avoided)
Total donated to charity	$76,200	$100,000
Federal income tax deduction (before phase-out)	$76,200 x 39.6% = $30,175	$100,000 x 39.6% = $39,600
Total potential tax benefit	**$6,375**	**$63,400**

Not sure who to give to? Make your tax-wise charitable contribution to a donor-advised fund (DAF). A DAF allows you to potentially receive an income tax deduction in the current year for the entire contribution (subject to certain AGI limitations and phase-outs) and then recommend grants from the DAF to qualified public charities over time. If there are restrictions on charitable contributions under future tax laws as have been proposed, your current deduction will not be affected. If you sold your business or otherwise had a spike in income this tax year, a contribution to a DAF could mitigate your current tax exposure.

QCD Your RMD

If you are at least age 70½ and looking for a tax-savvy option to satisfy your RMD obligation for 2016 and benefit a public charity of choice, consider making a Qualified Charitable Distribution (QCD) from your IRA. A QCD allows you to make a direct distribution of up to $100,000 of RMD per year per taxpayer from an IRA to a qualified public charity (but not to a DAF). Note that the dollar limitation is per taxpayer. If the specific requirements are satisfied, a QCD is excluded from your gross income and so may result in lower income taxes when compared to a taxable IRA distribution followed by a tax deductible contribution of the after-tax cash proceeds.

Additionally, QCDs are not subject to the phase-out for itemized deductions and do not count towards the annual AGI limitations for deductible charitable contributions. Excluding the RMD income from your AGI could also keep you below the income thresholds for purposes of the 3.8% NIIT and increased Medicare Part B premiums.

One mandatory requirement is that the distribution from the IRA administrator *must* be made payable *directly* to the charity. If the funds are made payable to the IRA owner and are then passed along to the charity, it is a taxable distribution to the IRA owner and not a QCD.

Review Estimated Tax Payments

The federal income tax is a pay-as-you-go system. When income is not subject to tax withholding, or when withholding is insufficient, you must make quarterly estimated tax payments. If you underpay, a penalty may be imposed. Accordingly, you need to project your anticipated tax for the year in order to withhold a sufficient amount or make adequate estimated payments to avoid penalty. Generally, you may owe an estimated tax penalty for the current year if the total of your withholding and estimated tax payments for the year do not equal at least the smaller of:

- 90% of 2016 tax liability;
- 110% (or 100% for married taxpayers with AGI $150,000 or less) of 2015 tax liability; or
- 90% of 2016 tax liability based on quarterly annualized year-to-date income.

The amount required to be paid (cumulatively) for 2016 taxes by each due date for calendar-year taxpayers is shown in the table below:

Cumulative amount of estimated taxes to be paid	**Due Date and Period**			
2016 Tax Payment Method	**April 15, 2016 (1/1 – 3/31)**	**June 15, 2016 (1/1 – 5/31)**	**Sept. 15, 2016 (1/1 – 8/31)**	**Jan. 17, 2017 (1/1 – 12/31)**
Current year's tax	22.5%	45%	67.5%	90%
Prior year's tax – safe harbor for AGI $150,000 or less	25%	50%	75%	100%
Prior year's tax – safe harbor for AGI over $150,000	27.5%	55%	82.5%	110%

If your year-end planning indicates that you may owe the penalty for underpayment of estimated tax, either because you realized a large capital gain later in the year or because you earned more than you projected, you may be able to reduce the amount you owe and reduce or eliminate penalties by increasing the amount withheld from salary, bonuses or IRA distributions. Taxes paid through withholding are presumed to have been paid evenly throughout the year, so you may increase your withholding tax before year-end to minimize the underpayment tax penalty attributable to a prior quarter.

You may also be able to reduce the amount you owe or reduce or eliminate penalties by calculating your estimated tax payment using the annualized income installment method. To see if you can pay less for any period, you should complete the Annualized Estimated Tax Schedule in IRS Form 2210. This worksheet and instructions are included in *IRS Publication 505, Tax Withholding and Estimated Tax*. This worksheet annualizes your tax at the end of each quarter, and is based on a reasonable estimate of your annual income, deductions and other items based upon events that occurred between the beginning of the tax year and the end of the individual period. Using this method, your required installment for one or more payment periods may be less than one-fourth of your required annual payment, and could reduce your underpayment penalty.

Proactively Plan for the AMT

The AMT functions as an alternative federal income tax system that operates parallel to the regular income tax system: if an individual is already paying at least as much under the regular income tax system, she does not have to pay it; if her ordinary tax falls below this minimum, the individual will have to make up the difference by paying AMT. The AMT has its own exemption amount, as shown below; however, it begins to phase out once your taxable income exceeds the phase-out threshold (based on your filing status) at a rate of $0.25 for every $1 of taxable income over the threshold. For single and married joint filers in 2016, the first $186,300 of taxable income is taxed at a rate of 26%. Taxable income in excess of $186,300 is taxed at a flat rate of 28%. For 2017, this amount is adjusted to $187,800.

Filing Status	AMT Exemption Amount		AMT Exemption Phase-out Threshold	
Tax Year	2016	2017	2016	2017
Married filing jointly	$83,800	$84,500	$159,700	$160,900
Single or head of household	$53,900	$54,300	$119,700	$120,700
Married filing separately	$41,900	$42,250	$79,850	$80,450

Although several factors could give rise to AMT liability, certain circumstances and tax items are likely to trigger the AMT, including:

- AGI over $100,000 (the vast majority of taxpayers subject to the AMT have AGIs between $200,000 and $500,000)[3];
- Large number of personal exemptions;
- Significant amounts of miscellaneous itemized deductions;
- Significant amounts of state and local taxes paid;
- Significant capital gains;
- Significant passive income or losses; and
- The exercise of significant incentive stock options during the year.

Some of these items are treated differently for AMT purposes than for regular tax purposes and could trigger the AMT. You should complete IRS Form 6251 to figure the amount, if any, of AMT liability. Tax software programs typically do this computation as a matter of course.

The AMT is a moving target and shifting income or expenses from one year to another can affect your AMT status for both years. You should always consider the AMT consequences before implementing a strategy. A further discussion of the AMT is beyond the scope of this *Insights*, and individuals are advised to consult with their trusted tax advisors.

AMT Red Flag: Incentive Stock Options

Exercising incentive stock options (ISOs) is a red flag for triggering the AMT. The ISO preferential income – the excess of the fair market value over the strike price or exercise price – is taxable under the AMT, while it is not under the regular income tax. Thus, when an individual exercises an ISO, she must report the income as an adjustment for AMT purposes. However, the stock acquired will receive a basis for AMT purposes equal to the amount paid plus the preferential income, potentially reducing the amount of gain subject to tax at a future sale of the stock.

Example: Mary exercises an ISO to purchase 1,000 shares of her company's stock at $20 per share when the stock is trading at $50 per share. For AMT purposes, Mary must report an adjustment of $30,000 preferential income ([$50 - $20] x 1,000), which is the difference between the exercise price and the fair market value. Mary's AMT basis in the acquired stock is $50 per share ($20 paid to exercise the ISO + $30 AMT adjustment for preferential income).

YEAR-END WEALTH TRANSFER PLANNING

Tax implications are important considerations in the development and execution of any wealth transfer plan. For 2016 we continue to benefit from the federal transfer tax exclusion/exemption amounts and rates set by ATRA three years ago and the historically low interest rate environment makes traditional gifting strategies all the more attractive. However, the times are changing, and the future wealth transfer tax landscape remains uncertain.

YEAR-END WEALTH TRANSFER PLANNING ACTION ITEMS

- Transfer additional amounts tax-free
- Make annual exclusion gifts to family
- Leverage your gifts with a GRAT while interest rates are still low
- Transfer interests in family-controlled entities before the window of opportunity closes

Transfer Additional Amounts Tax-Free

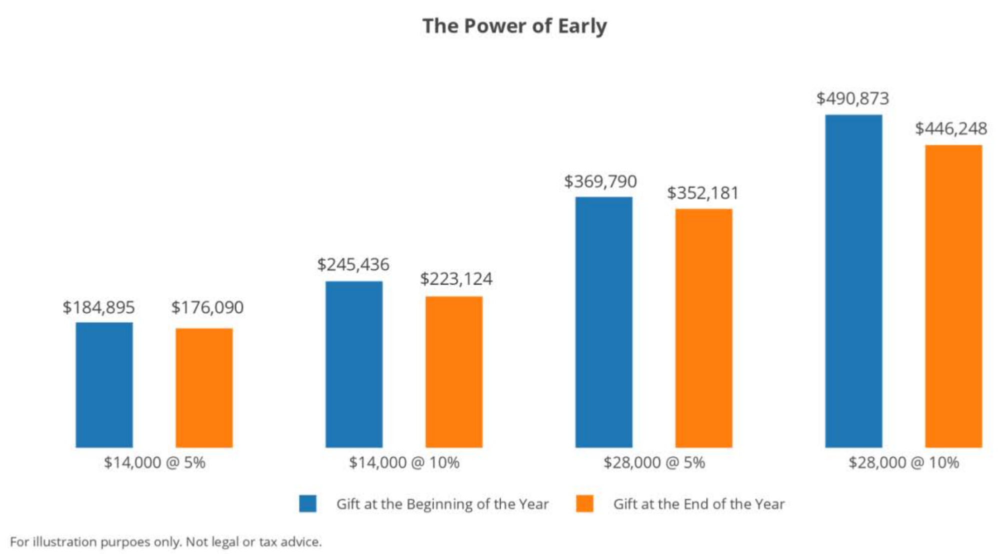
As a result of an inflation adjustment for 2016, even if you utilized your full gift tax exclusion or GST exemption of $5.43 million in 2015, the modest increase of $20,000 for 2016 provides an opportunity to make additional transfers tax-free. For transfers in excess of $5.45 million (up to $10.9 million for married couples with portability), the transfer tax rate remains set at 40%. For 2017, the inflation-adjusted exclusion/exemption amount is $5.49 million.

Make Annual Exclusion Gifts

The annual gift tax exclusion allows you to gift up to $14,000 per recipient each year ($28,000 for U.S. married couples electing to split the gift) to as many recipients you choose gift-tax free. One caveat: the annual gift tax exclusion is use it or lose it, so if you plan to use it be sure to do so on or before December 31 at the latest. If giving property other than cash, consider the following suggestions:

- To minimize potential estate tax, gift property with the greatest potential for future appreciation.
- To minimize your beneficiary's income tax, gift property that has not already appreciated significantly since you acquired it, as the beneficiary will take your income tax basis as her own for purposes of computing gain or loss on a future sale of the property.
- To minimize your own income tax, do not gift property that has declined in value (i.e., with a fair market value in excess of basis). Instead, gift other property or consider selling the property so you can preserve the tax loss and then gift the sale proceeds.

For 2017, consider making gifts early in the year as beneficiaries will benefit even more from the additional months of appreciation. To illustrate the potential benefit to beneficiaries, compare the future value of making $14,000 and $28,000 of annual exclusion gifts every year for 10 consecutive years in January to making the gifts in December, assuming 5% and 10% annual pre-tax returns.



GRATs Are Great With Low Interest Rates

When interest rates are low, grantor retained annuity trusts (GRATs) are great. The tax law requires the use of certain interest rates, known as "7520 rates," to value certain term interests in trusts for federal gift tax purposes. For October 2016, the 7520 rate is 1.6%.

GRATs are irrevocable trusts in which a grantor funds with assets in exchange for an annuity interest in the trust for a term of years, with the remainder interest passing to the trust's beneficiaries, such as children, after the end of the term. The trust pays the grantor a fixed amount of the assets held by the trust each year as an annuity. At the end of the term chosen by the grantor at the time the GRAT is established, the remainder of the trust property passes to the trust's beneficiaries. Assuming the grantor survives the trust term, which must be at least two years, the transferred assets will not be included in the grantor's gross estate.

For gift tax purposes, the value of the gifted remainder interest is determined by using the 7520 rate for the month of the initial transfer, or the 7520 rate from the prior two months if that yields a better result. If the transferred assets appreciate more than the applicable 7520 rate, the excess return inures to the benefit of the remainder beneficiaries without further gift tax.

Year-end may be an opportune time for you to transfer appreciating assets out of your estate at minimum gift tax cost. As a general rule, the lower the 7520 rate, the shorter the term required to maximize the value of the gift to the beneficiaries. To illustrate the impact of the low 7520 rate, assume you transfer a $5 million asset that appreciates at a pre-tax rate of 2% and generates income of 6% to a 10-year GRAT in September 2016 when the 7520 rate is 1.4%. At the end of the 10-year term, $3,019,781 passes to the trust's beneficiaries nearly gift-tax free. If the same transaction had been executed in May 2010 when the 7520 rate was 3.4%, only $2,164,458 would have been transferred nearly gift-tax free to the beneficiaries at the end of the term. Based on these assumptions, the lower 7520 rate creates an additional gift-tax free transfer of $855,323. The results are summarized in the following table.

Transfer Date	**September 2016**	**May 2010**
7520 Rate	1.4%	3.4%
Trust term	10 years	10 years
Transfer	$5,000,000	$5,000,000
Growth and Income	8%	8%
Gift tax value	$0.12	$1.19
Total annuity payments to donor	$5,393,045	$5,981,790
Remainder to beneficiaries	$3,019,781	$2,164,458

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Evaluate Transfers of Interests in Family Entities Before Year-End

On August 2, 2016, the Treasury Department published proposed tax regulations[4] that will dramatically change the rules for the valuation of interests in family-controlled business entities (including corporations and partnerships) if ultimately adopted as currently proposed. The valuation rules under Code § 2704 apply when an interest in a family-controlled entity is transferred to "family" and the transferred interest is subject to certain (1) lapsing rights and restrictions on voting or on liquidation, or (2) any "applicable restriction" on liquidation, subject to limited exceptions.

Although a complete discussion and analysis of Code § 2704 and the proposed regulations are beyond the scope of this *Insights*, these valuation rules are intended to prevent taxpayers from imposing restrictions on the transferred interests that are designed to reduce the transfer tax value of the interests without reducing the economic benefit to the beneficiary. If adopted in their current form, the regulations would effectively disallow the use of valuation discounts due to lack of control or due to holding a minority interest for intra-family transfers of interests in family-controlled entities for federal transfer tax purposes.

The provisions of the proposed regulations applicable to voting and liquidation rights are proposed to apply to rights and restrictions created after October 8, 1990, but only to transfers occurring after the date the regulations are published as final. Certain provisions of the proposed regulations will not take effect until at least 30 days after the date the regulations are published as final. A public hearing is scheduled for December 1, 2016, and the proposed regulations are not expected to be finalized until 2017 at the earliest.

Nonetheless, for those families looking to engage in transfers of interests in family-controlled corporations, partnerships and limited liability companies, the window to engage in wealth transfer planning to maximize current valuation discounts before the new rules take effect may be closing. It is important to remember that once gifts are made they are irrevocable, and the decision to accelerate gifting plans should consider more than just potential tax savings. If these rules apply to your family, you are advised to consult with your tax and legal counsel sooner than later.

CONCLUSION

We are once again bracing for possible uncertainty in the near future. As we embark on the final stretch of the 2016 presidential campaign, tax reform is surely a major concern for the candidates and the voters, and a number of comprehensive tax reform proposals have recently been proposed for consideration. At this point we can only plan for uncertainty, maintaining needed flexibility and agility. Times continue to change. What has not changed, however, is the need to review our circumstances and to adjust our course as appropriate in advance of turning the calendar to the New Year.

FOR MORE INFORMATION

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If you'd like to learn more, contact a Northern Trust professional at a location near you or visit us at northerntrust.com.

[1] IRS, Statistics of Income Division, Estate Tax Returns Study (Oct. 2015).
[2] Special rules apply for RMDs from 401(k) plans when certain participants continue to work for the sponsoring employer.
[3] IRS, Statistics of Income Division, Publication 1304 (Aug. 2016).
[4] REG-163113-02 (August 4, 2016).