TAXES IN FLUX
WHAT YOU NEED TO KNOW ABOUT EVOLVING TRUMP TAX REFORM
AS THE TRUMP ADMINISTRATION nears the end of its first full year in office, Republicans in the House and the Senate are gearing up for a major overhaul of the tax system. In April, the president released a one-page summary of his tax priorities, outlining broad goals for tax simplification and reductions. Late in September, the GOP’s Big Six Group — that is House Speaker Paul Ryan, Senate Majority Leader Mitch O’Connell, Treasury Secretary Steve Mnuchin, White House Advisor Gary Cohn, House Ways and Means Committee Chairman Kevin Brady, and Senate Finance Committee Chairman Orrin Hatch — expanded on this blueprint with a more detailed version of the plan.
The new plan envisions dramatic cuts in corporate tax rates (to 25%), as well as a simpler individual tax code with fewer brackets, a larger exemption, and few individual tax deductions. One change already provoking howls of protest on both coasts is state and local income taxes would no longer be deductible. In another more welcome alteration, the alternative minimum tax would disappear. A vaguely worded intention to allow small businesses to benefit from lower “pass-through” rates (which top out at 25%) seems likely to set the most agilest in accounting to work on tax-reducing strategies. Good news for the truly wealthy — and the advisors who serve them — estate tax and generation-skipping tax will be phased out.

Yet while the broad outlines of the plan are now available, the details are not. No one knows where the three — and perhaps four — tax brackets will begin and end. The end of state and local tax deductibility is under fire and seems unlikely to survive the legislative process. Which businesses will be able to convert ordinary income into pass-through income is yet to be defined. With sharp divisions within the Republican legislatures and between the President and the House and Senate — and the failure of health care reform still stinging — it is hard to envision a smooth transition from position paper to tax law.

**Waiting and seeing and not doing anything rash**

For all these reasons, and even though tax overhaul may ultimately affect nearly every part of the investment and wealth planning industry, financial advisors and their clients should not move precipitously.

Bill Sweet, CFP, an investment advisor at Ritholtz Wealth Management, says that he has heard some questions from clients already about the change in brackets and pass-through income. “Mostly, people want to know how it will affect them — negatively or positively. It’s being sold and discussed as a broad tax cut across the board, but with any “plan” (it’s really more like a broad wish-list, without much detail, the document circulated with the hysterical headline “Unified Framework for Fixing Our Broken Tax Code”) there are relative winners and losers with a sweeping change as outlined in the UFFOBTC,” he says. “For the most part, these questions are not answerable. We don’t know where the tax brackets start and end, for example. There’s not enough data in the proposal to analyze, thus it’s been a lot of speculation up to this point.”
“Most clients understand that it is far too uncertain at this point. There have been a few different variations of tax plans discussed by the new administration, none with much detail, and none speaking to how the decreased revenue would fit in terms of the broader federal budget,” says Carolyn Decker, CFP®, CPA, PFS, an owner and relationship manager at Lake Street Advisors in Portsmouth, NH. “While the new lower brackets ostensibly mean fewer taxes for most clients, the potential loss of some deductions could lessen the anticipated savings. Simply not enough details are known at this point.”

Making drastic changes now would be foolish says Nick Bertha, managing director and director of wealth and trust planning at New York City-based Fieldpoint Private. “I wouldn’t want to go out on a limb and do anything precipitous or radical until I knew what the rules were,” he says. “You can end up shooting yourself in the foot pretty easily by making some big and irreversible mistakes.”

Even if it is not yet time to take action, financial advisors and their clients should be aware of some of the changes under discussion. “At this point, it’s something to keep an eye on. You should pay attention. But you should sit tight,” says Brad McMillan, chief investment officer at Commonwealth Financial Network, the nation’s largest privately held independent broker/dealer—RIA. “At some point, there may be something to react to. But you shouldn’t worry because right now we’re not there.”

With that in mind, here are five major areas where tax reform may affect high net worth families and individuals.

**Fewer brackets, lower rates**

The Big Six tax proposal envisions three main brackets taxed at 12%, 25%, and 35%. (Currently, there are seven tax brackets, starting at 10% and going up to 39.6%.) The proposal would increase the standard deduction to $24,000 for married couples and $12,000 for individuals, while at the same time, eliminating the standard deduction (as well as itemized deductions except for home mortgage and charitable deductions). There would also be no alternative minimum tax.

That structure would significantly simplify individual tax calculations, which McMillan says would be basically a positive development if it were ever allowed to happen. “In general, the simpler and more transparent a tax system, the fewer distortions it introduces, the better off we are. I would love to see an absolutely simple tax system,” he says. “The problem is that abandons the government’s ability to enact policy objectives through the tax system. And the government has historically been very unwilling to give that up. I don’t actually see the tax system getting much simpler if at all.”

That is because some of these tax deductions are extremely popular. Ritholtz’s Sweet thinks that “State and local tax deductions are going to be a show stopper for representatives from New York, New Jersey, California, Minnesota, Oregon, Iowa, Wisconsin to name a few. The real estate industry is likely to lobby hard to keep both business interest deductions in at the corporate level, as well as real estate tax deductions in for individuals.”
Bertha’s firm, located in New York City, serves a wide swath of customers with high state and local taxes. “If it did pass and there was no state and local income tax deduction, a lot of people’s tax bill would go up because of the deduction going away,” he says. However, he explains, many of these people now have to pay alternative minimum tax. “It really becomes a flat tax with fewer marginal rates and less deductions.”

He adds, “The other fear is that there’s that kind of hidden ‘ghost bracket’ in there. The exact quote is ‘an additional top rate may apply to the highest income payers.’ That’s a definite possibility.”

However, this ghost bracket, like all the others, is so far undefined. That makes tax planning extremely difficult. Should you delay income into 2018 to take advantage of lower rates? No way to say. Should you realize capital gains this year or next? Not a clue. Should you make a large charitable contribution now or wait until the New Year? Impossible to say. Even if Congress manages to ram through a tax bill this year, or more likely next, there is no way to tell what its final shape will be or to identify clear winners and losers.

The proposal is similar to tax policies enacted in Kansas in 2012, which resulted in a massive movement to reclassify personal income as pass-through business income, reducing tax revenues by an estimated $700 million (or eight percent of the total) from 2013 to 2016.

The pass-through conundrum
One provision that might shape tax and financial planning considerably concerns business income from small and family-owned businesses structured as sole proprietorships, partnerships, and S corporations. Their income, per the Big Six summary, would be taxed at a maximum rate of 25%. However, the authors caution that it will not be so easy to recharacterize personal income as business income, though they do not specify exactly how they will make it difficult.
Bill Sweet says that the pass-through provision may be the most interesting — and maddeningly vague — element in the whole proposal. “The differential between the proposed pass-through rate of 25% and the highest marginal individual rate of 35% is significant and tantalizing. Yet the proposal warns that ‘committees will adopt measures to prevent recharacterization of personal income into business income,’ he says. “We have no clue what this means — after all, business income is personal income for your local barber or hedge fund manager, at the end of the day.”

Sweet adds that Treasury Secretary Steve Mnuchin has said in interviews that pass-through income will primarily be applicable to businesses that create manufacturing jobs. Still, the way that the rule is written will determine the provision’s scope and reach, and that, so far, is still conjecture. “How the government chooses to draw the line is anyone’s guess outside of the unfortunate and incorrect conclusion that accountants don’t create jobs,” Sweet quips.

Decker is also urging her clients to be cautious. “If the rate on pass-through income does get passed to be much lower than the top brackets, we would agree that many of the pass-through income generators would likely try to re-classify income to fit that bucket,” she says. “The planning for it though is challenging since you may not know the investment manager’s position until a K-1 is issued, so in the short run, we would suggest being conservative and assuming higher rates to avoid surprises or penalties/interest from underpaying based on an assumption that pass through income may be taxed at a lower rate.”

Bertha, too, scoffs at the notion of America’s wealthy being able to suddenly reclassify themselves as business owners. “They’re not going to let people go from 39.6% to 25% just because they’ve created an LLC or Sub S. That isn’t going to happen,” he says. “It’s going to be very restrictive and very definitive and likely it’s going to be restricted to…maybe, not manufacturers, but it will certainly not affect big law firms and big asset management firms.”

**Whither estate taxes?**

The most significant change, from a wealth planning perspective, is the complete elimination of the estate tax. If that part of reform were to be enacted what, exactly, would become of estate planning.

Ritholtz’s Sweet believes that wealthy families would still require planning services. “To begin, estate taxes will likely remain in place at most states that impose an estate tax at the state level. Currently, 20 do. Given that most state exemptions are at $1 - $2 million, estate tax planning for the purposes of minimizing estate and inheritance taxes will likely be important for wealthy investors even if estate taxes are repealed at the federal level,” he says. (Though, to be fair, Bertha believes that the repeal of federal estate tax might cause some states to get rid of their own estate taxes.)

And beyond that, large estates must be managed, even if they are not subject to estate taxes. “There is a lot of responsibility and diligence necessary for managing an asset base of that size. For example, a wealthy client who built his or her business and sold it might want to restrict the use of their wealth in current and future generations by creating trusts that distribute assets only for college tuition or other goals, allowing for their legacy to live beyond their own lifespan,” Sweet ventures.
Bertha cautions that even if the GOP gets rid of the estate tax in 2018 (or 2017, or whenever they manage to pass legislation), there is no guarantee that the next Democratic-majority government will not start it right back up again. So the question becomes, what do you do with a window of time, maybe one or two years, maybe more, when there is no estate tax?

While individuals with dynasty trusts might have the option to decant these trusts into other structures to loosen restrictions on asset use, they also might consider protecting even more assets.

“One thing we’re actually talking to people about is let’s say that there is no estate tax next year and no gift tax which is a key component of that, and you were visionary enough to see that this is not going to last. You could put a lot of assets into a dynasty trust,” says Bertha. “There’s no tax dimension going in because there’s no gift tax and no estate tax. And there’s no limit on it because there’s no estate tax. And when the sheriff comes back into town, you really have protected these assets in perpetuity.”

**Corporate taxes and the stock market**

Experts agree that a reduction in corporate taxes is the most likely element of Trump’s plan to eventually pass, even if it cannot be offset with additional revenues.

McMillan puts the chances of the Big Six proposal — or something like it — passing next year at about 25%. “The only reason I say that is because right now Republicans have a serious political need to get something done,” he explains, noting the base and donor’s anger that a unified government couldn’t pass health care reform. “But that said, what is far more likely to happen are modest cuts in tax rates and no other significant changes. That would be the minimum condition where Republicans could declare victory. So I think certainly cutting tax rates is easy. Actually reforming the system is hard. So I think they’ll end up defaulting to the easy option so they can say they’ve done something.”

Corporate tax cuts, says McMillan, will likely be good for the financial markets. “First of all it will materially help earnings growth and that’s a good thing. It would help make current valuations more reasonable. And because of that, I think there’s a real potential bump there. I don’t think it’s baked into the markets right now because I don’t think the markets really expect it to happen.”

He adds, “The markets largely rallied after the election on the expectation that things would happen. I think the air has largely gone out of that balloon. The improvements we’ve seen since then have been more about fundamentals, economics, earnings than about policy action, and I think the markets are pretty much in a ‘show me’ state. The good thing is that if it does happen, that would be a real upside surprise and that could be positive.”

Decker warns, however, that no one should be investing their portfolios on the expectation of a stock market bump that may never happen. “Advisors should be building or maintaining diversified portfolios designed to meet their clients’ long-term objectives. In the near term, there is a risk to the downside if corporate tax reform stalls or fails, but only if its success is already priced into the market. This is not easy to estimate and there is a host of other factors that could affect short-term market movements,” she says.
She also notes that over the long term, changes in corporate tax rates have not moved the market significantly. “From 1936 to 1969, the S&P 500 had an annualized return of 10.6%. During this time the corporate tax rate rose from 15% to 52.8%, according to taxpolicycenter.org. From 1970 to 2016 the corporate tax rate fell from 52.8% to 35% and the S&P 500 returns 10.3%, annualized,” she explained.

**Hold tight for now**

For now, all the experts agree that there are little investors can do to benefit from tax reform — and indeed, any sudden shifts now, before the legislation has been written, before it has been passed and before it has been enacted into law, would be premature. “Say you have a client with a $20 million estate, who needs to do some estate planning right now and hasn’t, and they say, well, you know, there’s a repeal provision in the proposals so let’s not do anything until we know. Well that’s a mistake,” says Bertha. “You also might get hit by a truck tomorrow. Until you know what the rules are going to be, you shouldn’t be making major decisions in your life.”

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**YOUR PARTNER IN CHANGING INVESTMENT MARKETS**

Tax reform, if and when it is enacted, may have a profound impact on the investment markets and the practice of wealth planning. As the administration, the House and Senate work to refine their tax proposals, we can expect the landscape to continue to shift. To navigate this changing environment, you need a partner to guide you through the details of estate planning and protecting your clients’ assets. Premier Trust can be that partner.

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