

STRATEGIC ADVISORY LETTER

NOVEMBER 2015

2015 Year-End Planning Checklist

As 2015 comes to a close, we remind our clients and friends of how important it is take time to review new tax rules, consider tax-saving opportunities and review investment and asset-protection plans before year's end.

As autumn rolls on and the holiday season approaches, it is once again time to consider a thorough review of your overall financial picture and your progress toward your long-term objectives.

As noted in our July letter, planning is a year-round process. We want to revisit your current circumstances with you frequently, to determine if there is a need to make adjustments to your investment allocation. As always we look to balance your assets between a liquid operating fund for current needs, a core investment portfolio for long-term preservation or appreciation, and an opportunistic pool for timely investments, taking into account your long-term investment objectives as well as any near-term requirements for funds. We also want to work consistently with you and your other advisors to improve the structure of your estate, reduce your tax liabilities, update your life, property and other insurance coverage, and find other ways to organize and optimize your financial situation. Embracing these opportunities in a timely and disciplined way can matter as much to your bottom line as the returns generated by your investments. While our year-end discussion is simply one of several throughout the year, it is a particularly important discussion given the many decisions and actions that are tied to a calendar-year deadline.

In this letter, we outline a number of tax-saving and other opportunities to consider before the close of the year. As always, we are available to discuss your situation and assist you however we can.

OVERVIEW OF 2015

The highest federal marginal tax bracket in 2015 is 39.6% (as it was in 2014). This rate applies to individuals with taxable income over \$413,200 and joint filers with taxable income over \$464,850. The Medicare tax on net investment income (the NII tax) 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 adjusted gross income (AGI) exceeds \$200,000 and joint filers with AGI in excess of \$250,000. As we note in some of the suggestions that follow, there are a number of ways to accelerate or delay income that may make sense for you, depending on where your income sits relative to the various thresholds listed above.

Despite its long-running gridlock, Congress did in fact pass tax legislation in July, embedded in the "Surface Transportation and Veterans Health Care Choice Improvement Act of 2015" (also known as the "Highway Bill"). While tax rates were not impacted, it is still important to be aware of the changes included in the Highway Bill. Several of the changes focused on revising filing deadlines. For example, the filing dates for reporting foreign gifts and foreign accounts will move from March 15 and June 30, respectively, to April 15 for tax years 2016 and beyond (to be clear, these deadlines won't change this year, the changes take effect in 2017 for 2016 returns). It is hoped that with better alignment with the deadlines for filing income tax returns, there will be less confusion and fewer instances of late filings.



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Additionally, the Highway Bill included a basis-reporting consistency provision: anyone who inherits or receives estate property cannot use a basis higher than that reported for estate tax purposes. Estates that have to file estate-tax returns must furnish basis-information reports to the Internal Revenue Service (IRS), as well as payee statements to any person acquiring an interest in property from the estate. (These basis-reporting rules take effect immediately, meaning they are applicable for 2015 returns.) We await further clarification on how these new reporting requirements will be administered.

However, Congress failed to extend a number of important provisions, such as the ability to make direct rollovers to charities from an IRA and the deduction for state sales taxes. We hope that Congress will take action on these extensions before the end of the year, and we will monitor developments on this front.

The following tax-related strategies for the 2015 tax year may be beneficial given the tax laws currently in effect. Of course, any of these strategies should be considered within the context of your specific circumstances, and all of these suggestions should be revisited in the event that any new tax laws are enacted.

INCOME TAXES

Here are some suggestions for limiting your 2015 income tax exposure.

1. Shift income into the more advantageous tax year. If you expect your AGI to be higher in 2015 than 2016, or you anticipate being in the same or higher bracket in 2015, you may benefit by deferring income into 2016. Conversely, you may benefit by accelerating income into 2015 if you anticipate that you will be in a higher bracket in 2016 or the additional income would allow you to take advantage of an offsetting deduction

or credits that may not be available to you in future years.

EXAMPLE: A high-income wage earner who files jointly with her spouse learns that she is likely to receive a large compensation increase next year. That increase would cause the couple's joint 2016 income to exceed the \$464,850 threshold and place them in the 39.6% tax bracket. If she is entitled to a year-end bonus for 2015 and can choose to receive the bonus in either 2015 or 2016, she may benefit from accelerating the bonus into 2015 when the bonus would be subject to a lower marginal tax rate.

2. Manage the NII tax. As noted above, the NII tax applies to individual taxpayers whose AGI exceeds \$200,000 and joint filers with AGI in excess of \$250,000. AGI includes all taxable income, including wages, bonuses, taxable interest, dividends, capital gains, retirement distributions, annuities, rents and royalties. By managing income and deductions to keep AGI below the NII thresholds, a taxpayer can potentially reduce or eliminate NII taxes in a given tax year. To reduce your AGI, you might consider looking into postponing income from retirement plan distributions, capital gains and even employer bonuses from one year to another in order to manage the amount of AGI realized in any given year.

The tax rate for long-term capital gains for those who are in the highest tax bracket is 20%, and when you add in the NII tax of 3.8%, the tax approaches 24% for gains. This is a significant increase over the rate for long-term gains rate of 15% for the highest bracket prior to 2013. Accelerating gains planned for next year into 2015 should be considered if such acceleration will not cause you to exceed the NII threshold this year. Alternatively, if you expect lower AGI in 2016, it may be wise to postpone planned capital gains until January of 2016 to reduce the impact of the NII tax. However, we emphasize that any specific transaction should always be driven first by investment considerations and only secondarily by tax consequences. In addition, it may make sense to elect to treat long-term capital gains as short-term to increase the deductibility of investment interest expense for both NII and the Alternative Minimum Tax (AMT).

EXAMPLE: If a retired couple has realized significant capital gains in 2015 and they are approaching the \$250,000 AGI threshold for the NII tax, they may choose to defer additional distributions from their retirement plan to remain below that threshold amount for this current year. If they remain below the \$250,000

threshold for AGI, they will not have to pay the NII tax.

3. Harvest capital losses to offset realized gains. Given the peak 24% rate on long-term capital gains mentioned above for high-income taxpayers, you should always look for unrealized losses that make sense to harvest in your taxable portfolios prior to year's end. Your team will review your Brown Advisory accounts to identify such losses, and we always encourage a broader conversation about realized gains and harvestable losses across all of your investments, at Brown Advisory or anywhere else.

4. Convert to a Roth IRA—OR Recharacterize a Roth Conversion as a Traditional IRA.

Conversion: A Roth conversion can be beneficial for taxpayers who can pay the tax due on the conversion with funds outside the IRA. This strategy may be particularly helpful if you have limited taxable income in 2015 and the thresholds for the higher brackets do not apply to you. You will pay taxes on a Roth conversion at today's tax rates, but because there are no minimum required distributions from Roth IRAs, you can choose to retain funds invested in a tax-free environment and reduce your AGI in coming years to reduce the impact of the NII tax on future investment income.

Recharacterization: But what if you 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? Given the volatility in capital markets in recent years, you may find yourself in this situation. This means that you will owe tax on the Roth conversion based on the higher value at the time of the conversion, even though the value of the IRA is now less. There is a path to relief in such circumstances, but only if you elect to "recharacterize" the conversion and complete a trustee-to-trustee transfer to a traditional IRA before filing your return. Although the ability to recharacterize a 2015 conversion has passed, it is useful to know that the "reset" button exists.

5. Re-examine asset location. Investments producing taxable income—such as dividends, interest and annuities, among others—may now be subject to a higher tax rate than in prior years. One way to reduce capital gains tax would be to relocate income-producing assets to tax-deferred vehicles. This can be accomplished by allocating bonds, hedge funds, REITs or other tax-inefficient investments into your IRA or other deferral vehicles such as 401(k) plans and other qualified retirement plans.

6. Accelerate or postpone deductions to maximize tax advantages. The timing of certain deductions may have a material impact on your tax burden. For example, if your income will be below the AGI thresholds for the NII tax in 2015 but you anticipate moving above one of the thresholds in 2016, you may wish to postpone certain deductions until next year. These might include charitable deductions, the payment of real property taxes and the payment of state estimated income taxes. Conversely, if your income is greater this year and you are likely to trigger one or both of the thresholds, you may wish to accelerate your deductions into 2015.

Another important reminder for those considering charitable contributions: Appreciated stock held for over one year is often the best source for such donations from a tax perspective. This is particularly true with the advent of the additional NII tax.

7. 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 only \$12,300 in 2015 (\$12,400 in 2016). That is a considerably lower income amount than the threshold for individuals and joint filers. As a result, where it is appropriate, fiduciaries should consider making distributions to beneficiaries in lower tax brackets in an effort to increase overall tax efficiency between the trust and the beneficiary.

GIFT AND ESTATE TAXES

Since 2012, the \$5 million lifetime gift and estate tax exclusion available to each taxpayer has been indexed for inflation. For 2015, the exclusion amount is \$5.43 million and will increase to \$5.45 million in 2016. This means that even if you used your \$5 million exemption back in 2011 (or your \$10 million exemption as a married couple) and haven't made taxable gifts since, you have \$430,000 (or \$860,000 for you and your spouse) in exemption remaining. This may be relevant to many families who took definitive action in 2011 in fear that favorable estate rules would be eliminated during the "fiscal-cliff" negotiations that year. The sooner you take advantage of your remaining exemption, the greater the potential estate-tax savings, because the appreciation of the gifted assets also will take place outside of your estate. You also should consider how to most effectively utilize the exclusion inflation adjustments.

One additional note: We mentioned in our mid-year planning letter in July that the IRS was promising new rules to reduce the availability of valuation discounts when family members gift or transfer to each other their interests in LLCs and similar entities. At one point those rules were expected by early autumn, but a number of industry observers now believe that they won't be issued until early 2016. Families contemplating gifts or other transfers of entity interests to family members (or trusts) should take advantage of this reprieve if discounts on the transfers are a possibility.

Here are some strategies to consider for minimizing your gift and estate tax.

1. Consider making gifts to children and grandchildren.

a. The gift tax annual exclusion for 2015 is \$14,000 per gift recipient. Remember that the annual exclusion is a "use it or lose it" opportunity, meaning that the annual exclusion does not carry over from one year to the next. Gifting on a tax-free basis is an ideal option for reducing and possibly eliminating larger gift and estate taxes in the future.

b. With the increase in the gift and estate tax exclusion amount from \$5 million in 2012 to \$5.43 million today, a couple may have as much as an additional \$860,000 in potential gift- and estate-tax-free gifts available to them as options. Of course, in evaluating any gifting strategy, your first test should always be your financial security. No amount of tax savings can make up for reducing your assets to a point that threatens your ability to achieve your 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 educational or medical purposes—in other words, a donor such as a grandparent can pay tuition costs or medical bills or medical insurance premiums directly to institutions on behalf of their grandchildren, and those payments will not be subject to gift tax. Remember that the

YEAR-END 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)
- ☐ Consider recharacterization of ROTH IRA conversion

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 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

payments must be direct—if you simply reimburse family members for an expense they have already paid, it will be viewed as a taxable gift if you have exceeded the annual gift tax exclusion limit.

3. Consider strategies that work best in a low interest rate environment. Interest rates have risen slightly in the past year, but are still at historically low levels. Many deferred gifting strategies use current interest rates to determine the value of the grantor's ongoing or retained interest before the gift is fully realized. There are several ways to take advantage of these continuing low rates:

Loans: Today, family members can extend long-term loans to each other at an interest rate of approximately 2.7%, and rates on loans for shorter periods can be even lower. The low interest rate is beneficial because any future appreciation in excess of the interest payments due is retained by the borrower/family member. Today's long-term rates may also be attractive when privately financing a mortgage for a child.

Sales: Sales of assets between family members (or family trusts or entities) that are supported in part with a note also can take advantage of these low rates. To the extent that the appreciation on the assets sold exceeds the interest payments due on the note, that excess appreciation benefits the buyer (typically children, grandchildren or trusts for their benefit).

Grantor Retained Annuity Trusts: Referred to as "GRATs," these trusts also use interest rates to determine the value of the annual annuity due to the grantor. Again, if assets transferred to this type of trust exceed the applicable interest rate, there is a tax-free gift of the appreciation to the trust's remainder beneficiaries (typically children or trusts for their benefit).

4. Consider the impact of state estate taxes. As you look to optimize your long-term tax picture using these or any other strategies, state taxes should be an important factor in your thinking. Currently, 19 states—including states where many of our clients live, such as Maryland, Massachusetts, Delaware and New York—impose an estate or inheritance tax, as does the District of Columbia. With a few exceptions, the top estate tax rate in most of these states is between 15% and 16%, and while a number of states are enacting rules to raise their estate tax exemptions, they are still far lower than the federal exemption level in a number of jurisdictions. This additional potential burden on your estate should be a part of your calculus as you develop your estate structure and gifting strategy.


PRIVATE FOUNDATIONS

We work with many of our clients to help them develop and implement various philanthropic strategies. A number of our clients have created private foundations, an option that makes sense when you have a charitable mission and you want to play an active role in putting charitable dollars to work. The burdens associated with creating and managing a private foundation can be substantial, but in return you are able to completely customize the specific causes and organizations you wish to support and modify your priorities over time if you wish to do so.

In addition to ensuring that you are "keeping the lights on"—i.e., fulfilling the foundation's annual legal, accounting, tax filing and administrative tasks and expenses—you can take several steps before year's end to contribute to the tax efficiency of your foundation. First, you should confirm that the foundation has reached or exceeded its required 5% of net investment assets in qualified charitable distributions. Remember that reasonable and necessary administrative expenses also count toward this 5% requirement, in addition to charitable grants. Additionally, you should be aware that you can reduce the 2% excise tax on foundation income to 1% simply by exceeding the 5% minimum on charitable distributions (provided that you have met this requirement during the previous five tax years). Finally, several of the concepts we have discussed for your own portfolio are equally applicable here—you should consider harvesting unrealized losses and/or making grants in the form of appreciated stock, all of which can reduce or eliminate the tax liability created by the foundation's investment income.

CONCLUSION

This year, there have not been significant changes in the tax laws that affect most of our clients. As always, we recommend that you consult your tax and investment advisors to determine what, if any, actions you should take before the end of the year to minimize your tax burden this year and in the future.

While the suggestions highlighted above should be an important part of your year-end planning discussions, there are a number of equally important matters to consider. The checklist on page 3 covers a more comprehensive range of matters that we recommend that you review on an annual basis. We encourage you to speak with your team at Brown Advisory, who can help tailor your portfolio and your estate planning strategies to your particular circumstances. 

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