Brown ADVISORY
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STRATEGIC ADVISORY LETTER

NOVEMBER 2016

2016 YEAR-END PLANNING LETTER

TAKEAWAYS

- A Republican sweep of Congress and the White House increases the possibility of changes to the law in areas like tax, health care and trade. While there will not be any firm proposals until 2017 at the earliest, we will be looking for and analyzing changes that may have an impact on our clients.
- However, the *current* policy environment remains relatively steady, at least through the end of 2016. There are few shifts in tax policy that present clients with a need to act before a specific deadline.
- As we noted in our midyear letter, it is helpful to build long-term plans on a foundation of stable, incremental yearly steps. Despite the political winds of the campaign, 2016 is shaping up to be a stable planning year, giving us room to focus on reviewing long-term goals vs. acting on policy deadlines.

KEY PLANNING NOTES FOR 2017

- 2017 may see the elimination of valuation discounts on transfers of family-held business assets. Clients with family businesses or family limited partnerships should consider whether it makes sense to consider transferring assets while policy still allows for these discounts.
- Provisions recently extended or made permanent include tax-free treatment of some distributions to qualified charities from retirement plans, as well as several provisions designed to benefit small business owners and entrepreneurs.
- As always, we are available to work with clients to review various annual planning items, such as accelerating or postponing income, gains or deductions, using annual exclusion gifts, and taking advantage of lifetime wealth transfer opportunities.

ANNUAL PLANNING CHECKLIST

INCOME TAX

- ☐ Review opportunities for tax-loss harvesting to offset realized gains.
- ☐ Review opportunities to accelerate/decelerate income and capital gains, based on current tax environment and future tax expectations.
- ☐ Review charitable gifts and assets to maximize deductions.
- ☐ Ensure optimal timing of state tax payments.
- ☐ Maximize retirement plan contributions.
- ☐ Consider Roth IRA conversion(s).

TRANSFER TAX

- ☐ Review use of annual exclusion gifts.
- ☐ Review use of gift exclusion for payments of tuition and medical expenses.
- ☐ Review lifetime gift and GST gifting opportunities.
- ☐ Evaluate options for advanced planning vehicles.
- ☐ Review intrafamily loans and opportunities to leverage a low interest–rate environment.
- ☐ Consider use of short-term GRATs for concentrated positions.

INVESTMENTS

- ☐ Re-examine asset allocation, expected income and principal return expectations.
- ☐ Optimize asset location for achieving best long-term balance of liquidity and tax efficiency.
- ☐ Review outstanding mortgages and other loans to identify opportunities to improve structure.
- ☐ Complete annual review of all trusts and trust documents.

PROTECTION

- ☐ Review property and casualty insurance in light of changes that may have taken place with your tangible assets.
- ☐ Review beneficiaries of retirement plans and life insurance policies.
- ☐ Review health care proxies, living wills, powers of attorney and other important legal documents.


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The result of the 2016 Presidential election raises many questions about the direction of government policy, and we will not have answers to many of those questions for some time to come. Despite this uncertainty, the *current* policies governing our long-term investment planning environment are relatively steady, at least through the end of 2016.

Despite a lack of pressing planning deadlines, we believe that year-end reviews with clients are essential steps to realign plans with long-term goals and ensure that annual planning steps are being put into action.

We approach the end of the year after a prolonged and combative political season that resulted in a Republican electoral sweep, with President-elect Donald Trump winning the White House and the GOP retaining control of the Senate and House of Representatives. As a result, it is reasonable to expect policy proposals from the new administration in areas such as tax, health care and trade. Certainly there is precedent for post-inauguration changes in tax policy; tax changes were put in place in the inaugural years of the Reagan, Clinton, George W. Bush and Obama administrations.

Through the rest of the year, we are focusing on readiness rather than reaction. Over many years, we have seen many instances where the broad market has reacted swiftly, suddenly and perhaps irrationally to surprising events. Indeed, various corners of the market rose and fell sharply in the days following the election, and yet none of us really have any clear sense yet of what policies will result from this political transition. Any new policies will not be enacted until 2017, but we are watching carefully in the coming months for new proposals and assessing their implications.

Despite the politically charged atmosphere, we note that there are very few looming changes to tax policy pending before the end of the year. In some years, we have visibility into meaningful shifts in tax policy that suggest a need for broad-based modifications to long-term financial plans. This is not one of those years. Below we discuss the one significant shift that is squarely in sight for 2017, namely the possible elimination of valuation discounts on the transfer of family-held business assets. Beyond this proposed change, as well as a small number of tax provisions extended or made permanent by Congress last year, the planning environment is relatively stable heading into the end of the year.

So we are closing in on the year-end planning period with something of a blessing, in that there are no strong drivers pushing us to recommend major adjustments to our clients' long-term plans. As we noted in our midyear letter, it is helpful to build long-term planning efforts on a foundation of stable, incremental yearly steps, and 2016 is shaping up to be a year that helps us build on that groundwork. Over time, we seek to supplement that foundation with more significant actions based on timely opportunities, whether those opportunities are provided by changes in income and estate tax policies under the new administration, or other policy-driven or market-driven factors in the years to come.

During some year-end review periods, we find ourselves sitting alongside our clients in a more reactive mode, looking at major pending changes to policy (as was the case in 2012's long march to the edge of the "fiscal cliff"), or meaningful shifts in market valuations (as was the case in the aftermath of the 2008-2009 financial crisis), and determining how best to respond to external factors. To be sure, such circumstances often provide meaningful opportunity to add value to one's long-term prospects, but such shifts and their timing is out of our control.

However, with fewer outside factors disturbing the planning status quo this year, we can focus our attention entirely on your long-term plan, putting into action all of those incremental steps that can add up to striking results over time, and making sure that we have evolved your plan thoughtfully alongside any changes in your goals and circumstances.

In terms of incremental steps, there are a variety of concepts outlined in this letter that can contribute to a solid planning foundation. For example, an annual process of accelerating or postponing income, gains and deductions plays an extremely important role in spreading out taxable events in a beneficial manner. Another example is taking advantage of gifting strategies and limits available to you each year, from more complex trust strategies to the annual $14,000-per-beneficiary gift allowance available to you each year for an unlimited number of beneficiaries.

Additionally, we note several tax provisions relevant to our clients that were extended or made permanent in last year's PATH ("Protecting Americans from Tax Hikes") act. Individuals over 70½ can now receive tax-free treatment of up to $100,000 of distributions to qualified charities from their retirement plans. The act also includes several provisions designed to benefit business owners, such as favorable treatment for qualified small business stock (QSBS) and more advantageous treatment for those converting C corporations to S corporations. For those clients affected by these provisions, they create notable opportunity.

As noted, the only major pending policy shift for 2017 is the potential elimination of valuation discounts on the transfer of family-held business assets. The IRS in 2016 issued proposed regulations that would virtually eliminate valuation discounts on the transfer of shares of Family Limited Partnerships or Limited Liability Companies. The IRS currently allows the discounts for estate and gift purposes because the holder of a partial interest in an entity lacks marketability and wields only limited control. It is not yet certain that this IRS proposal will take effect but it does appear increasingly likely. We believe that clients with family business interests should absolutely review their current ownership structures, to see if it makes sense to pursue meaningful ownership transfers to take advantage of their ability to discount valuations for tax reporting purposes.

Notwithstanding those specific planning opportunities, we still see 2016 as a year with a minimal amount of external factors pressing our clients to action. That provides us with additional breathing room to spend time with you, deepen our understanding of your evolving situation, and learn whether your long-term objectives have shifted and thus whether your long-term plans should shift in response. We understand the strong temptation to "set and forget" when it comes to long-term planning—an in-depth planning process requires a great deal of time and emotional energy—but one of the obstacles to a successful long-term planning effort is an insufficient commitment to regular reappraisals of the plan's fundamental assumptions about goals and circumstances. In years when there are numerous external deadlines that dictate planning steps, there may be less time for introspection and reflection, but in years like this one we hope to have ample opportunity to re-examine your plans from a 20-year, 50-year, even a 100-year perspective and help you make sure that they reflect your ultimate aims for your lifetime and future generations.

INCOME TAXES

Clients should weigh the following tax strategies based on their current needs and circumstances, and adjust their approach based on any tax law changes made in 2017.

All individual income tax calculations are based on adjusted gross income (AGI), which includes all taxable income, such as wages, bonuses, taxable interest, dividends, capital gains, retirement distributions, annuities, rents and royalties. For many clients, there is unexpected flexibility in moving some of these items—including retirement plan distributions, capital gains and even employee bonuses—from one year to another in order to manage the amount of AGI realized in any given year.

1. Shift income into the more advantageous tax year. A client expecting AGI to be higher in 2016 than in 2017, or anticipates being in the same or higher bracket in 2017, may benefit by deferring income. Conversely, a client may benefit by accelerating income into 2016 if they will be in a higher bracket in 2017, or if additional income in 2017 would permit offsetting deductions or credits that may be unavailable in future years.

2. Manage the tax on net investment income (NII). The Medicare tax on net investment income imposes an additional 3.8% tax on most types of income and capital gains earned from personal investments, less any applicable investment expenses. The NII tax applies to individual taxpayers whose AGI exceeds $200,000 and joint filers with AGI exceeding $250,000.

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The tax rate for long-term capital gains for those in the highest tax bracket is 20%. With the NII tax of 3.8% included, the tax approaches 24% for long-term capital gains. By managing income and deductions to keep AGI below the NII thresholds, a taxpayer can potentially reduce or eliminate NII taxes in a given year. Consider accelerating planned gains, retirement distributions and even employer bonuses into 2016 if you will not reach the NII threshold this year. Alternatively, a client expecting lower AGI in 2017 may want to defer planned capital gains, retirement distributions and employer bonuses into 2017 to reduce NII impact. Note that any specific transaction should always take into account investment considerations before tax consequences. In addition, a client may wish to treat long-term capital gains as short-term gains to increase the deductibility of investment interest expense for both NII and the AMT.

3. Use capital losses to offset realized gains. A client in the 39.6% tax bracket with a short-term capital gain should identify unrealized capital losses to generate prior to year-end. Given that the peak rate on long-term capital gains for high-income taxpayers is 24%, deploying unrealized capital losses can be especially beneficial. We encourage a broad conversation about realized gains and harvestable losses among assets held at Brown Advisory and elsewhere.

4. Re-examine asset location. Investments producing taxable income—such as non-qualified dividends and interest—are subject to higher tax rates. One way to reduce the tax impact is to use tax-deferred vehicles such as IRAs, 401(k) plans and other qualified retirement structures.

Placing taxable bonds, high-yield bonds, REITs or other tax-inefficient investments in these vehicles can result in meaningful tax savings.

5. Accelerate or postpone deductions to maximize tax advantages. The correct timing of deductions can significantly reduce a tax burden. Individual taxpayers must calculate tax liability under two methods—the regular tax method or the AMT method. Whichever tax calculation results in a higher tax is what is owed. AMT is usually triggered by relatively common deductions, including state income taxes, real estate taxes, a large number of personal exemptions for large families and high miscellaneous itemized deductions. These deductions are typically what we look for when trying to reduce regular tax liability. However, they are not allowed to taxpayers subject to the AMT. Changes under the American Taxpayer Relief Act of 2012 reduced individual exposure to the AMT at higher income levels by reviving the "Pease" phase-out rule on itemized deductions and "PEP" phase-out rule on personal exemptions. These rules effectively reduced itemized deductions and eliminated personal exemptions for high income taxpayers.

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Taxpayers can deploy charitable deductions under both the regular and the AMT method. Appreciated stock held for more than one year is often the best source for such donations from a tax perspective. A client can use the cash to buy stock that will be contributed to charity and benefit from a stepped-up basis in the security. This is also helpful with planning related to the NII tax.

6. Distribute income out of trusts to reduce federal taxes. It is important to note that trusts are subject to the top 39.6% tax bracket as well as the NII tax if they earn income greater than $12,400—a considerably lower figure than the threshold for individual and joint filers. As a result, where it is appropriate, fiduciaries should consider making distributions to beneficiaries in an effort to increase overall tax efficiency between the trust and the beneficiary.

7. Convert to a Roth IRA where appropriate, or recharacterize a Roth conversion as a Traditional IRA.

Conversion: A Roth conversion can benefit taxpayers who can pay the tax due on the conversion with the funds outside of the IRA. This strategy may be particularly useful for a taxpayer who pays at a lower rate on conversion than the rate expected in the future. Tax on a Roth conversion is based on today's rates.

Recharacterization: But what if a taxpayer converted a traditional IRA to a Roth at a time when the assets were at peak valuation, and the value of the assets have since declined? This means that tax will be owed on the Roth conversion even though the value of the IRA has declined. This circumstance has not been unusual given market volatility in recent years. There is a path to relief in such circumstances, but only if the taxpayer "recharacterizes" the conversion and completes a trustee-to-trustee transfer to a traditional IRA before filing a tax return. Although the deadline for recharacterizing a conversion in 2016 has passed, it is worth keeping in mind that this "reset" button exists for future years.

GIFT AND ESTATE TAXES

The federal estate tax exemption will rise to $5,490,000 in 2017 from $5,450.000 in 2016. If families deployed $10 million in federal estate tax exemption in 2012 and haven't taken further action since, they will have an additional exemption of approximately $980,000 available to them. Clients should talk with their Brown Advisory team to determine how to best use the exemption.

The proposed IRS rules limiting the availability of valuation discounts to family entities are especially broad, eliminating almost all discounts for owners with a minority share of closely-held entity interests, including an active family-owned business. Clients who use an FLP structure holding marketable securities that have not fully transferred to the next generation should consider completing the transfer prior to adoption of the new rules. In addition, they should consider transferring family business ownership to the next generation in order to take advantage of the existing law.

Here are additional strategies for minimizing gift and estate tax:

1. Consider making gifts to children and grandchildren. The gift-tax exclusion for 2016 is $14,000 per gift recipient. Remember the annual exclusion gift is a "use it or lose it" opportunity, meaning that the annual exclusion does not carry over from one year to the next. Providing gifts on a tax-free basis is an ideal way to reduce, and possibly eliminate, larger gift and estate taxes in the future.

Example: Grandparents establish a trust for a grandchild at birth and contribute $14,000 each on January 1 for 15 years. Assuming annual growth of 7%, the trust would be worth more than $752,000 at the end of 15 years. At a 40% estate tax rate, the family would reduce estate tax by more than $300,000. If no more gifts were made and the trust annually grew at 7%, the grandchild at age 55 would have a trust worth approximately $11.3 million. The example shows the benefit of giving early and leveraging the power of compounding.

As mentioned previously, with the increase in the exclusion from $5 million in 2012 to $5.45 million today, a couple may be able to provide as much as $900,000 in additional tax-free gifts. Of course, when evaluating any strategy for giving, a client's first priority should be financial security. No amount of tax savings can make up for reducing assets to a point that jeopardizes a client's long-term objectives.

2. Consider making direct gifts for education and medical expenses. In addition to making annual exclusion gifts, donors can make "direct gifts" for the educational and medical needs of their children or grandchildren without generating gift taxes. Such payments must be directly paid to the provider—reimbursements to family members for expenses already paid will be considered a taxable gift if the amount exceeds the annual gift-tax limit of $14,000.

3. Consider alternative strategies for providing gifts. Married couples not prepared to completely part with assets should consider a Spousal Lifetime Access Trust (SLAT). This allows a couple to give away property to the next generation while having the option, if the need arises, to make distributions to a spouse designated as a beneficiary. Clients should discuss with their advisors the risks of a SLAT, including the loss of access to the trust should the spousal beneficiary die.

Clients should also consider several ways to leverage historically low interest rates when providing gifts to family:

Loans/Sales: Family members can lend to one another at an interest rate set by the IRS and known as the 7520 rate. The long-term rate, currently 1.95%, is used for discounting present values, annuities or future interests. The rate for shorter-duration loans is 1.6%. The loans enable a client to shift investment opportunities to a younger generation without incurring a gift tax. Borrowers will receive the spread between the interest owed and whatever return they can earn on the portion of the loan that is invested. This strategy facilitates the sale of assets to a family member who can fund the purchase by taking a loan.

Grantor Retained Annuity Trust (GRATs): A GRAT is established for a specific term of years, with its creator (the "grantor"), contributing assets in trust. During the term of the trust, the grantor retains the right to receive the original value of the assets used to fund the trust while earning an IRS-determined rate of return, currently 1.6%. When the trust expires, the remaining assets—those that appreciated more than 1.6%—are distributed to the beneficiaries of the trust. An example: A grantor established a GRAT in March 2016 for $1 million and invested in high-growth assets. By September 2016, the assets appreciated by more than $100,000 beyond required annuity payments and the amount expected to transfer. The grantor swapped the initial holdings for less volatile assets, securing the $100,000 transfer to heirs.

Charitable Lead Annuity Trusts (CLATs): A CLAT pays a fixed amount each year to charity, with the remainder at end of term going to non-charitable beneficiaries. Interest rates are low, so clients with philanthropic goals seeking estate reduction should consider creating a CLAT. The transactions are designed not to generate gift or estate taxes.

4. Consider the impact of state estate taxes. State taxes are also an important consideration for clients seeking to provide gifts and optimize long-term tax savings in estate planning. Currently, 14 states impose an estate or inheritance tax, including Maryland, New York, Massachusetts and Delaware, along with the District of Columbia. With few exceptions, the top estate tax rate in most of these states ranges from 16% to 20%. While some states are enacting rules raising estate tax exemptions, the rates are still far lower than the federal exemption level in a number of jurisdictions.

PRIVATE FOUNDATIONS

We work with many of our clients to help develop and implement philanthropic strategies. Some of our clients have created private foundations, which are especially suitable when the objective for the charitable assets is clear and a client wants to play an active role in putting the funds to work. Although the burden associated with creating and managing a private foundation can be sizable, clients can target the organizations they support and modify their priorities over time. Clients can also involve their children in the foundation, creating educational opportunities and responsibilities. While managing a foundation, the different generations in a family can grow closer together, and younger members can gain "social capital" in tandem with their "financial capital."

One of the burdens of a private foundation is that it must annually distribute 5% of net investment assets to qualified charities. Several strategies described above are applicable to foundations, such as harvesting unrealized losses and making grants in the form of appreciated stock. Such moves can reduce or eliminate the tax liability created by the foundation's investment income.

CONCLUSION

We have covered a variety of planning steps in this letter; some are universally applicable while others may only apply to some clients. The effectiveness of some of these steps, such as gifting strategies related to Family Limited Partnerships, may be reduced or eliminated if policy changes before you act, so as always we recommend a thorough examination of the steps available to you, and prompt action when warranted. More importantly, we want to emphasize the value of regular planning reviews as more than a backstop against calendar-year or policy-driven deadlines. We welcome the opportunity to sit with you and your other advisors in the next few months to reconfirm your goals, so we can be sure that the plan we are helping you implement is aimed squarely in the right directions.