TRUST & ESTATE PLANNING IN 2017: PLANNING IN UNCERTAIN TIMES

First Run Broadcast: January 11, 2017
1:00 p.m. E.T./12:00 p.m. C.T./11:00 a.m. M.T./10:00 a.m. P.T. (60 minutes)

Trust and estate planning in 2017 will be an exercise in uncertainty. The US Treasury Department issued controversial regulations on discounting of estates under Internal Revenue Code §2704, the bedrock of many estate plans. But the incoming Trump Administration has signaled its intention to withdraw or revisit those regulations. In addition, legislative proposals from the new administration to eliminate the estate tax and modify the gift tax will work dramatic shifts in trust and estate planning, if enacted in even modified form. Many of these seismic changes are reminiscent of the 2010 repeal of the estate tax and its subsequent restoration with substantially different exclusion amounts. Planning in 2017 may be an unprecedented exercise in trying to navigate uncertainty for clients. This program will review where we are at the start of 2017, major legislative and regulatory proposals and pivot points, and practical guidance about how to plan and counsel clients in an environment that is changing rapidly.

- Trust and estate planning in 2017 in a climate of substantial uncertainty
- Proposed regulations on discounting under IRC §2704 & responses of new Trump Administration
- Proposals to eliminate the estate tax and its impact on planning
- Impact of changes on the gift tax and charitable giving
- Revisiting the lessons of 2010 planning when the law is changing dramatically
- Practical guidance frame plans and counseling clients in this new environment

Speakers:

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IRS releases 2017 inflation-adjusted numbers

On October 26th, the IRS released its 2017 inflation-adjusted numbers for various tax rate schedules (see Revenue Procedure 2016-55 and IR-2016-139), and on October 27th, it released its inflation-adjusted numbers for 2017 pension plan limitations (see Notice 2016-62 and IR-2016-141). Because inflation is low, the increases (if any) are modest. Here is a selected run-down of these 2017 figures, along with other points to keep in mind, both for year-end and in general:

**Income tax – top brackets.** *Individuals* are subject to the following rates: 10%, 15%, 28%, 33%, 35% and 39.6%. The 35% and 39.6% rates will apply to taxable income that exceeds the following amounts:

<table>
<thead>
<tr>
<th>Rate</th>
<th>Married filing jointly, surviving spouses</th>
<th>Heads of households</th>
<th>Single taxpayers</th>
<th>Married filing separately</th>
</tr>
</thead>
<tbody>
<tr>
<td>35%</td>
<td>$416,700</td>
<td>$416,700</td>
<td>$416,700</td>
<td>$208,350</td>
</tr>
<tr>
<td>39.6%</td>
<td>$470,700</td>
<td>$444,550</td>
<td>$418,400</td>
<td>$235,350</td>
</tr>
</tbody>
</table>

The income ranges for the lower rates differ (and yes, there really is only a $1,700 difference between the 35% and 39.6% rate for single taxpayers).

**Trusts and estates** are subject to the following rates: 15%, 25%, 28%, 33% and 39.6%. They will hit the top two rates of 33% and 39.6% if their taxable income exceeds the following amounts:

<table>
<thead>
<tr>
<th>Rate</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>33%</td>
<td>$9,150</td>
</tr>
<tr>
<td>39.6%</td>
<td>$12,500</td>
</tr>
</tbody>
</table>

*“Kiddie tax.”* The “kiddie tax” applies to: a) children under age 18, and b) children who don’t earn more than half of their own support and are: i) age 18 or ii) full time students, ages 19-23. This means that if these children have more than $2,100 of unearned income (the same as in 2016 and 2015), it effectively will be taxed at their parent’s top rate. (“Unearned income” refers to items such as interest, dividends and capital gains.)
Note that if parents elect to report their child’s unearned income on their own income tax return, that income will factor into the parents’ calculation for the 3.8% tax on net investment income (see below); if the child is married and files a joint return, the kiddie tax does not apply.

**AMT Exemption.** The alternative minimum tax (AMT) is a parallel tax system that originally targeted a relative handful of wealthy taxpayers, but now reaches deep into the middle class. Taxpayers especially vulnerable to the AMT are those who live in high-tax states and have large itemized deductions for state and local taxes, or those with large families and numerous personal exemptions for their dependents (but see the personal exemption phase out below). Now permanently indexed for inflation, the AMT exemption amounts for 2017 are as follows:

<table>
<thead>
<tr>
<th>Type of Taxpayer</th>
<th>AMT Exemption</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married filing jointly, surviving spouses</td>
<td>$84,500</td>
</tr>
<tr>
<td>Heads of households &amp; single taxpayers</td>
<td>$54,300</td>
</tr>
<tr>
<td>Married filing separately</td>
<td>$42,250</td>
</tr>
<tr>
<td>Estates and trusts</td>
<td>$24,100</td>
</tr>
</tbody>
</table>

These exemptions are phased out, and disappear completely, if the taxpayer has “too much” alternative minimum taxable income (AMTI):

<table>
<thead>
<tr>
<th>Type of Taxpayer</th>
<th>AMT Exemption Phase-out Begins</th>
<th>AMT Exemption Fully Eliminated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married filing jointly, surviving spouses</td>
<td>$160,900</td>
<td>$498,900</td>
</tr>
<tr>
<td>Heads of households &amp; single taxpayers</td>
<td>$120,700</td>
<td>$337,900</td>
</tr>
<tr>
<td>Married filing separately</td>
<td>$80,450</td>
<td>$249,450</td>
</tr>
<tr>
<td>Estates and trusts</td>
<td>$80,450</td>
<td>$176,850</td>
</tr>
</tbody>
</table>

**AMT brackets.** The 26% AMT rate applies to AMTI up to the threshold amounts below; the 28% AMT rate applies to AMTI above these amounts:

<table>
<thead>
<tr>
<th>Type of Taxpayer</th>
<th>AMT Exemption</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married filing jointly, single taxpayers, estates &amp; trusts</td>
<td>$187,800</td>
</tr>
<tr>
<td>Married filing separately</td>
<td>$93,900</td>
</tr>
</tbody>
</table>

**Standard deduction.** The standard deduction reduces a taxpayer’s taxable income, and is used when a taxpayer does not itemize deductions to reflect payments for items such as state and local income taxes, mortgage interest, and charitable contributions. As with many itemized deductions, the standard deduction does not count against the AMT. The 2017 standard deduction is as follows:

<table>
<thead>
<tr>
<th>Type of Taxpayer</th>
<th>Standard Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married filing jointly, surviving spouses</td>
<td>$12,700</td>
</tr>
<tr>
<td>Heads of households</td>
<td>$9,350</td>
</tr>
<tr>
<td>Single taxpayers &amp; married filing separately</td>
<td>$6,350</td>
</tr>
</tbody>
</table>

**Personal exemption and phase-out.** Taxpayers get a personal exemption for themselves and for each of their dependents (usually, their children). Regardless of filing status, the 2017 personal exemption is $4,050 (the same as in 2016). Yet taxpayers whose adjusted gross income (AGI) exceeds a threshold amount will see those exemptions phased out, and disappear completely, if they have “too much” AGI (the phase-out is 2% for every $2500 of AGI over the threshold amount; AGI refers to total income minus certain “above-the-line” deductions, such as those for alimony paid or one-half of the self-employment tax). **PEP** (the personal exemption phase-out) will apply as follows in 2017:
AGI Threshold:  Exemptions

<table>
<thead>
<tr>
<th></th>
<th>Phase-out Begins</th>
<th>Fully Eliminated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married filing jointly, surviving spouses</td>
<td>$313,300</td>
<td>$436,300</td>
</tr>
<tr>
<td>Heads of households</td>
<td>$287,650</td>
<td>$410,150</td>
</tr>
<tr>
<td>Single taxpayers</td>
<td>$261,500</td>
<td>$384,000</td>
</tr>
<tr>
<td>Married filing separately</td>
<td>$156,900</td>
<td>$218,150</td>
</tr>
</tbody>
</table>

“Pease limitation.” Taxpayers with “too much” AGI will see most itemized deductions reduced by the lesser of 3% of AGI over the PEP threshold amounts above or 80% of those deductions. This so-called “Pease limitation” applies to all itemized deductions except those for medical expenses, investment interest, and casualty, theft and wagering losses; in other words, “Pease deductions,” such as those for state and local taxes, mortgage interest and charitable contributions, may get a haircut. Note, however, that unless a taxpayer’s AGI is exponentially higher than these deductions, the haircut will likely be limited to 3%.

Retirement accounts:

- **IRAs.** The contribution limit for IRAs remains unchanged at $5,500. Taxpayers who are at least 50 can make “catch-up” contributions of $1,000 (this number is not indexed for inflation and is frozen).

- **Roth IRAs.** Roth IRAs are funded with after-tax dollars, and have the same contribution limits as the IRAs mentioned above. Taxpayers can’t contribute to a Roth, however, if they have “too much” modified adjusted gross income (this is generally the same as adjusted gross income). In 2017, contributions will be phased-out at the following income levels:

  - Married filing jointly: $186,000 to $196,000
  - Heads of households & single taxpayers: $118,000 to $133,000
  - Married filing separately (not indexed): $0 to $10,000

  **Note:** as of 2010, any taxpayer – regardless of income level and filing status – can convert a “traditional” IRA into a Roth, a move that may trigger significant current income tax.

- **401(k) contributions and other elective deferrals.** The contribution limit for deferred plans such as 401(k)s is unchanged at $18,000; catch-up contributions for taxpayers who are at least 50 are also unchanged at $6,000 (such taxpayers can therefore contribute up to $24,000 to their accounts).

Estate and gift taxes:

- **Basic exclusion amount.** The basic exclusion amount protects transfers from gift and estate taxes, and will rise to $5.49 million (a $40,000 increase from 2016’s basic exclusion amount of $5.45 million); a married couple therefore will be able to collectively protect property worth $10.98 million – or just $20,000 shy of $11 million – from gift and estate taxes.

- **Generation-skipping transfer tax (GST) exemption.** The GST exemption protects transfers (outright or in trust) to people such as grandchildren from GST, an additional transfer tax. Because the GST exemption equals the basic exclusion amount, it too will rise to $5.49 million in 2017. This means that with proper planning, a married couple will be able to protect property worth $10.98 million from GST in 2017.
• **Annual exclusion gifts.** These gifts will still be **$14,000 per donee**, or $28,000 if the taxpayer’s spouse joins in the gift – amounts that have been unchanged since 2013. (Annual exclusion gifts do not erode the basic exclusion amount, and often take the form of cash or marketable securities.)

• **Annual exclusion gifts to non-citizen spouses.** These gifts rise to $149,000 (up from $148,000).

**Social Security.** The Social Security Administration recently announced that there will be a small cost of living increase in Social Security benefits for 2017: 0.30%, or 30 basis points (3/10th of 1%). By contrast, the maximum amount of taxable earnings subject to the 6.2% payroll tax will increase to $127,200 from $118,500 (the 2015 and 2016 ceiling), a jump of $8700, or 7.34%. (The 6.2% payroll tax represents the OASDI, or old age, survivors and disability insurance portion of FICA, the Federal Insurance Contributions Act.) The 1.45% Medicare hospital insurance portion of FICA applies to an unlimited amount of wages, and increases by another 0.90% (90 basis points) for wage income that exceeds the following unindexed (and therefore frozen) amounts: $250,000 (married filing jointly), $200,000 (single taxpayers) and $125,000 (married filing separately); the total Medicare tax for wage income above those amounts is thus 2.35%. Once a wage-earner’s income exceeds $200,000, the employer must withhold this additional tax, regardless of the wage-earner’s filing status.

**3.8% tax on net investment income.** Like the additional 0.90% Medicare tax on wage income mentioned above, the 3.8% tax on net investment income took effect in 2013; both were part of the Affordable Care Act, or “Obamacare,” as many refer to it. Net investment income refers to items such as interest, dividends, capital gains and royalties. The 3.8% tax can apply if the taxpayer’s “modified adjusted gross income” (AGI plus otherwise excluded foreign income) exceeds the same frozen thresholds as the additional 0.90% Medicare tax: $250,000/$200,000/$125,000. Because there is no automatic withholding for this 3.8% tax, taxpayers should be mindful of it when determining whether they are “current” with their tax payments (see below).

**Other points:**

• **Charitable IRA rollovers.** Congress finally made charitable IRA rollovers permanent in late 2015, along with 22 of the 50+ temporary tax provisions that had expired at the end of 2014 (those 25+ “extenders” will expire in the next year or two without Congressional action). Charitable IRA rollovers let taxpayers who are at least 70½ give up to $100,000 from their IRA to a public charity such as the taxpayer’s favorite museum or alma mater (donor advised funds, supporting organizations or private foundations won’t work). The distribution:
  • Counts towards the taxpayer’s “required minimum distribution”
  • Is not subject to federal income tax, and
  • Is not deductible as a charitable contribution (it nevertheless equates to a 100% deduction because it is not subject to federal income tax)

In addition, the taxpayer can’t receive anything in exchange for the contribution (no chicken dinners at the local charity event!), but can use it to satisfy an outstanding pledge. Although the check must be payable directly to the charity, the taxpayer can still deliver it herself; the charity must provide the usual written acknowledgement of the contribution. (Note that the state income tax treatment of charitable IRA rollovers may differ.)

• **Being “current” with tax payments.** To avoid interest and penalties on underpayments of income tax, taxpayers must be current with their tax obligations. This means that taxpayers must either pay in 90% of their current year’s liability (through a combination of withholding and quarterly estimated tax payments)
OR use the so-called “safe harbor”: paying in 100% of their prior year’s income tax liability (110% if their adjusted gross income in the prior year exceeded $150,000 ($75,000, if married filing separately)).

- **“Married” versus “single” filing status.** The “marriage bonus” may reduce a married couple’s federal taxes if the spouses have a significant income disparity, but the “marriage penalty” could significantly increase the couple’s taxes if they have similar amounts of income; in addition, a married couple is more likely to be caught by the 3.8% tax on net investment income. That is because an unmarried couple can have household income of $400,000 ($200,000 each) and not be subject to the net investment income tax, whereas a married couple can be subject to the 3.8% tax at $250,000 of household income (see above). Note that individuals in a civil union or a registered domestic partnership are treated as single taxpayers for federal tax purposes (though not necessarily for state purposes), whereas same-sex married couples are now treated as married for both federal and state tax purposes, and no longer have a potential mismatch between their state and federal tax treatment.

- **Avoid the wash sale rule.** The end of the year is often when taxpayers look carefully at their investment portfolios and “harvest losses” to offset realized gains. So if Mom, for example, is selling stock or securities that are worth less than her “adjusted basis” (generally, what she paid for the asset), she’ll be caught by the wash sale rule if she repurchases those same assets within 30 days before or after the sale (even if she repurchases them in her IRA). If the wash sale rule applies, Mom can’t take the current loss – it’s added to the cost basis of the repurchased stock or security and is thereby deferred (there’s no issue if Mom is merely selling winners and “harvesting gains”).

**Things to remember for year-end gifts:**

- **Gifts to individuals.** Time is running out for 2016 annual exclusion gifts of $14,000 to family and friends ($28,000 for a married donor whose spouse agrees to the gift). Cash gifts may be given up to 11:59 p.m. on December 31st and still count as a 2016 gift. Checks, however, must be cashed before January 1, 2017 to count as 2016 gifts (p.s.: the generous donor must also stay alive until the bank makes good on the check).

  *In addition to annual exclusion gifts*, generous donors can make direct payments for tuition, medical expenses and health insurance premiums – none of which count against the donor’s $5.45 million basic exclusion amount.

- **Gifts to charities.** For last-minute gifts to charities to qualify as a 2016 deduction, the check must be sent before January 1, 2017 (it need not be cashed before then, however).

**Planning points on the horizon:**

- **Transfer tax changes?** It goes without saying that, depending on the results of the imminent national elections, tax law changes could be on the horizon in the next year or two. If it turns out that Democratic transfer tax proposals are on the agenda — and enacted, say, sometime in 2017 — the current $5.45 million basic exclusion amount and top rate of 40% could disappear, to be replaced by a $1 million gift tax exclusion, a $3.5 million estate tax exclusion and generation-skipping transfer tax exemption, and a top rate of 45% (the 2009 transfer tax parameters).

In light of this, should generous donors rush to take full advantage of this $5.45 million exclusion amount — or top off the $5 million gifts they might have made at the end of 2012, when it looked as if there might be a return to a $1 million exclusion?
“Rush” may be too strong a word, but it is certainly conceivable that the exclusion amount may drop, and that wealthy taxpayers could be facing a number of potential income and transfer tax increases. Assuming a taxpayer can comfortably part with assets, lifetime gifts – from “easy-peasy” annual exclusion cash gifts that don’t erode the $5.45 million exclusion amount, to sophisticated techniques that can have a number of moving parts and do erode the exclusion – can make good sense. Keep in mind that a gift of hard-to-value “stuff,” such as an interest in a family limited partnership or limited liability company, requires a qualified appraisal to accompany the gift tax return reporting this gift.

- **Disappearing valuation discounts?**

As previously discussed in *Tax Topics* (see the 08/31/16 and 09/30/16 editions), the IRS issued proposed discount regulations on August 2, 2016. These regs appear to eliminate most valuation discounts that taxpayers have successfully used in transferring interests in family-controlled entities — such as partnerships, corporations and limited liability companies — to family members. The regs have generated much controversy, including several House and Senate Republican-sponsored bills that would circumvent implementation of the regs. The depth of this opposition appears to have taken Treasury officials by surprise; they have signaled that they do not intend to rush into making the regs final, and will carefully consider the comments they receive (written comments are due on November 2nd, and the actual hearing on the regs is on December 1st; the earliest the regs could be made final is 30 days after the hearing).

What does this mean for owners of family-controlled entities, where the entity agreement (or local law) imposes restrictions on liquidating the entity or an interest in it? Assuming that the entity owner was already intending to give entity interests to family members, that owner might want to consider accelerating those gifts.

**November 7520 rate**

The IRS has issued the November 2016 applicable federal rates: the November 7520 rate remains at 1.6%, where it was in October. The November mid-term rates are up just a touch: 1.33% (annual, semiannual, quarterly and monthly), from the October mid-term rates of: 1.29% (annual, semiannual, quarterly and monthly).

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President-elect Trump and possible tax law changes

The election season “like no other” ended with a result that most polls and pundits failed to predict: Donald Trump as our 45th president. As that surprise starts to fade, questions commence on what to expect from a Trump presidency. Because our focus is taxes, we will address possible changes on that front – understanding that this currently involves trying to read the tea leaves, including Mr. Trump’s campaign website, the House Republican blueprint for tax reform called A Better Way, and the “Death Tax Repeal Act of 2015” (H.R. 1105). We’ll start with Mr. Trump’s website.

Trump proposals

Income tax – individuals. Our current system has seven rate brackets: 10%, 15%, 25%, 28%, 33%, 35% and 39.6%. The Trump proposal would collapse these into three, as follows:

- 12% for taxable income under $75,000
- 25% for taxable income from $75,000 but less than $225,000 and
- 33% for taxable income in excess of $225,000

Comment. These brackets would apply to married couples filing jointly (single filers would be subject to half these amounts). By way of comparison, in 2016, married couples filing jointly are subject to the current 33% bracket at taxable income over $231,450, the 35% bracket at taxable income over $413,350, and the 39.6% bracket at taxable income over $466,950.

The existing capital gains rate structure would remain, with its maximum rate of 20%; “carried interest,” which managers of hedge funds and private equity funds typically receive, would be taxed at ordinary income tax rates rather than capital gains tax rates, which currently apply.

The following items would be repealed or replaced:

- The 3.8% net investment income tax.
Comment. This tax commenced in 2013 under the Affordable Care Act (a/k/a “Obamacare”), and is a surcharge on net investment income (such as capital gains, dividends and royalties); it can apply if a taxpayer’s income exceeds certain threshold amounts that are not indexed for inflation (e.g., $250,000 for married filing jointly).

- The alternative minimum tax (AMT).

Comment. This is a parallel tax system that reaches deep into the middle class and is designed to ensure that taxpayers pay “enough” tax; the AMT adds back various items that can reduce a taxpayer’s “regular” tax, such as itemized deductions for state and local taxes. If a taxpayer’s AMT exceeds the taxpayer’s regular tax, the taxpayer pays the higher amount.

- Personal exemptions and the “head of household” filing status.

Comment. In 2016, the personal exemption is $4,050, and is available for the taxpayer, the taxpayer’s spouse and the taxpayer’s dependents, such as minor children. Nevertheless, these exemptions are phased out (and eliminated) if the taxpayer has “too much” income; they also do not count against the AMT. “Head of household” status applies to single parents with, say, dependent children, and provides more favorable tax brackets than the “single” taxpayer status. Both items – the personal exemption and head of household – would be replaced by a larger standard deduction ($30,000 for married filing jointly, and $15,000 for single taxpayers).

Other changes would include:

- Itemized deductions would be capped at $200,000 (married filing jointly) or $100,000 (single filers). (These deductions currently include payments for items such as mortgage interest, state and local taxes and charitable contributions.)

- Married taxpayers with income up to $500,000 ($250,000 for single taxpayers) could take an “above-the-line” deduction for children under age 13 (capped at a state average), limited to four children per taxpayer. There also would be a similar deduction for an elderly dependent, capped at $5,000 per year (indexed for inflation).

- Spending rebates for childcare expenses would be available for certain low-income taxpayers through the Earned Income Tax Credit. The rebate would equal 7.65% of remaining eligible childcare expenses, subject to a cap of half the payroll taxes paid by the taxpayer. This rebate would be available to married joint filers earning $62,400 ($31,200 for single taxpayers).

- Taxpayers could establish Dependent Care Savings Accounts for specific individuals, including unborn children, up to $2,000 per year from all sources (e.g., parents, grandparents, employers). If established for children, rather than dependent elders, funds still in the account when the child reaches age 18 could be used for educational expenses, but additional contributions could not be made. For low-income taxpayers, the government would provide a 50% match on parental contributions of up to $1,000 per year.

Estate tax. The website states that the “Trump plan will repeal the death tax, but capital gains held until death will be subject to tax, with the first $10 million tax-free as under current law to exempt small businesses and family farms. To prevent abuse, contributions of appreciated assets into a private charity established by the decedent or the decedent’s relatives will be disallowed.”
Comment. Although the estate tax would be eliminated, there would be a capital gains tax at death for appreciated assets in excess of $10 million. It is unclear whether this amount applies per person, or per married couple. In addition, the proposal is silent on the fate of the gift tax, as well as the generation-skipping transfer tax, which applies to transfers, either outright or in trust, to people such as grandchildren. Finally, it appears that gifts of appreciated property to a private foundation created by the decedent or the decedent’s family would be subject to capital gains tax at death, although gifts to someone else’s private foundation or to a public charity apparently would not trigger capital gains tax.

Business tax. The business tax rate would drop from 35% to 15%, and the corporate alternative minimum tax would be eliminated. Off-shore corporate profits could be repatriated at a one-time rate of 10%. Most corporate tax “expenditures” (i.e., tax benefits that reduce taxable income, such as credits) would be eliminated, except for the Research and Development credit. Firms manufacturing products in the United States could elect to “expense” their capital investment and lose the deductibility of corporate interest expense (this is similar to some of the corporate tax suggestions in A Better Way – see below).

A Better Way

House Republicans released A Better Way - Our Vision for a Confident America on June 24, 2016. This 35-page document is a blueprint for “bold, pro-growth” tax reform. It states that our tax code and the IRS are broken (it would restructure both), and that the tax code imposes “burdensome paperwork and compliance costs, delivers special interest subsidies and crony capitalism, penalizes savings and investment, and encourages businesses to move overseas.” A Better Way (ABW) thus advocates for a tax system that is “simpler, fairer and flatter,” with reduced tax rates in exchange for a broader tax base. Reform would be “revenue neutral” and bring in the same amount of revenue, taking account of anticipated economic growth. Translated, this means that the new system would significantly reshuffle the deck, and presumably result in the loss of cherished tax benefits for some, but the advent of welcome changes for others. Here is some of what ABW proposes:

Income tax – individuals. ABW would collapse the current seven rate brackets into the same three as Mr. Trump: 12%, 25% and 33%. It would also:

- Eliminate the AMT (see above).
- Eliminate the various taxes associated with “Obamacare,” for which repeal is assumed. (These include the 3.8% net investment income tax, the additional 0.90% Medicare tax on income above a threshold amount (e.g., $250,000 for married filing jointly), the 2.3% medical device tax, and the 40% excise tax on so-called “Cadillac” plans (now scheduled to go into effect in 2020, rather than 2018).)
- Permit individuals to deduct up to 50% of their net capital gains, dividends and interest income – which would make for a maximum tax rate of 16.5% on such income (note that under current law, interest income is typically taxed as ordinary income, rather than at favorable capital gains tax rates).
- Consolidate various family benefits, such as personal exemptions and the child tax credit into a larger standard deduction and enhanced child and dependent tax credit.
- Eliminate itemized deductions except for mortgage interest and charitable contributions (taxpayers could use the larger standard deduction OR these two deductions).
- Simplify and consolidate higher education tax benefits (this would include a savings incentive, such as 529 plans).
- Have taxable employee “compensation” match the “compensation” employers may deduct (this could make employer-provided health care taxable, although this issue would be addressed by a separate task force).
• Consolidate and reform the various retirement savings provisions.

**Estate tax.** ABW would repeal the estate tax and the generation-skipping transfer tax. It is silent about the gift tax, and whether the current basis adjustment rules would remain (these eliminate a decedent’s built-in capital gains AND losses) or would be replaced by a capital gains tax at death for a decedent’s appreciated assets or some kind of carryover basis regime, whereby heirs effectively “inherit” a decedent’s built-in capital gains and losses.

**Business tax.** There would be a new business tax rate for small businesses organized as sole proprietorships and for pass-through entities (such as partnerships, S corporations or limited liability companies). The maximum tax rate would be 25%, rather than the proposed top rate of 33% for individuals. For large businesses operated through C corporations, which are currently subject to a corporate tax rate of 35%, ABW would lower the corporate tax rate to a flat 20%, while eliminating the corporate alternative minimum tax. In addition, ABW would allow the immediate write-off of business investments (what’s known as “expensing”). Interest expenses could be deducted against interest income, but no current deduction would be allowed for “net interest expense”; this would eliminate “a tax-based incentive for businesses to increase their debt load beyond the amount dictated by normal business conditions.” In general, “special-interest deductions and credits” would disappear, in favor of lower rates for businesses and not taxing business investment, so that business decisions would be based on “economic potential rather than…targeted tax benefits” (the Research and Development credit would be retained). ABW would also move away from a worldwide approach to taxing corporate profits in favor of a more “territorial” approach, whereby tax jurisdiction follows where a product is consumed rather than where it is made.

The Death Tax Repeal Act of 2015 (H.R. 1105)

In early 2015, Rep. Kevin Brady (R-TX), Chairman of the House Ways and Means Committee, introduced “The Death Tax Repeal Act of 2015” (H.R. 1105) in the House. The bill had 135 co-sponsors: one Democrat and 134 Republicans. On April 16, 2015, the House passed the bill (240 to 179); the following week, it was introduced in the Senate, where no further action has been taken on it.

The bill repeals the estate tax and the generation-skipping transfer tax (GST), while retaining the gift tax in a somewhat modified form: there would be a $5 million gift tax exclusion, indexed for inflation, and a top rate of 35%; transfers in trust would be treated as gifts unless the grantor or the grantor’s spouse was responsible for paying the trust’s income taxes (what’s known as a “grantor trust”). For ten years after the bill’s enactment, qualified domestic trusts (QDOTs) would continue to be subject to estate tax (a QDOT is a trust for a non-citizen surviving spouse; it postpones estate tax at the deceased spouse’s death but triggers estate tax if principal distributions, other than those necessitated by hardship, are made to the surviving spouse). The Joint Committee on Taxation estimated that the bill would cost $269 billion over 10 years.

The Death Tax Repeal Act of 2015 essentially mirrors the legislation that repealed the estate tax and GST in 2010 (but just for that year), with one major difference: it does not have the “modified carryover basis” provisions that allowed a limited basis step-up of $1.3 million for the decedent’s appreciated property, with an additional $3 million step-up for appreciated property passing to a surviving spouse. In other words, although the Death Tax Repeal Act of 2015 would repeal the estate tax and GST, it preserves the existing basis adjustment rules, so that the decedent’s built-in capital gains (and losses) would be eliminated at death.
Comments. The above discussion reflects possible tax law changes. Yet until there is draft legislation, no one really knows what it will say or do. And several factors make tax reform especially challenging: cost and constituencies. As those close to the tax legislative process often observe, “There are budget constraints.” Independent budget watchdogs have estimated that Mr. Trump’s proposals could run some $3-$6 trillion over ten years, notwithstanding his assurance of economic growth. Such a number, if accurate, could add significantly to the deficit, and potentially entail cuts to entitlement programs to help pay for it— even though Mr. Trump has said he does not want to cut Medicare or Social Security benefits.

A Better Way’s promise of revenue-neutral tax reform means that in exchange for lower rates, various tax benefits would be on the chopping block, such as the deduction for state and local income taxes and the current tax-free status of employer-provided health care. This is where constituencies come into play: for every such benefit, there is an attentive and insistent “someone” who pays close attention to the continued longevity of that coveted benefit, and presumably will fight hard to preserve it.

As for the estate tax, it is a true “hot button” item. When the Death Tax Repeal Act of 2015 passed the House, there was intense rhetoric from both sides of the aisle, with Republicans insisting that the estate tax was immoral and unfair, and that repeal was needed to save family farms and ranches; Democrats just as insistently maintained that the estate tax affects less than 1% of the population, and that its repeal would be a costly give-away to the wealthy, at nearly 1/3 of a trillion dollars over ten years. (It goes without saying, of course, that President-elect Trump would benefit greatly from repeal.)

To sum up. What will happen? Considering that there is a highly motivated Republican trifecta – an incoming Republican president and a Republican-controlled House and Senate – tax reform seems likely to take off in the new 115th Congress. Although there is room for bipartisan agreement in certain areas, such as the need to repatriate offshore corporate earnings, what to do with those potential tax revenues differs: Republicans would like to use those dollars to reduce the corporate tax rate, while Democrats would like to put them towards infrastructure projects. There is also disagreement on how to address the individual income tax. And while Republicans could use “reconciliation” to pass tax reform legislation in the Senate, thereby only requiring 51 votes (as opposed to 60), reconciliation has a poison pill: provisions that would adversely affect revenues beyond the related 10-year budget window can only have a 10-year shelf life (thus, the “sunset” that was part of the 2001 Bush tax cuts).

p.s. End of year actions? Given what appears to be a high probability for reduced taxes within the next year (or two), what might taxpayers consider doing between now and year end? Defer income, to the extent possible, while accelerating deductions that might otherwise be limited or disappear under various reform scenarios. In other words, for example, it may make sense to accelerate charitable contributions, as those deductions may be limited, just as it may make sense to prepay estimated state and local tax, as that deduction may disappear— understanding, however, that this deduction is an “add-back” for AMT purposes and can exacerbate a taxpayer’s potential exposure to that tax.

p.p.s. Curtains for the proposed 2704 discount regulations? On August 2nd, the IRS released proposed regulations dealing with valuation discounts that taxpayers have successfully used to transfer interests in family-controlled entities to family members. (See the 8/31/16 and 9/30/16 editions of Tax Topics for more on these regs.) The regulations have been criticized from many quarters as harmful to small businesses. Most recently, on November 3rd, the Republican members of the House Ways and Means Committee wrote to Treasury Secretary Jacob Lew urging that the regulations be withdrawn, as they are “not consistent with congressional intent”; the letter also states that any “new proposal in this area should be clearly defined and narrowly targeted within the reach of the applicable statutory rules.” Given all of this expressed hostility and the
clear pro-growth and pro-business slant of the incoming Congress and President, it seems doubtful that these regs will be finalized in their current form – if indeed they are finalized at all. Taxpayers worried about the impact of these proposed regs on existing or imminent planning therefore appear to have gotten a reprieve (at least for the moment).

December 7520 rate

The IRS has issued the December 2016 applicable federal rates: the December 7520 rate is 1.8%, an increase of 0.20% (20 basis points) from November’s 7520 rate of 1.6%. The December mid-term rates are also up: 1.47% (annual) and 1.46% (semiannual, quarterly and monthly). The November mid-term rates were: 1.33% (annual, semiannual, quarterly and monthly).

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End of year thoughts and a brief look ahead

As the Obama administration winds down and the Trump administration is about to begin, we wanted to recap a few things…

Elections – and taxes. The surprising outcome of the November elections means that we are likely to see tax law changes that significantly depart from the tax proposals consistently put forth in the Obama administration’s budgets (these include the “Buffett Rule” (or “Fair Share Tax”) that would mandate an effective rate of 30% for taxable income over $1 million, and a capital gains tax at death for most of a decedent’s appreciated property). Last month’s Tax Topics (see the 11/28/16 edition) discussed some of those possible changes, including proposals from “A Better Way” (ABW), the House Republican blueprint for tax reform that was released on June 24th. As stated in ABW, the goal of reform is to produce a tax code that is “simpler, flatter and fairer.” We wanted to revisit ABW and those three words.

“Simpler.” “Simpler” is a straightforward concept. ABW recommends, for example, streamlining and consolidating multiple provisions and rules that are ultimately designed to accomplish the same goal, such as those that benefit families with children or that encourage taxpayers to save for retirement. To this end, ABW depicts a 14-line, postcard-sized form that taxpayers could use for “simple, fair” tax filings. (This is in stark contrast to the current individual income tax return (Form 1040), with its two pages, 79 lines, and multiple schedules reporting different types of income and tax information.) If simplification were truly possible, it would be a watershed. Yet “tax simplification” seems like an oxymoron: there is rarely anything “simple” about taxes, or reform, which is bound to face resistance from affected constituencies. (In other words, no matter what happens, tax professionals are still likely to have a job!)

“Flatter.” A “flatter” tax system means fewer tax brackets and a broader tax base. Under both Mr. Trump’s proposals and ABW, our current system’s seven income tax brackets (ranging from 10% to 39.6%) would be collapsed into three: 12%, 25% and 33%. These lower rate brackets would be made possible by broadening the tax base, and eliminating most, if not all, “tax expenditures” (these are tax benefits that reduce taxable income, namely, deductions, credits, exemptions, exclusions, deferrals and preferential tax rates). A broader tax base therefore would likely tax employer-provided health care (it is currently tax-exempt), and eliminate most itemized deductions, including those for state and local taxes. Would the lower rates and broader base
be a wash for most taxpayers, or might it benefit some more than others? Without seeing actual legislation, it’s
hard to know. Yet logic suggests that if the bulk of a taxpayer’s income is subject to the current top rate of
39.6%, for example, that same taxpayer could presumably save significant tax dollars if that top rate became
33%.

“Fairer.” A “fairer” system relies on a baseline definition of “fairness,” something that depends, of course, on
underlying beliefs. To illustrate, from ABW’s perspective, the current tax system is unfair because it is “biased”
against savings by taxing investment returns; this situation is only partially mitigated by the lower tax rate for
long-term capital gains and dividends. (This position reflects the belief that a dollar should only be taxed once,
namely, when it is earned.) By contrast, from the Democratic perspective (see the “Buffett Rule” above), it is
unfair that many salaried workers pay a higher effective rate of tax than a high-income individual whose income
chiefly stems from investment returns. (This position reflects the belief that income is income, and that our tax
code shouldn’t play favorites.) And so forth.

…which means…Given these deep philosophical differences, it is hard to envision a bipartisan meeting of the
minds on, say, individual income tax reform. The lack of bipartisan agreement won’t matter in the House,
where there are sufficient Republican votes to pass legislation, even without Democratic support; the Senate,
however, is a different story. There, if the Republicans use “reconciliation” to pass their “simpler, flatter and
fairer” tax legislation, they only need 51 votes (as opposed to 60) – but the law will not be permanent and will
need to “sunset” after 10 years. Stay tuned.

Other things to watch out for next year:

• **Basis reporting and consistency rules – final regulations coming.** The Treasury Department has
indicated that the final regulations on the basis reporting and basis consistency rules are likely to be out in
late January. (The 03/31/16 edition of *Tax Topics* discussed the proposed regulations on this topic). Some
key points to remember about these rules are that:

• Executors who **must** file an estate tax return because the decedent’s gross estate plus “adjusted
taxable gifts” are over the estate tax return filing threshold ($5.45 million in 2016 and $5.49 million in
2017) must also file a basis reporting statement (Form 8971 and related Schedules A) with the IRS
within 30 days of filing the return (penalties apply for failure to file).

• Executors of estates under this filing threshold who are merely filing an estate tax return to elect
“portability,” so that the deceased spouse’s unused exclusion amount carries over to the surviving
spouse, do NOT need to file the basis reporting statement.

• The proposed regulations had some controversial requirements, including: 1) heirs who receive
property that was reported to them on a Schedule A must also file a basis reporting form if they later
give this property to a “related transferee,” such as a family member; and 2) “after-discovered” property
will generally have a zero basis until it is reported.

• **Whither the proposed regulations on valuation discounts?** These proposed regulations have been
discussed in prior issues of *Tax Topics*, starting with the 08/31/16 edition. As mentioned before, these
rules are designed to eliminate perceived valuation abuses in transfers to family members of family-
controlled entities, such as partnerships and limited liability companies. Yet because these rules aim
broadly, family businesses – and not just entities funded with cash and marketable securities – are also in
the crosshairs. This has resulted in unprecedented criticism from family business owners and groups, advisors and many Republican members of Congress. At the December 1st hearing on these regs in Washington, D.C., only one of the approximately 37 people testifying supported the regs; the message from the other individuals was that the regs were irreparably flawed and should be withdrawn. The question, then, is not when these proposed regs will be made final, but whether they will be withdrawn and completely revamped, or simply withdrawn. As a practical matter, it seems doubtful that the incoming Trump administration will be interested in fixing them.

To sum up…it has been an interesting year, and will be even more so next year!

[About the January 2017 7520 rate – it is not yet out at this writing and will be in next month’s Tax Topics.]

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