NORTHERN TRUST

2018 YEAR-END TAX AND WEALTH TRANSFER PLANNING

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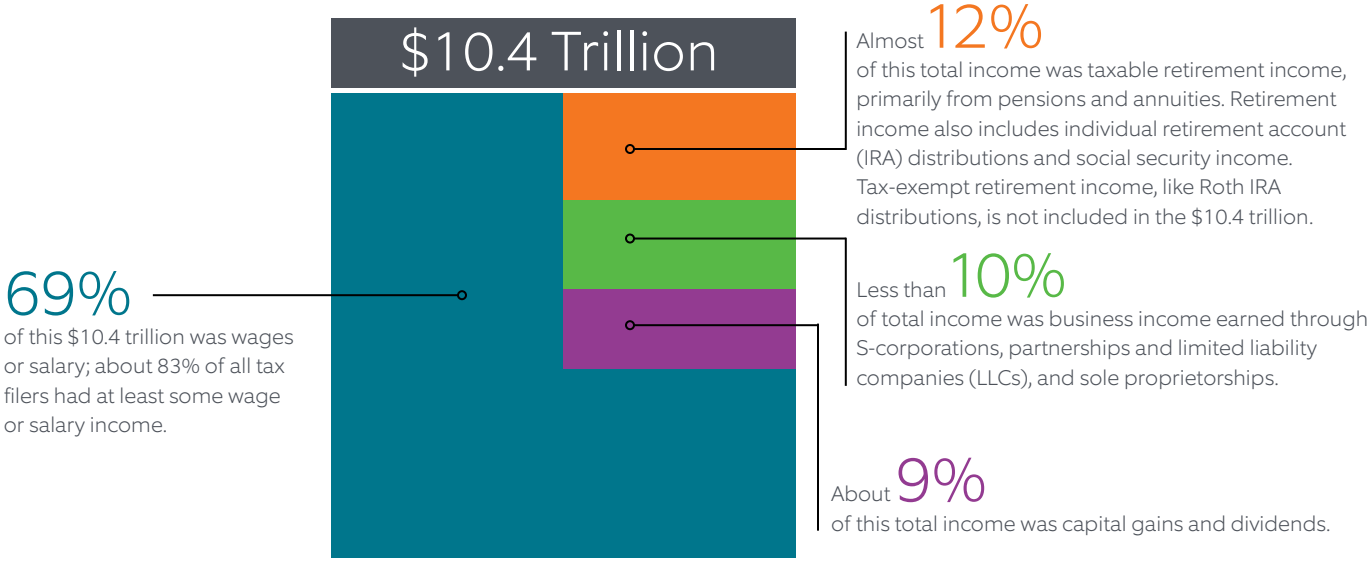
With the passage of the Tax Cuts and Job Act, we find ourselves in a dynamic tax environment. January 1, 2018 brought a host of individual and business tax changes. Some of these new rules, like the 21% corporate income tax rate, are permanent, while others expire at the end of 2025. These expiration dates can complicate long-term planning.

Compounding the uncertainty, the House of Representatives has passed a second round of tax changes, dubbed "Tax Reform 2.0." And, it is possible that some or all of the Tax Reform 2.0 provisions could pass the Senate during the lame duck session, which lasts from the mid-term elections on November 6 to the Congressional swearing in on January 3 of next year. Tax changes happen slowly, until they happen fast.

Despite the external environment (and in some cases because of it), there are things that you can do today to help reduce your federal and state tax liability. A bit of planning, particularly before the close of the 2018 tax year, can pay off on April 15. Of course, your tax situation is unique and should be evaluated with the help of your trusted legal and tax advisors.

THE AMERICAN TAXPAYER

Taxpayers reported $10.4 trillion of total income on their individual tax returns, according to the most recent data from the Internal Revenue Service (IRS). The breakdown is as follows:



Source: The Tax Foundation, Sources of Personal Income, 2015

Additionally, in 2015 the Joint Committee on Taxation reported that only 0.2% of estates paid the estate tax. This percentage should be even lower going forward because the tax overhaul doubled the amount that an individual can pass along free of gift, estate and generation-skipping transfer (GST) taxes.

Below we will discuss year-end tax planning tips for people who earn wages or salary, have retirement income, own a business, or plan on giving to charity or transferring wealth to family members.

YEAR-END PLANNING CHECKLIST
For additional considerations, a checklist is available for you.

IF YOU EARN WAGES OR SALARY

Consider State Residency

The tax overhaul caps the state and local tax deduction at $10,000 through 2025. For many, state income taxes plus local property taxes easily exceed $10,000 per year. The Tax Foundation estimates that the state and local tax deduction taken per federal return in New York City is $24,898 and is $16,956 in Marin County, California. If you traditionally have itemized deductions on your federal return, you may have a smaller itemized deduction for 2018. Or, you may not itemize at all because the standard deduction is bigger than the sum of your itemized deductions.

ESTIMATED STATE AND LOCAL TAX DEDUCTION PER FEDERAL RETURN

Domiciled in New York City	Domiciled in Marin County, California
NY $24,898	**CA** $16,956
Estimated state and local tax deduction per federal return.	Estimated state and local tax deduction per federal return.

Taxes alone should never drive a move. But, if you are retiring, spending more time at a second home, or simply looking for a change of pace, you should evaluate your state tax domicile and the state income taxes, sales taxes and estate and inheritance taxes you pay. A January 1 move is not necessary but does simplify state tax filing and personal recordkeeping, so it could make sense to start your move now in anticipation of the 2019 tax year.

DOMICLE CHECKLIST

There are actions you can take to help prove residency in a new state for tax purposes (such as registering to vote in your new state). This checklist is available for you.

IF YOU HAVE RETIREMENT INCOME

Model the Potential Benefits of a Roth Conversion

Retirement account options include Individual Retirement Accounts (IRAs) and employer plans like 401(k) plans. IRAs and 401(k)s come in two flavors: Traditional and Roth.

In the distribution phase, Roth IRAs and 401(k)s are better than Traditional IRAs and 401(k)s for two reasons. First, the tax rules generally say you must take annual distributions from traditional retirement accounts after you turn 70½. But, these "required minimum distribution" or "RMD" rules do not apply to Roth accounts. Second, distributions from traditional accounts are taxed at ordinary income tax rates, whereas qualified distributions from Roth accounts are not taxed at all.

Consider whether it makes sense to convert traditional IRAs and 401(k)s to Roth accounts. The conversion will generate a current tax bill but could reduce your future taxes. Also, under the tax overhaul, Roth conversions cannot be undone, so it is important to think through all of the implications of a conversion before you act. The only way to know whether a conversion makes sense is to model the numbers, but it is an exercise worth doing.

IF YOU OWN A BUSINESS

Evaluate Eligibility for the 20% Qualified Business Income Deduction

The tax overhaul created a new income tax deduction for individuals, trusts and estates that own non-corporate businesses. Those businesses include sole proprietorships, partnerships, limited liability companies taxed as partnerships and S-corporations. The deduction equals 20% of "qualified business income" and is taken against the business owner's taxable income. For example, if you are a partner in a partnership and you are allocated $100 of the partnership's net profits, your deduction could be as high as $20.

The 20% business income deduction, however, is not automatic. There are six limitations on a taxpayer's ability to take the deduction. The two most significant limitations apply to individuals, trusts and estates with more than $207,500 of taxable income. This number is $415,000 for married couples who file a joint return. If your taxable income is close to the $207,500 / $415,000 threshold, and you have qualified business income, consider whether it makes sense to contribute additional money to a retirement account, health savings account, charity or donor advised fund in order to get your taxable income below the threshold.

Reexamine Choice of Business Entity in Light of the New Law

Business owners and self-employed individuals have options when it comes to choosing the best legal and tax structure. Those options include sole proprietorships, partnerships, limited liability companies (LLCs), S-corporations and C-corporations. B-corporations, which encompass public benefit corporations, social purpose corporations and special benefit corporations, are taxed as S-corporations or C-corporations and do not have special federal tax status.

A business that is considering conversion from one entity type to another (such as an LLC to a C-corporation) must model the numbers and weigh the competing factors. These include the considerations in the table below:

BUSINESS ENTITY SELECTION CONSIDERATIONS

Whether the conversion will generate a current tax bill	Whether the business currently has overall taxable profit or taxable loss	Whether the business expects to have overall taxable profit or taxable loss in the future
Whether the business plans to distribute profits to owners and shareholders or whether it plans to reinvest those profits	Whether there is eligibility for the 20% qualified business income deduction	Whether an exit is anticipated and, if so, how the exit will be structured (initial public offering, sale to a strategic buyer, sale to a private fund, etc.)
Whether the new entity structure will increase administrative complexity and cost	Whether the state tax liability will be impacted	Whether the conversion would impact current or future estate planning, if any

Business entity selection is a complex analysis that may not be able to be completed by the end of the year. But, the significant changes to the business tax rules beg the question: Am I using the right entity?

IF YOU GIVE TO CHARITY

Bunch Charitable Contributions to Itemize Deductions

In any given year, you can take the standard deduction or you can itemize your deductions on your federal tax return. Generally, you will want to take whichever deduction is bigger. The itemized deduction is the sum of several deductions, the most common being the deductions for mortgage interest, state and local taxes, and charitable contributions. Thus, charitable contributions only give you an additional federal tax benefit if you itemize deductions and forego the standard deduction. But, it is estimated that less than 10% of taxpayers will itemize deductions in 2018 because the tax overhaul doubled the standard deduction to $12,000 per individual and $24,000 per married couple.

You may want to consider bunching your charitable contributions, either by donating directly to charity or by using a donor advised fund.

EXAMPLE

Dick and Jane are married. They donate $10,000 to charity each year, pay significant local property taxes and do not have a mortgage. Here is how bunching could increase their federal tax deductions:

	TRADITIONAL GIVING		BUNCHING	
	Itemized Deductions	**Larger of Standard Deduction or Itemized Deductions**	**Itemized Deductions**	**Larger of Standard Deductons or Itemized Deductions**
2018	$10,000 charitable contribution deduction plus $10,000 state and local tax deduction	Standard Deduction of $24,000	$30,000 charitable contribution deduction plus $10,000 state and local tax deduction	Itemized Deduction of $40,000
2019	$10,000 charitable contribution deduction plus $10,000 state and local tax deduction	Standard Deduction of $24,000	$0 charitable contribution deduction plus $10,000 state and local tax deduction	Standard Deduction of $24,000
2020	$10,000 charitable contribution deduction plus $10,000 state and local tax deduction	Standard Deduction of $24,000	$0 charitable contribution deduction plus $10,000 state and local tax deduction	Standard Deduction of $24,000
Total deductions over three year period*		**$72,000**		**$88,000**

**Does not account for inflation adjustments in the standard deduction each year.*

Donate your IRA Required Minimum Distribution to Charity

If you are 70½ or older and you have a traditional IRA, you can donate your required minimum distribution to a charity. This strategy is called a "qualified charitable distribution" or "QCD."

Under current tax law, you can donate up to $100,000 of your required minimum distribution per year to charity and you will not pay federal tax on the amount you donate because it will not be included in your taxable income. Unfortunately, you cannot use the QCD strategy to donate to a donor advised fund or private foundation. You also will not receive a charitable contribution deduction. You can, however, make QCDs not only from IRAs that you opened, but also from IRAs that you inherited.

IF YOU PASS WEALTH TO FAMILY

Take Advantage of the Annual Gift Tax Exclusion

If you would like to support family members or loved ones, annual gifting is a good strategy. For 2018, the federal gift tax rules let you give up to $15,000 to as many people as you would like free of gift tax. This number is $30,000 for a married couple. The $15,000 / $30,000 exclusion does not roll over from year to year, so it pays to make gifts annually.

If you expect that federal or state estate or inheritance taxes will need to be paid when you die, annual gifting can be a good way to reduce the size of your taxable estate and the associated future tax bill. However, we encourage you not to gift exclusively for tax reasons. Consider the impact that the gift will have on your recipient, and make sure the gift aligns with your broader goals and values.

Remember Income Tax Basis

Thanks to the tax overhaul, for 2018 you can pass on a total of $11.18 million to your chosen beneficiaries free of federal gift, estate and GST taxes (together called "transfer taxes"). The amount is doubled for a married couple. Transfers during life and at death both count toward the $11.18 million allowance (also called an exclusion or exemption amount). The good news is that the $11.18 million exclusion amount increases each year for inflation and is in addition to the annual gift tax exclusion, which is $15,000 in 2018. The bad news is that the exclusion amount presently is set to return to $5 million, adjusted for inflation, on January 1, 2026. Transfers in excess of the exclusion / exemption amount are taxed at a top federal rate of 40%, a significant liability.

If you anticipate that your total transfers (both during life and at death) will be large enough to trigger federal or state transfer taxes, then it makes sense to engage in proactive wealth transfer planning. This could mean that you transfer appreciating assets to your beneficiaries today. On the other hand, if you do not anticipate that your total transfers will trigger federal or state transfer taxes, then it could make sense to hold on to appreciating assets and give them to your beneficiaries when you die. This is because, for income tax purposes, the tax basis of an appreciated asset will be increased to its fair market value on the

date of death. This means that your beneficiaries will enjoy a higher tax basis than they otherwise would, and will pay less capital gains tax if and when they sell their inherited asset. For example:

FATHER WANTS TO GIVE HIS DAUGHTER $1M OF STOCK

Father sells today	Father gives during life	Father gives at death
Father pays **$214K** in tax today	**Daughter** pays **$214K** in tax when she sells	**Daughter** pays **$0** in tax when she sells *Based on the 'stepped up basis'
23.8% capital gains tax on	23.8% tax on	23.8% tax on
$1M – $100K	$1M – $100K	$1M – $1M
present value of stock – price father originally paid for stock	present value of stock – price father originally paid for stock	value of stock on the day daughter sells – value of stock on the day father died

Bottom line: Consider the tax consequences of transferring property during life versus at death.

CONCLUSION

Year-end is the ideal time to mitigate your 2018 income tax burden, begin your 2019 income tax planning and execute on your transfer tax strategy. We encourage you to work with your financial planning, legal and tax advisors to create a plan that aligns with your values and helps you achieve your goals.

FOR MORE INFORMATION

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