Wealth Planning Insights

Helpful Tips for Year-End Tax Planning and Charitable Giving

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Highlights

- The election of Donald Trump as president will almost certainly have a substantial impact on tax and philanthropic planning.
- While specifics are lacking in many areas surrounding tax reform, and the differences between proposed legislation and enacted legislation can sometimes be profound, we can identify some of the more likely possibilities — and some of the potential planning opportunities and pitfalls.
- In this *Wealth Planning Insights,* we provide a brief overview of some of the more probable changes to the tax code and their broader implications, as well as some helpful tips for your tax and philanthropic planning as we head into year-end.

The November 8 election results seem certain to have far-reaching implications for tax and philanthropic planning.

In fact, we expect a potentially comprehensive tax bill to be one of the first orders of business for the new administration, although the details are presently unknown. We do know that Speaker Ryan, who recently introduced his own tax-reform plan, will likely have a great deal of input in the final package.

It is important to note that although Republicans retain control of the Senate, their majority is still short of the 60 votes required to overcome a filibuster. Major tax legislation will probably require Senate Republicans to use the reconciliation process, which could result in a 10-year "sunset" provision similar to the Bush-era tax cuts.

Moreover, the proposals are expensive and would require revenue offsets or spending cuts to address the concerns of deficit hawks in Congress.

Also, we can expect industry lobbyists to be on high alert as cherished tax provisions may be on the table.

While all of this means real uncertainty about the specific changes ahead, we can identify some broad themes and proposals we could see in the next few months:

- **Individual tax rates on ordinary income.** Top income tax rates are likely to decrease for individuals. Trump and Ryan have coalesced on a top rate of 33% on ordinary income, a significant drop from the current top rate of 39.6%.
- **Itemized deductions.** Trump has offered few details on how revenue lost to lower rates will be offset. A significant trimming of allowable itemized deductions, either through a cap or outright elimination of many, is a distinct possibility. Ryan's plan eliminates all itemized deductions with the exception of mortgage interest and charitable contributions.
- **Investment income.** Another priority for the new administration will be the repeal of much of the Affordable Care Act, including the 3.8% net investment income tax. While Trump has proposed a top rate of 20% on qualified dividends and long-term capital gains, the Ryan plan goes much further. His plan includes a 50% exclusion on dividends, capital gains (including, presumably, short-term gains) and taxable interest. This would equate to a preferential

top tax rate of 16.5% on an expanded class of investment income, much of which is currently taxed at top rates of 23.8% and 43.4%.

- **Pass-through business income.** Trump's plan would allow owners of sole proprietorships, S corporations, partnerships, and other pass-through businesses to elect to be taxed on their pass-through business income at a newly reduced corporate rate of 15%. Ryan's plan incorporates a similar concept but provides for a higher rate of 25%. Strict rules will likely be included to prevent individuals from converting taxable wages and other ordinary income into business income through the creative use of LLCs and other pass-through entities.

- **Alternative minimum tax (AMT).** The AMT — which attempts to ensure that taxpayers who benefit from certain exclusions, deductions, or credits pay a minimum amount of tax — would be repealed in both the Trump and Ryan tax plans.

- **Estate tax.** The estate tax and the generation-skipping transfer (GST) tax would be repealed in the Trump and Ryan plans as well. However, Trump has proposed taxing gains on assets held at death beyond a $10 million threshold and repealing the step-up in basis at death. The potential for the repeal of the gift tax as well is unclear at this point.

What Should You Do About Tax Planning?

It is prudent to exercise caution when considering tax-planning moves in advance of tax legislation that is likely to occur but will not be introduced until the following tax year. With this in mind, the broad themes outlined above do present some significant opportunities and potential pitfalls — and AMT concerns play a role in most scenarios.

- **Accelerate deductions.** As a general rule, itemized deductions are worth more when tax rates are higher. With lower rates likely on the horizon, it could make sense to accelerate deductions into the current year. Consider large charitable gifts or the use of a private foundation or donor-advised funds where current deductible contributions can be made with grants to charities paid out in future years. Prepayment of state income taxes and real estate taxes can also provide a benefit.

- **Defer income.** With tax rates likely to decrease across the board on both ordinary and investment income, you may find it beneficial to defer income receipt or recognition into the future. Of course, as always, your investment decisions should not be driven solely by tax rates. (Caution: see alternative minimum tax point below.)

- **Harvest tax losses.** With lower tax rates on capital gains potentially on the way, it now makes even more sense to offset gains in the current year's higher tax environment.

- **Adopt a strategic approach to the alternative minimum tax (AMT).** Although it is never a good thing to be subject to AMT, there can be a silver lining. The top marginal tax rate for AMT taxpayers is only 28%. With the AMT facing probable repeal and a reduced (but still comparatively higher) marginal tax rate of 33% next year, it may make sense to actually accelerate income into 2016. For taxpayers with a traditional IRA, converting all or some portion of this into a Roth IRA at a 28% rate may be beneficial.

  There is a concern that some taxpayers who are currently subject to AMT may end up paying more tax in 2017 under the Ryan plan. The Ryan plan actually looks similar to present-day AMT (allowable deductions for mortgage interest and charitable giving), but the proposed top tax rate of 33% on non-portfolio income is higher than the current AMT rate of 28%. The end result could be a repeal of AMT along with a new tax system that looks quite similar to AMT, but with a higher rate. The key tradeoff may be lower rates on investment income, which could more than offset the higher tax rate on ordinary income. The devil is in the details, which are sorely lacking at this point. We will be watching this closely as the majority of Bessemer clients are subject to AMT.

- **Keep track of passive income and losses.** Many higher-income taxpayers report significant passive income — that is, rental income or income from businesses in which the partner is not actively involved.

  If you do have substantial passive income, you and your advisor may benefit from exploring ways you might increase your involvement in a venture that may be classified as a non-passive investment. The income from the non-passive investment would be excluded from net investment income tax.

If you have passive losses, you can only offset them with passive income; these losses may be suspended and carried forward to future years, indefinitely, to offset future passive income. However, if you're carrying suspended passive losses at the time of your asset's disposal, these losses may be used to offset taxable income regardless of the presence of passive income.

- **Take advantage of qualified retirement planning opportunities.** If you report business income or are self-employed, you may wish to utilize the favorable tax treatment of qualified retirement planning opportunities, including a simplified employee pension individual retirement account (SEP IRA). Similar to the tax treatment of a traditional IRA, a filer who contributes to a SEP may take a pretax deduction against income equivalent to the contribution up to certain limits. As the tax deduction is available for an individual who funds his or her own retirement plans, we often describe a SEP IRA as a way to reduce a tax bill by moving money from one pocket to another.
- **Consider a tax physical.** Bessemer's tax physical — a proprietary, comprehensive analysis of your previous-year tax returns — can provide you with a more informed picture of your financial health and help to uncover tax-saving opportunities for the year ahead.

A New Reality for Philanthropy?

Trump's presidency will significantly influence philanthropies and nonprofit organizations, but it is still unclear precisely how.

On one hand, if high-net-worth people see an increase in after-tax income under his administration, which seems likely, they may have more to give to charity and choose to do so. And if wealth becomes more concentrated in the uppermost tier because, for example, the estate tax is repealed, major gifts to nonprofit organizations may get even bigger.

On the other hand, with Republicans controlling both the White House and Congress, comprehensive tax reform in 2017 could lead to fewer incentives for — and a decline in — charitable giving. Some analysts estimate that Trump's plan could reduce individual giving by 4.5%-9.0% (between $13.5 billion and $26.1 billion) in 2017, since the after-tax value of the charitable tax deduction would shrink in the (highly likely) event that marginal tax rates on the affluent are cut.

Trump's plan to raise the standard deduction and put a $200,000 per-couple cap on itemized deductions could also discourage donors from making tax-deductible donations in the future.

Furthermore, his tax plan also calls for repealing the estate tax and imposing a capital gains tax on assets left to heirs above a certain threshold, which could influence decisions donors make about charitable bequests.

As crucial as government leadership is and irrespective of political perspective, most citizens would probably agree that the country still needs an independent and vibrant civil society and nonprofit sector to address issues and challenges that may be outside the government's domain. In particular, if government funding ends up being reduced for particular causes, certain donors and foundations could want to boost their giving in select areas.

You may desire to shift your philanthropic funding to a more national level, or concentrate more on statewide and local efforts.

Certain philanthropists may wish to give more to support public policy advocacy, or perhaps choose to support direct services.

In addition, since this presidential campaign drew attention to alleged questionable practices associated with both candidates' charitable organizations, there may be calls for greater regulation of foundations and charities. The leadership of the Ways and Means and Senate Finance tax-writing committees in the House and Senate will mostly remain the same, and the Philanthropy Caucus co-chairs in the Senate and House all retained their seats. Regardless of whether foundation regulations are reformed, Bessemer will continue to advise clients on how to avoid self-dealing and conflicts of interest.

What Should You Do About Charitable Giving?

So, given all of the above, how should you approach charitable giving as we head into year-end?

- **Consider a larger charitable contribution this year.** With lower tax rates imminent, it could be wise to consider making large contributions to public charities or private foundations, or creating or adding more to a donor-advised fund (see accelerate deductions section above). Donor-advised funds currently provide the maximum allowable charitable tax deduction in the year the contribution is made while enabling you to recommend grants to charities in future years. For more information about DAFs and other giving vehicles, please see *A Closer Look: Ways to Give*.

  Moreover, while there is a good deal of uncertainty as to what the rules may be in 2017 and beyond, there is no doubt about the rules in 2016. Making charitable gifts now will result in a tax benefit that is not subject to an overall cap or some other restriction on allowable itemized deductions that may be incorporated into a tax reform package in 2017 as a tradeoff for lower tax rates.

  That said, taxpayers who will be subject to AMT in 2016 may face a more difficult choice when it comes to accelerating charitable contributions (see alternative minimum tax discussion above). It is conceivable that some current AMT taxpayers could face a higher tax rate next year such that deferring charitable giving may be beneficial. Unfortunately, we will need more clarity on the likely path of tax reform legislation before we can know for sure.

- **Make sure you donate to a qualified and effective organization.** Donations must be made to qualified tax-exempt organizations to be tax deductible. Our philanthropic advisory team can help determine if the intended recipient organization qualifies. Also, for more information, you can refer to our recent *How to Select a Nonprofit to Support Financially: Four Key Steps*.

- **Keep deadlines in mind.** A contribution is tax deductible in the year it is made. A check that is written, mailed, and postmarked on December 31, 2016, is deductible for 2016 tax return purposes. Similarly, any contribution made via credit card that posts to the account in 2016 is tax deductible in 2016. Phone contributions are eligible in the year the funds are transferred, regardless of the verbal pledge's timing.

  If you are uncertain about choosing a nonprofit to support but still want to take advantage of the tax deduction by giving prior to year-end, you may decide to contribute to a donor-advised fund (DAF), such as the Bessemer National Gift Fund.

- **Consider giving appreciated assets in lieu of cash to reduce capital gains taxes.** Depending on the recipient organization's ability to accept and use a gift, you may choose to give cash, securities, real estate, personal property, and/or other assets. The most suitable strategy depends on many factors, including how much you want to give and the cost basis of the asset, but donating an appreciated asset rather than cash, if possible, can be tax effective as it would avoid capital gains taxes on the sale of the asset, allow you to take a charitable tax deduction, and accomplish your charitable goals.

- **Be aware of any value of goods and services exchanged in consideration for a donation.** If you receive any physical merchandise, goods, or service in return for a donation, you must reduce the value of the tax deduction by the value of the merchandise, goods, or service. For example, if you make a gift to a museum and receive a seat at a dinner gala, you must deduct the value of the dinner and any entertainment. The acknowledgement letter will specify how much of the gift is eligible for tax-deduction purposes.

How Bessemer Can Help

Our mission is to help our clients develop comprehensive long-term approaches to tax and charitable planning within the context of their greater wealth planning needs.

Please contact your Bessemer Trust client advisor if you are interested in obtaining additional information about how Bessemer Trust can help you and your family with year-end tax planning and charitable donations.

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