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STRATEGIC ADVISORY LETTER
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Midyear Planning Tools for 2016

Although markets have been stormy of late, the planning environment in 2016 is relatively stable. While there are no policy-driven deadlines on the horizon, this time of year is still a prudent time to move your long-term plan forward with thoughtful planning steps.

As we write this letter, financial markets are grappling with plenty of controversy and uncertainty, from the aftershocks of the dramatic fall in oil prices, to the potential impact of a British exit from the EU, to the implications of the pending U.S. Presidential election. Yet despite a heavy dose of recent market volatility, the planning environment in 2016 is relatively stable. Economic growth in the U.S. has slowed but is still positive—during the first quarter of 2016, U.S. GDP grew for the eighth straight quarter. The Federal Reserve is keeping a lid on interest rates for the time being, and even if the Fed raises rates once or twice over the next year, rates will still be very low relative to history. And there are no looming changes to tax policy and little discussion of new proposals as we head into the general election.

With tax policy in a steady state and relatively calm economic conditions, there are no strong external reasons to make major planning adjustments. If there were, we might recommend bigger steps, as we have in the past. A good example took place in 2012; at the time we helped many clients prepare for anticipated changes to policy regarding taxes on asset transfers. We reviewed long-term plans and helped clients decide whether the timing of larger transfers made sense given their circumstances—tax benefits from transfers should always be viewed in the context of each client's near-term and long-term investment goals for their family or business. But in 2016, there are no such policy reasons driving us to action in advance of a specific planning deadline.

Nonetheless, this is a good time of the year to consider steps to begin or continue your long-term planning process. Asset values since the end of 2012 have broadly risen; for some clients, returns from investments have largely replaced the values that were gifted during that 2012 planning period for those who took advantage at the time. Exploring further options for making lifetime gifts may make sense. The transfer-tax exemption has been indexed to inflation since 2012, which has added an additional $450,000 per individual in allowable lifetime gifts. There are a variety of trust strategies and planning tools you can use for larger lifetime gifts, each offering the advantage of allowing your assets to grow outside of your estate and eventually pass to your heirs or to charities in a highly tax-efficient manner.

Additionally, you can make smaller gifts each year (currently a $14,000 maximum per individual) to an unlimited number of beneficiaries without impacting your estate tax exemption at all. This option offers you the ability to move a small portion of your assets out of your estate each year. Taking these incremental steps each year can add up to dramatic results over time.

The ultimate goal is to incorporate both the larger ideas and the smaller annual actions into a long-term plan. If you act early and often, chipping away each year with regular steps while looking for the right moments to execute more significant strategies, you can make impressive headway over time. As we work with clients on incremental, long-term plans, each step along the way is an opportunity for us to listen to them and learn something new

BY SANDRA MOFFET
Strategic Advisor

about them. Over time, this information helps us immensely as we seek to put ideas in context for them, and understand the right times to put bolder recommendations on the table. One of our longer-term clients began a number of years ago with an estate of $100 million, and over time we have moved all but $15 million out of the estate. Over many years, we have greatly reduced the family's potential estate-tax burden while comfortably navigating issues of liquidity, cash flow, timing and magnitude regarding generational transfers. Another more recent example is a couple in their sixties who are actively engaged in our incremental approach to chipping away at their estate. In less than ten years we have helped reduced their estate from $55 million to $35 million, with plenty of runway ahead to make further progress.

The future will certainly bring shifts in markets or policies that lead us to consider targeted planning steps in response. But the recurring theme of our midyear letter is to encourage early and consistent action on a variety of fronts, rather than waiting until the end of the year. Prompt action ensures the ability to take advantage of current conditions, allows time for assets to grow, gives you and your broad advisory team time to thoughtfully implement plans, and helps you better prepare for unforeseen events. Here are some of the types of strategies we are encouraging clients to consider; as always, we welcome the opportunity to discuss these concepts with you and determine which may be most beneficial in your situation.

TAKE ADVANTAGE OF CURRENT CONDITIONS

Market circumstances at any given time can often present timely opportunities for planning steps. In 2016, low interest rates and the prospect that rates may rise presents just such an opportunity.

PLANNING TOOL: GRATS
CLEAR THE HURDLE

Example: A couple transfers $1 million to a two-year GRAT for the benefit of their children when the applicable hurdle rate is 2%. If the investment return on the GRAT assets is 8%, then at the end of two years, the children would receive more than $95,000 free of gift taxes. If the couple waited until the hurdle rate rose to 4%, the benefit would be reduced to less than $65,000.

Low-interest, intrafamily loans are one of several tools that can help you take advantage of low interest rates. Currently, you can provide long-term loans to family members at rates below 3%, and rates on shorter-term loans are even lower. Such loans let you shift investment opportunities to a younger generation without incurring a gift tax. Borrowers receive the spread between the interest owed and whatever return they can earn on the loan proceeds when invested. Such loans are most effective when the permitted interest rates (these applicable federal rates or "AFR" are set monthly by the IRS and linked to U.S. Treasury yields) are low. If the Fed raises interest rates, you can expect AFRs to rise as well.

For example, an eight-year balloon note of $2 million to one's child would need to charge an AFR of 1.41% as of June 2016. If those funds were invested and earned a 7% rate of return over the eight years (net of income taxes if the parent choose to cover those taxes), then the child would have approximately $3.15 million at the end of the period and owe back $2 million. The net transfer of $1.15 million would be achieved free of gift tax consequences.

Grantor retained annuity trusts (GRATs) are another option to consider. These trusts, after a fixed term of several years, return to the grantor any initially invested principal plus a required interest payment. The interest rate is determined up front and governed by IRS rules. Meanwhile, a GRAT's beneficiary would receive any additional growth earned above that "hurdle rate," free of gift taxes. In simplistic terms, if the "hurdle rate" for a GRAT was 2% and the GRAT earned a return of 8%, the beneficiary would receive the incremental 6% upon the GRAT's expiration.

The selection of investments for the GRAT is key—the GRAT is beneficial only if the return exceeds the required hurdle rate. In a time of market volatility, one idea is to create two GRATs, with each holding a single security and with those securities being ones that are likely to have noncorrelated returns, thereby increasing the odds that at least one GRAT will outperform the hurdle rate.

Charitable lead annuity trusts (CLATs) work in a manner similar to GRATs, except that the annual annuity is paid to charity rather than to the grantor. CLATs allow you to achieve meaningful wealth transfer benefits while furthering your philanthropic goals. Also, CLATs often run for a longer period of time than GRATs, so the cumulative effect of "excess" investment returns is magnified.

When using these techniques, always remember that the allowable hurdle rate will play a huge role in determining the eventual proceeds that can pass to a beneficiary. All else being equal, it makes sense to consider using them when the hurdle rates are lower and, in theory, easier to surpass.

ALLOW TIME FOR ASSETS TO GROW

Gifts remove assets from your taxable estate. Importantly, those assets can grow outside of your estate, which gives you a powerful way to transfer wealth in a tax-efficient manner.

The rules for ***annual exclusion gifts*** let you gift up to $14,000 each year to an unlimited number of beneficiaries without gift tax liability and without chipping away at your estate tax exemption. These gifts should therefore be a cornerstone of your estate plan if your estate exceeds the applicable estate tax exemption (currently $5.45 million). It may make sense to make these gifts at the beginning of the year so the recipient has more time to benefit from potential returns (as opposed to you earning those returns within your estate).

529 plans are tax-advantaged programs for setting aside funds for education. They are often funded through annual exclusion gifts and can therefore benefit from earlier gift dates for the reasons noted above. 529 plans offer a big incremental benefit for planning

ahead, as they can be "prefunded" with up to five years of annual exclusion gifts. Other alternatives for funding someone's education include tuition gifts paid directly to an educational institution. We can help you determine the best approach for you and your family.

PLANNING TOOL: ANNUAL GIFTS

THE SOONER, THE BETTER

If a $14,000 annual exclusion gift were made on Jan. 1 rather than Dec. 31, the beneficiary could earn an additional $1,120 during the year on the gifted assets (assuming an 8% return). The early gift would also effectively reduce the donor's taxable estate by an additional $1,120 and the donor's estate tax liability by $448. The benefits over time and across multiple recipients can add up: If you followed a plan of Jan. 1 gifts for eight beneficiaries over 20 years, the cumulative benefit of gifting earlier in the year would exceed $71,000.

In implementing gifting plans such as those described above, we can also link investment decisions with your planning choices. For example, when assets are gifted to a child or grandchild, one may adopt a different time horizon and risk stance depending on the age of the child and whether the assets are intended for education or some other long-term goal.

ALLOW TIME TO IMPLEMENT

When considering various planning steps, it may seem as though paperwork and details might be the things that bog down progress. But generally speaking, the time-consuming part is the big-picture work. Defining and refining your precise objectives can involve many months of worthwhile and meaningful discussion, and for certain strategic options, knowing those precise objectives is absolutely essential to ensure long-term success.

As an example: ***Generation-skipping trusts*** are funded using a grantor's generation-skipping transfer tax exemption. They seek to protect assets from estate taxation through multiple generations of transfers. So-called dynasty trusts run for an indefinite time and, at least under current law, permanently remove trust assets from the gift and estate tax regime.

Because of the long-term nature of these trusts, we need to build them to withstand unpredictable future family dynamics, economic and societal changes, and tax law fluctuations. They are often complex and can take many months to design, draft and implement. In addition, dynasty trusts are frequently created in jurisdictions such as Delaware with favorable legal frameworks, which may not be your state of residence. If so, we will need to coordinate with counsel in more than one state, likely adding time to the implementation schedule, so it is helpful to start this process early.

It also takes time to develop philanthropic plans, which may include donor-advised funds under a community foundation as well as various charitable trusts. For many families, a ***private foundation*** forms the core of their charitable planning, and structuring private foundations involves complex and time-consuming discussions regarding goals, purposes and governance. It can also take six to nine months to apply to the IRS for tax-exempt status and provide all necessary financial and legal disclosures, so beginning this process as early as possible makes sense.

For many families, a family business represents a large proportion of their net worth. In such cases, we want strategies that allow the value of that business to pass from generation to generation with as little tax impact as possible. ***Gifts or sales of your ownership interest in a family business*** to your heirs may be helpful, but effectiveness hinges on how much you can discount the value of your interest when gifting or selling it. Such discounts are allowed based on several factors, such as lack of liquidity or lack of control. If you expect the business to grow in value over a period of time, then an earlier gift or sale of your interest to family members may make sense before a new (and potentially higher) valuation is established for the business. Again, transactions of this nature require substantial lead time, for documenting the transaction, appraising assets and valuing the business. If you are contemplating a transfer of this sort within a given tax year, consider getting as much of a head start as possible.

OPPORTUNITIES FOR EARLY ACTION

STRIKE WHILE THE IRON'S HOT

Low-interest, intrafamily loans
Shift investment opportunities to younger generations with low-interest, long-term loans.

GRATs
Lower hurdle rates provide greater potential shift of future returns for beneficiaries.

CLATs
Their long-term nature allows for a magnified cumulative effect of "excess" returns above a hurdle rate.

GIFT EARLY

Annual exclusion gifts
Gifting earlier generally increases the size of the gift by transferring all post-gift investment returns.

Section 529 plans
Gifting early magnifies the transfer of post-gift returns because plans may be prefunded with up to five years of annual exclusion gifts.

PLAN AHEAD

Generation-skipping trusts
Starting before year-end allows this complex trust instrument to be drafted to withstand future changes.

Creation of a private foundation
Ensure the tax deductibility of year-end gifts by filing for tax-exempt status early.

Gifts or sales of family business interests
Secure valuation discounts by obtaining necessary valuations early in the year.

PREPARE FOR UNFORESEEN EVENTS

Finally, there are a number of situations where it is simply better to be safe than sorry and where early action reduces the risk of being waylaid by unpleasant surprises.

For example, ***asset protection planning*** can shield family assets from third-party claims via lawsuits, spousal claims or bankruptcy. Strategies include limited liability companies (LLCs) as well as domestic and offshore asset protection trusts. Note that this kind of planning is rarely effective after claims arise, so setting up these entities as early as possible is highly recommended.

Several of the tools we have already mentioned in this article could be impacted by unforeseen events. The death of a grantor would obviously impact any plans to take advantage of annual exclusion gifts. In the future, the IRS may restrict business owners' ability to discount the value of their businesses for purposes of intrafamily gifts and sales. In these and other similar situations, it is best to act before circumstances prevent you from doing so.

CONCLUSION

We have covered a variety of planning steps in this letter, and some of them are likely to offer meaningful benefits to you regardless of the outcome of the upcoming presidential election or the near-term direction of the economy. The effectiveness of some of these steps may be reduced or eliminated if policy changes before you act—as such, some actions make sense to tackle now, while others should still wait until the end of the calendar year. As always, we are here to work with you and with your other advisors to help you achieve your goals through a deliberate and thoughtful planning process that seeks to prepare you for whatever the future may hold.

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.