NORTHERN TRUST

2017 YEAR-END TAX AND WEALTH TRANSFER PLANNING

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Tax reform is in progress, and Congress and the White House are pushing for a historic tax overhaul. We have not seen major tax reform legislation since President Reagan's Tax Reform Act of 1986, so this would be momentous. As we write today, many in Washington are still calling for tax reform by year end, but the reality is that the process may continue into 2018. We will wait and watch.

In light of the present uncertainty, how do you plan for the certainty of 2017 coming to a close on December 31? Consider taking an "if-then" approach to evaluating your 2017 year-end tax planning alternatives. It is important to ask, "If tax reform were to pass in 2017, what should I be doing now? If tax reform were to pass in 2018, what should I be doing now? And, if tax reform fails, what should I be doing now?"

Areas to focus on as 2017 comes to a close include:

- the timing of income and deductions,
- the impact of the Alternative Minimum Tax (AMT),
- required minimum distributions from retirement accounts,
- loss harvesting to minimize capital gains,
- gift planning, and
- the new partnership audit rules.

A bit of planning, particularly before the close of the 2017 tax year, can help minimize your tax bill. Of course, your tax situation is unique and should be evaluated with the help of your trusted legal and tax advisors.

SIX YEAR-END TAX PLANNING CONSIDERATIONS

Defer Income, Accelerate Deductions

We expect individual income tax rates to stay the same in 2018 if tax reform does not pass, or decline if tax reform does pass. There is a possibility that tax reform will pass and will raise the top marginal individual income tax rate for certain taxpayers. But, given the likelihood of flat or declining rates, the tried and true advice of “defer income and accelerate deductions” holds true.

How might you defer income? First, remember that individuals are cash basis calendar year taxpayers. This makes income deferral relatively straight forward for individuals. A self-employed consultant who bills his clients at the conclusion of a project could wait until January 2018 to bill for a recent project. An investor could wait until January to sell stock. A business owner who wants to sell company stock could defer the closing until after year end. There are many ways to defer income, but you will need to talk with your tax advisor about the “constructive receipt of income” rules and other limitations. And, there may be non-tax considerations to evaluate as well.

On the deduction front, Congress wants to significantly limit individual itemized deductions. If you have deductions that you may use in 2017, but could lose in 2018, you may want to use your deductions before you lose them. For example, consider prepaying state and local income taxes or deductible medical expenses in December 2017 instead of waiting until January 2018. But, be aware of any AMT impact associated with the timing of your deductions. This is particularly important this year end as the tax reform proposals call for repeal of the AMT. And remember that the benefit of itemized deductions is limited by the phase-out rules that come into play once your adjusted gross income (AGI) reaches $261,500 (single filers) or $313,800 (married filing jointly).

Consider asking your tax return preparer to model your 2017 income tax liability before the end of the year. A pro forma return will help you understand the interplay of the timing of your income and deductions and the regular tax and the AMT. A pro forma 2017 return also may help you avoid overpaying tax in April 2018, if you put your 2017 return “on extension” as many taxpayers do. A return extension means that you do not have to file your 2017 income tax return until mid-October of 2018,

Year-End Planning Checklist

For additional considerations, a checklist is available.

but it does not mean you get additional time to pay your 2017 year-end tax liability. The more accurate your pro forma tax return, the more confident you can be that your April 2018 payment for any remaining 2017 tax liability is close to correct.

Take Required Minimum Distributions

If you are 70 ½ and have retirement accounts or if you have inherited retirement accounts like traditional IRAs and traditional 401(k)s, be sure to determine whether you are required to take any minimum distributions before year end. You typically must withdraw your first required minimum distribution (RMD) from your retirement accounts by April 1 of the year following the calendar year in which you reach age 70 ½ and each yearly required minimum distribution thereafter must be made by December 31. Thus, the April 1 option only applies to the first distribution. And, it is costly to be late – a 10% penalty is imposed in addition to the ordinary income tax for any late distribution.

If 2017 is your first distribution year, consider using the April 1, 2018 option in order to defer your 2017 distribution until April 1. But, be aware that in 2018 you will have a bunching of your first and second year RMDs and this could push you into a higher income tax bracket. It is very difficult now to determine with any degree of certainty what the effect of 2018 bunching will be since we do not know what tax rates will apply at which income levels. Calculate your options and make the most informed decision you can with the tea leaves as you see them.

Finally, if you are the beneficiary of an inherited retirement account, determine what distributions you must take. You may be required to take distributions even if you are not 70 ½. We have stated it before, but it bears repeating in the midst of the complexity of RMDs: you should confer with your tax advisor regarding your situation.

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 you already pay at least as much tax under the regular income tax system as you would pay under the AMT system, then you do not owe AMT. If your regular income tax falls below the AMT, then you will have to make up the difference by paying AMT.

Charitable Year-End Planning

If you are charitably inclined, the tax code rewards your generosity. A discussion of year-end charitable giving strategies is available.

Congress and the White House would like to eliminate the AMT as part of tax reform, but at this point the AMT remains in effect for 2017. There are a number of triggers that could cause you to become an AMT payer, including:

Alternative Minimum Tax: Common Triggers
State and Local Income Tax (or Sales Tax) and Property Tax Deducted on Schedule A as Itemized Deductions
Miscellaneous Itemized Deductions Subject to the 2% AGI Floor
Interest on a Home Equity Line of Credit
Exercise of Incentive Stock Options
Private Activity Bond Interest Exempt from Regular Income Tax

Manage Taxable Gains

Fundamentally, gain is the difference between the amount you receive when you sell an asset and your cost basis in the asset. The classic example is the long-term capital gain or short-term capital gain you have when you sell a stock. Gain, whether capital or otherwise, can represent a big part of taxable income, especially if you are living off of investment income.

The latest tax reform proposal does not change the long-term capital gains rates (0%, 15% and 20%) in effect under current law. The proposal also does not eliminate the 3.8% net investment income tax that applies to many gains. Regardless of whether tax reform passes, it might make sense to manage your gains.

Tax loss harvesting is a familiar year-end activity in which investors estimate recognized capital gain for the year. Then, they look to see whether they have capital losses, either carried forward from prior years or harvested in the current year, to offset any recognized capital gain for the year. Markets have been on the rise this year, so year end is a great time to look at your capital gain and loss position.

Stay the Course on Transfer Tax Planning

Transfer taxes include gift, estate and generation-skipping transfer (GST) tax. In 2017, the federal transfer tax rate is 40% and the federal transfer tax exclusion/exemption amount is $5.49 million. This means that an individual can pass on $5.49 million over the course of his life or at death to a transferee of his choice free of federal transfer taxes; a married couple together can pass on $10.98 million. These amounts were $5.45 and $10.9 million respectively in 2016, and under the current law they will increase to $5.6 million and $11.2 million respectively in 2018 because they adjust annually for inflation. Tax reform proposals have proposed repeal of the estate and GST taxes (but not the gift tax).There has been talk of keeping the taxes, but significantly increasing the exclusion/exemption amounts as part of tax reform.

What does this suggest for year-end transfer tax planning? There is nothing like tax law ambiguity to drive us back to our roots. Consider both the tax and, arguably more importantly, the non-tax reasons for giving. If you want to give for the sake of giving, use any remaining annual gift exclusion amounts ($14,000 per donor per donee). If you want to make larger gifts, use a part of your remaining lifetime exclusion amount, and remember that if you used what you had by the end of 2016, you received a bit more with the inflation adjustment from 2016 to 2017 ($400,000 for an individual and $800,000 for a married couple).

How to fund any additional gifts? Cash is easy and always appreciated. But the tried and true strategies for leveraging gifts remain available:

- Assets with the potential for future appreciation are a common choice. But recall that donees typically receive the donor's basis in gifted assets.
- Interests in family entities (limited liability companies and limited partnerships) may still be gifted with the potential for valuation discounts for minority interests and limited marketability. Proposed regulations that would have impacted discounts for family entities have been withdrawn.
- With interest rates still at modest levels (and expected to rise), gifts using grantor retained annuity trusts are still attractive. The rate calculating gift values of remainder interests is 2.4% in November. This is a bit above the lows of recent years, but well below pre-great recession rates.

- If time permits, sales of assets with appreciation potential to what are commonly referred to as intentionally defective grantor trusts are an alternative.

Is there a down-side to making tax-free gifts in 2017? If the estate tax is repealed and your primary motivation for making gifts is to reduce your taxable estate at death, you could have donor's remorse after the fact. If the estate tax remains in effect but with a much higher exemption/exclusion amount and the basis adjustments for assets transferred at death remains in effect, you will have lost the benefit of the basis adjustment at death for appreciated assets. (Remember, there is no basis increase for lifetime gifts of appreciated assets.) So we come full circle. If you want to give, you have the opportunity to make tax-free gifts and the season of giving is upon us.

Annual or Lifetime Gifts of Property: Helpful Considerations
To minimize potential estate tax, gift property with the greatest potential for future appreciation.
To preserve tax losses on property, you might not want to gift property that has declined in value (tax basis in excess of fair market value). Instead, consider whether you can recognize the tax loss by selling the property first and then gifting the sale proceeds. If you transfer the loss property to a donee, the tax loss likely will be limited, or may even be eliminated.
To account for current uncertainty about the future of the estate and GST taxes, you might want to avoid making taxable gifts at this point.

Prepare for the New Partnership Audit Rules

Effective January 1, 2018, the Internal Revenue Service (IRS) will change the way it audits partnerships. Entities taxed as partnerships can include limited partnerships, general partnerships and LLCs. The new audit rules allow the IRS to collect unpaid tax from the partnership itself, rather than from the individual partners, unless the partnership is eligible to elect out of the new audit regime and does in fact elect out. The option to elect out is not available for entities that have trusts as partners or members.

Partnership agreements and LLC operating agreements should be updated to reflect the new audit rules. The agreement should designate a "partnership representative." This person will be the sole point of contact with the IRS in the event of audit and should be chosen carefully. The agreement also should address whether current or former partners will bear the economic burden of a tax assessment and provide indemnification as appropriate. Your legal advisor can help you execute the necessary amendments.

CONCLUSION

Year end is the ideal time to plan to mitigate your 2017 income tax burden, begin your 2018 income tax planning, evaluate your transfer tax strategy and make any appropriate transfers. The prospect of tax reform creates uncertainty, but we encourage you to take a strategic and calculated approach. Many familiar tax planning techniques are useful even in the current environment. We urge you to work with your wealth, legal, and tax advisors. They are committed to helping you achieve your goals.

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11/17