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A Post-Trump Election Era for Wealth Management

- How to Manage Estate and Tax Planning Without a Crystal Ball –

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With promises often comes compromise, and promises for an overhaul of our Tax Code are always inherent in political fodder. With the election of Donald J. Trump as our 45th President, the unexpected has lead to vast amounts of uncertainty in business and estate planning. Extensive change has been promised, with many aimed at our nation's tax system. In particular, existing estate, tax, and wealth plans have been put in doubt at a time when the IRS has proposed a number of regulations aimed at closing loopholes. What should one do? This Special Edition Client Update is aimed at providing what we hope is helpful guidance and information. (For an introduction to some of these topics, see our Fall Client Update, which was published in October (Newsletter Fall 2016)

A "W" Bush Era Perspective

Whether history will repeat is questionable, but at least a perspective can be gained by a look at the last time the Republicans controlled Congress with a Republican President. Many of the currently proposed changes are similar to those that occurred with the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") that Congress enacted in 2001, with business and individual income tax reduction the primary goals. One should note the context, however, and that these changes were made after the "dot.com" bubble burst and the commencement of what became a 49% drop in the equity markets. One should also remember that the 9/11 terrorist attacks in New York occurred three months after this reform. During that time, the Bush administration proposals were being made with large ($5.6 trillion) projected budget surpluses and a choice to pay down the federal debt, pursue fundamental tax reform, or cut taxes. The Bush administration opted to prioritize large tax cuts, with the hope that the positive economic impact would increase tax revenues further than projected and reduce the deficit. Rather than a surplus, the current 10 year budget is for a projected deficit in 2026 of $1.4 trillion and a $9.4 trillion cumulative budget deficit through that period. Furthermore, the economy in 2001 was more robust than our currently tepid expansion. Therefore, for starters, our economy is in worse shape to withstand further deficits, and our equity markets aren't falling but they are tenuous as a result of high valuations.

Like in 2001, the Trump proposals are primarily focused on reducing taxes for individuals and businesses. Trump advisors are encouraging him to fast track business relief, while delaying individual proposals that would take longer. House Ways and Means Committee Chairman

Kevin Brady (R-Texas) has said he prefers a single bill that comprehensively reforms the tax code. This would take longer, perhaps two years, but avoid the limitations associated with a reconciliation process. Others are worried about recession and a present corporate and business system that is discouraging U.S. investment. They want a fast tracked reconciliation process uncomplicated by more complex individual tax reform. The priorities could be impacted by World competition to cut taxes in order to attract business and also an imminent fight over Medicare reform. Unlike in 2001, though, equity market valuations are rising and not falling. Though not at valuation levels believed to be lead by Greenspan's "irrational exuberance," some believe equity market valuations are ahead of themselves, but not as far ahead as they were in 2000.

President George W. Bush did not posses, and neither will President Trump, the 60% party control of the Senate needed to avoid a filibuster. Bush relied on the budget reconciliation process to pass EGTRRA, and if the fast track is chosen by Trump he will also likely follow that process. The reconciliation process requires a 10 year budget and restrictions, but some believe the current business proposals can pass in months. However, under the so- called Byrd rule any reconciliation legislation that increases deficits in years beyond the period covered by the budget resolution is subject to a point of order which can be waived only by a three-fifths vote of Senators (60% if all members are present). As a result, President Bush had to sunset many tax cut provisions to avoid the application of the Byrd rule, since deficits were projected to extend past the 10 year budget period. This ultimately resulted in a one year repeal of the estate tax (but not the gift tax) and what was called the Fiscal Cliff in 2012. A major impact of the Fiscal Cliff after 2012 was the potential decrease of the federal estate tax exemption from $5.12 million to $1 million. In early 2013, retroactive legislation was passed avoiding the reduction in the estate tax exemption.

From this perspective, we can see that several factors play against Trump's ambitious proposals. Many were similarly faced by President Bush. Unlike in 2001, however, the Country now faces huge budget deficits and less than a robust economy. There is also increasing competitive pressures from foreign countries.

Trump Proposals and Priorities- a World View

One could take the view that Trump's domestic priories will seek the passage of laws that encourage investment in the U.S., in kind-of a Reaganist manner but with what is likely more of a competitiveness against foreign countries. Presently the U.S.'s 35% corporate tax rate is the highest in the World, and with state income taxes added can exceed 39%. The U.S. has the highest tax rates in the Group of 20 (which is a collection of the World's richest nations). After the recent Brexit, the U.K. proposed reducing their 20% tax (already 15% lower than ours) to 17% by 2020. Donald Trump has proposed a reduction of the U.S. corporate tax rate from 35% to 15%. Japan, Italy, Canada, and France have all recently reduced their corporate taxes in order to attract foreign investment in their countries. Ireland presently has a 12.5% corporate rate. The Republican proposal in Congress is to reduce the corporate tax rate from 35% to 20%. The odds are that a substantial reduction in our corporate tax rates will be the primary goals of President-elect Trump and a Republican Congress aimed at fostering international competitiveness and investment with business operations in the U.S.

Both Trump and the Republican House proposals for taxing the repatriation of untaxed offshore earnings will cause a revenue windfall. The estimated amount of foreign profits that could be repatriated is estimated at $2.6 trillion, and Trump has proposed taxing these at 10%. Senator Brady desires to use these tax revenues to fund tax rate reductions, while he acknowledges a developing plan to fund domestic infrastructure projects. It appears that U.S. companies are already planning to increase their domestic "CAPEX" (business capital expenditure) with these domesticated earnings, with Ford and Apple recently announcing the expansion of U.S. facilities. Several proposals in past years encouraged investment of repatriated earnings in CAPEX or employee training in order to obtain the benefits of a tax holiday. Reducing corporate tax rates is also being leveraged to encourage U.S. companies to remain in the U.S. and not move factories overseas, such as with recent lobbying efforts to keep air conditioning company, Carrier Corporation, from moving its Indiana plant to Mexico.

Various other Reagan type business tax incentives are proposed, that are intended to stimulate CAPEX and U.S. focused investment. These generally involve accelerating the write-off of investments that are made in areas targeted by the government. Real estate was targeted in the Reagan era, but programs aimed at training workers and revitalizing America's infrastructure and manufacturing sectors will likely be the focus of any new measures.

Individual Tax Reform

Individual income tax reduction proposals focus on reducing the present seven tax brackets that range from 0% to 39.6% to three, 0%-12%, 25%, and 33%, while eliminating the 3.8% net investment income surtax. Itemized deductions would be reduced but the standard deduction would increase by more than double to $15,000 for single filers and $30,000 for married couples filing jointly. Both President-elect Trump and the Republican House have proposed elimination of the alternative minimum tax. Various other business and individual tax proposals complicate reform, which some argue will slow positive business changes that can pass more quickly if a reconciliation process is not followed. As a result, some are suggesting two legislative bills, rather than one comprehensive measure that seeks to avoid the reconciliation process limitations.

Estate and Gift Tax Repeal

Both President-elect Trump and the Republican House have proposed elimination of the estate and gift tax. Trump has proposed implementing capital gains tax recognition on unrealized gains at death, but with a $10 million exception where the first $10 million of unrealized gains will secure a tax basis step-up to date of death fair market value. Variations of these concepts in taxing wealth at death have existed in the U.S. and in other countries before, and a review of some history may help in planning for change. A review of the variations of these concepts, and the Bush era approach to eliminating the estate tax, provide a useful historical background and context in assessing current estate planning.

The first estate tax was implemented in 1797, and it has been repealed and reinstated four times-1797-1802; 1862-1870; 1898 -1902; in 1916; and 2010. The estate tax was implemented and reenacted after repeal to pay for the cost of wars. The Tax Reform Act of 1976 introduced "carry

over basis" of assets at death, and after an outcry carry over basis was retroactively repealed in 1980. The outcry stemmed from the difficulty in maintaining and proving historic cost basis and maintaining records for property that may have been owned for decades by ancestors. Proposals attempted to ameliorate this problem by giving everyone a fresh start and a new basis for assets as of December 31, 1976. Repeal of carryover basis was favored in the debate, and it was retroactively eliminated. From then until 2010, when EGTRRA repealed the estate tax, assets passing from decedents to heirs received a date of death value cost basis for purposes of calculating future capital gains on sales. In 2010, carryover basis reemerged for one year, with a $1.3 million exclusion which received a step-up in basis to date of death value. The balance of the estate received a carryover basis.

President-elect Trump is proposing a system that is similar to Canada's on amounts in excess of $10 million. Under the Canadian system, all assets are deemed sold at death and unrealized capital gains are recognized. When the Canadian system was implemented, all taxpayers received a step-up in basis on assets in order to establish a starting point for cost basis recordkeeping. Under the current Trump proposal, the first $10 million of unrealized gains would receive a basis step-up to fair market value, and amounts over $10 million would be recognized and capital gain taxes paid.

Although President-elect Trump has proposed repeal of both the estate and gift tax, in the most recent repeal of the estate tax in 2010 the gift tax was not repealed and only a $1 million exemption was provided. The gift tax should be recognized as not only a backstop to the estate tax, but also to the income tax. The purpose of retaining the gift tax in 2010 was likely a recognition that if it were known that the estate tax was only a temporary repeal for one year as a result of the sunsetting of EGTRRA, failure to leave the gift tax intact would leave a gaping hole that allowed taxpayers to remove wealth from the estate tax system, which would be reenacted the following year. With respect to the gift tax being a backstop to the income tax, without a gift tax wouldn't it be easy to gift assets with unrealized gains before death to escape the Canadian system of recognition of gains on death?

Some combination of the measures described above will likely be enacted to replace our current estate and gift tax system. What is not clear, however, is whether the estate tax will be phased-out over time, will be a complete repeal, whether it will model the capital gain recognition system used in Canada, will eliminate tax on gifts, or involve some combination of all of these measures. Given our present deficits and the present business tax reduction priorities, it is likely President Trump will face a dilemma similar to what President Bush faced in 2001, particularly if the reconciliation procedure is followed and the Byrd rule is avoided to fast-track business tax reform. It is common for the estate tax to take a back-seat to individual and business tax reform, since only 1/10th of 1% of estates pay the estate tax.

What to Do Now?

Income Tax Planning: Deductions are going to be more valuable if taken in 2016 because of its higher rates given the likelihood of a January 1, 2017 retroactive tax reduction, while income will likely be taxed at lower rates in 2017. So, as in most years, if one has the ability to shift income into the following year it will likely provide not only deferral but also a lower tax.

Contrariwise, accelerating ordinary type expenses, such as interest payments on mortgages, into 2016 will produce higher marginal tax benefits. Business capital expenditures should be delayed to 2017, as forms of accelerated cost recovery through write-offs and amortization are likely to be enacted with a retroactive date to January 1, 2017.

Estate Tax Planning: Until some certainty is established, the bias is to sit and wait and see. The priorities of President Trump and the Republican controlled Congress appear to be domestically focused business investment and to foster global competitiveness. Income tax reform for businesses and individuals appears to be the next priority, with estate tax repeal a major objective but one that might be hindered or delayed by higher priorities. Much like President Bush faced in 2001, estate tax repeal may have to be phased-in or compromised with a greater level of capital gain recognition on death or a phase-out of the present system by increasing exemptions. President-elect Trump does not have the benefits of a more robust economy and budget surpluses that President Bush had in 2001.

Much of estate planning involves shifting wealth out of the taxable estate. As a result of pending proposed regulations, one of the preferred methods using family partnerships has been threatened. Many are in the middle of implementing strategies to shift wealth using present law, prior to the potential finalization of these regulations. One may question whether to continue with this planning, though most understood that there was a possibility Trump would be elected and the estate tax could be repealed. In this context our advice has been based upon the following facts and logic:

1. We don't know whether or when the estate tax will be repealed.
2. We don't know whether it will be phased-out, as President Bush sought to do in 2001.
3. We know that the estate tax has been repealed several times in our history, but has been repeatedly reenacted. It was repealed most recently for one year in 2010. After all of those events, having wealth outside of the taxing system has proven to be a good thing!
4. We know that President-elect Trump has proposed taxing unrealized gains like Canada, but with a relatively high proposed threshold. Planning to avoid this tax will involve wealth shifting techniques, very much like those historically used and presently being pursued in confronting the pending proposed IRS business and family partnership regulations.
5. We don't know whether the gift tax system will be changed as part of estate tax repeal. It would seem too easy to avoid the Canadian system of taxing gains on death, if they could simply be gifted away prior to death. Some tax cost will likely be imposed to avoid this loophole, which could come by either maintaining the gift tax system or recognizing unrealized gains on gifts. The Canadian system taxes unrealized gains (capital gains) on gifts of property at a rate of 50%.
6. One can conclude that the sooner wealth can be removed from a taxing system, the better. This is particularly true if the shifted wealth can be returned if the system permanently changes. That said, recognizing the estate tax system has changed and been reinstated several times in our history, one might conclude nothing is permanent and that it is best to maintain exempt wealth, exempt until you hold that verifiable crystal ball!

Summary

The prospects for major tax reform are the highest they have been since 2001. However, the current economy and federal budget are not as conducive. A focus on tax reform that will stimulate domestic business will likely be the priority, which is enhanced and likely coupled with a form of tax holiday aimed at repatriating offshore earnings and profits at favorable tax rates. Both public and private use of these earnings and tax revenues will likely be the subject of significant debate and policy compromise.

Reduction of individual income tax rates will also be a high priority. Reagan era business stimulus measures will likely be aimed at small business, with measures aimed at encouraging the training of employees also likely. Estate tax repeal has been a goal of the Republican party for years, and the death tax will likely be a major focus but subordinate to the other priorities set forth in this paper.

Accelerating deductions into 2016, and deferring income into 2017 is the conventional advice for income tax planning. Proposals are aimed at flattening the tax by reducing the number of brackets, increasing the standard deduction, and eliminating some itemized deductions. These will likely pass later in the year, with a January 1, 2017 effective date. Capital investment should be deferred until 2017, when fiscal stimulus will likely encourage such investment with the prospect of accelerated cost recovery as was done by Reagan in 1981.

Estate tax reform and repeal is likely, but it may be delayed or phased in. To some degree, the estate tax may be repealed with the imposition of a capital gain tax at death and on gifts. Methods of shifting wealth to avoid the estate tax will likely similarly be used to avoid capital gain recognition. The bias for further death tax reduction is one of waiting to see, but for those with larger estates and relatively short life expectancies, continuing to shift wealth (particularly in advance of the recently proposed family business and partnerships regulations) would seem prudent. These shifts will not only reduce estate tax exposures in the interim, but properly managed may serve to potentially avoid capital gains taxes on unrealized gains under a Canadian modeled system.

Though it is anyone's guess what will happen, managing wealth in exempt form, but with flexibility built-in to confront various types of tax systems and change, seems to be the best advice for larger estates.

As always, we are pleased to be of service and invite questions or comments. We hope you had a wonderful Thanksgiving and have a great Holiday Season,

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