The views expressed herein do not constitute, and should not be considered to be, legal or tax advice. The tax rules are complicated, and their impact on a particular individual may differ depending on the individual’s specific circumstances. Please consult with your legal or tax advisor regarding your specific situation.
HOW CAN YOU PLAN FOR YOUR FUTURE WHEN YOU DON’T KNOW WHAT TAX LAW WILL BE?

Both President Trump and House Republicans have proposed reforms intended to cut income taxes, cut corporate taxes, eliminate the estate tax, and simplify the Internal Revenue Code. But the two plans differ on critical points, and there’s no telling when they’ll agree on a tax plan—or what it will look like.

In any case, any plan the President and House Republicans agree on is bound to face stiff challenges, due to the slim Republican majority in the Senate (see “The Politics of the Tax Cuts,” page 6). It’s also unclear whether a plan would take effect in 2018 or later, or retroactively for 2017, and whether it would be permanent or temporary.

And it’s possible that aspects of either proposal, if adopted, will result in higher overall income-tax bills for some individuals and families, and that elimination of the estate tax could be “paid for” by eliminating the step-up in cost basis that benefits a far wider group of heirs.

You may be tempted to throw up your hands and delay taking action until tax law is settled. In many instances, that would be a mistake. Several strategies are likely to be far more beneficial if adopted today than if adopted a year or more from now, if tax law doesn’t change or the changes turn out to be temporary. The trick is to adopt a plan that could be canceled at little or no cost, if need be.

In this paper, we review the tax proposals under consideration and how they would impact various groups of taxpayers if adopted. Then, we review the steps clients could take to best position themselves before a new tax law is enacted—and, in some cases, after.
THE PROPOSALS

Many features of the Trump\(^1\) and House Republican proposals\(^2\) seem appealing (\textit{Display 1}). Both would cut corporate tax rates and the top marginal individual income-tax rate. Both would repeal the net investment income tax and the alternative minimum tax (AMT). Both would eliminate the estate tax and generation-skipping transfer (GST) tax, and perhaps the gift tax.\(^3\)

But since these provisions would drastically reduce tax revenues, they are at least partially offset by other revenue-enhancing provisions. The various features of both plans interact in ways that could substantially increase taxes for some affluent individuals and couples by thousands of dollars a year.

\textbf{DISPLAY 1: TRUMP AND HOUSE GOP TAX PROPOSALS DIFFER ON KEY ISSUES}

<table>
<thead>
<tr>
<th>PROPOSAL</th>
<th>CURRENT</th>
<th>TRUMP</th>
<th>HOUSE GOP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top marginal corporate income-tax rate</td>
<td>35%</td>
<td>15%</td>
<td>20%*</td>
</tr>
<tr>
<td>Top marginal individual income-tax rate</td>
<td>39.6%</td>
<td>33%</td>
<td>33%</td>
</tr>
<tr>
<td>Net investment income tax</td>
<td>3.8%</td>
<td>Repeal</td>
<td>Repeal</td>
</tr>
<tr>
<td>Alternative minimum tax</td>
<td>Applies to certain trusts and individuals</td>
<td>Repeal</td>
<td>Repeal</td>
</tr>
<tr>
<td>Itemized deductions</td>
<td>Subject to “3% cutback”</td>
<td>Limit to $100K per individual, $200K per couple</td>
<td>Eliminate all deductions except mortgage interest and charitable contributions</td>
</tr>
<tr>
<td>Estate tax and GST tax</td>
<td>$5.49 mil. inflation-indexed exclusion; 40% “flat” rate</td>
<td>Repeal</td>
<td>Repeal</td>
</tr>
<tr>
<td>Step-up in cost basis at death</td>
<td>Applies to all decedents’ estates</td>
<td>Deemed recognition of gain on estates &gt;$10 mil.</td>
<td>Unclear</td>
</tr>
</tbody>
</table>


Source: Deloitte Development LLC and Bernstein

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\(^1\)The President’s September 2016 tax plan was no longer available on his campaign website or the White House website at the time of this writing. A detailed description and analysis of the plan by the Tax Foundation, dated September 19, 2016, is available in FISCAL FACT no. 528: https://taxfoundation.org/details-analysis-donald-trump-tax-plan-2016/


\(^3\)The gift tax isn’t mentioned in either proposal. It’s unclear if that is an oversight that will be corrected.
INCOME-TAX SIMPLIFICATION

Both proposals compress the number of tax brackets for both income and capital gains (Display 2). In some cases, this could result in a high-income married couple with a substantial investment portfolio paying an additional $3,000 or more in capital gains tax and qualified dividend income tax in 2017, even if the 3.8% surtax on net investment income is repealed (Display 3, next page). The President’s proposal also eliminates the head of household filing status, which may increase the taxes due for some people.¹

...the deduction for state and local taxes paid would be eliminated...it’s possible that taxpayers in states with high income taxes will see their tax burdens rise.

Both proposals also seek to simplify the income tax by limiting itemized deductions and expanding the standard deduction. The President’s proposal would cap itemized deductions at $100,000 per individual or $200,000 per couple,⁵ while the House Republican plan calls for the elimination of all itemized deductions except for the deductions for mortgage interest and charitable contributions.⁶

According to the House Republicans’ “blueprint on tax reform,” the aim of these changes is to reduce the number of taxpayers who itemize their deductions from about one-third to approximately 5%.⁷

This change might have the effect of reducing charitable contributions by removing the tax incentive for charitable gifts: Currently, you have to itemize in order to deduct charitable contributions. Under both the President’s and the House Republicans’ proposals, the deduction for state and local taxes paid would be eliminated. As a result, it’s possible that taxpayers in states with high income taxes will see their tax burdens rise.

⁴Id.
⁵“ATO Better Way: Our Vision for a Confident America” (House Ways and Means Committee blueprint on tax reform), June 24, 2016, page 20
⁶Id., page 19
⁷Id., page 19
While they might assume they will receive a substantial tax cut when the AMT is eliminated, crunching the numbers shows that isn’t necessarily true. Under the Trump plan, they would receive a tax cut of approximately $8,200, but under the House Republican plan, they would actually see a tax increase of about $900.

**INCOME-TAX REFORM: WHAT YOU CAN DO**

If you want to understand how the income-tax reform proposals could affect your wealth plan, contact your Bernstein Advisor. We can work with your tax professional to explain how various proposals may be advantageous or detrimental to your individual tax situation.

We can provide an analysis that will help you ensure that you are still on track to achieve your financial goals, even under *worst case* assumptions about the future of the income-tax laws. We can also use our knowledge of your individual tax situation to tax-manage your portfolio in light of the coming tax changes.

Here are some other steps your Advisor could help you to evaluate if and when it becomes clear how tax reform will affect your tax liability:

- **Relocating** to a state with lower income taxes (or none).
- **Paying down your mortgage** or keeping funds invested in the capital markets. Depending on your interest rate and ability to deduct the interest, you may be paying more for the mortgage than you are earning from your portfolio.
- **Accelerating charitable gifts** into tax year 2017, if tax reform is not expected to take effect until 2018. In that case, donating more this year would allow you to take advantage of a deduction that may go away or be limited in the future. If you are unsure which cause or organization to support, you could make a gift this year to a donor-advised fund (DAF) that would make grants to various organizations in future years.³
- **Accelerating or deferring income and capital gains** this year, depending on whether you will have higher or lower taxes under the proposals.

We will provide more details after Congress enacts a tax bill and the President signs it.
THE POLITICS OF THE TAX CUTS

With Donald Trump elected President and Republicans retaining a majority in both houses of Congress in last November’s election, many observers expected tax reform to be adopted early in 2017. That’s no longer the case.

The Republican majority in the Senate is too slim—just one or two votes—to enact a tax bill that includes all of the provisions that House Republicans seem to want. Under current Senate rules, they need a supermajority of 60 votes. Under the alternative reconciliation process, only 51 Senate votes are needed, but then the legislation either must be revenue-neutral or must expire after 10 years.

The Republicans’ best bet may be to pass a temporary bill that would expire in 10 years. After the midterm elections in November 2018, when they hope to gain a big enough supermajority in the Senate, they could seek to make that legislation permanent.

Also, the President’s tax plan differs materially from the Republican House tax plan—and his priorities differ from theirs. President Trump has said his highest priorities are now border security and immigration, job creation, and tax reform. The impasse over repealing and replacing the Affordable Care Act showed that the President and House Republicans are not on the same page about key policy issues.

Given this lack of cohesion, it seems reasonably likely that any tax law changes enacted this year will not take effect until 2018 or later. In addition, it’s possible that these tax reforms, like those enacted under President George W. Bush in 2001, will “sunset” in 10 years, leaving a future Congress and President to debate whether to renew them.
TRANSFER TAX ISSUES

On the wealth transfer front, there’s far more to do immediately, at least for very wealthy families, and some potential consequences that a larger group of affluent Americans should consider.

Repeal of the estate tax, the generation-skipping transfer (GST) tax, and possibly the gift tax would be great news for very wealthy families. After various exemptions, deductions, and credits, all three transfer taxes now have a top tax rate of 40%.

The estate tax applies to transfers at death that don’t qualify for one of the various exemptions or deductions and are in excess of the applicable exclusion, which is now $5.49 million for an individual, and twice that for a couple, and is indexed to inflation.

The gift tax is imposed on transfers during life in excess of the same exclusion amount. However, current law allows individuals to give away $14,000 a year (married couples, $28,000), adjusted for inflation, to as many individuals as they want, without incurring gift tax or using any of their lifetime applicable exclusion. Over time, the annual exclusion of such gifts to many children can shield a lot of wealth from taxation. (Again, the gift tax isn’t mentioned in the Trump or House Republican proposals.)

The GST tax applies to gifts during life and transfers at death to grandchildren, later generations, and unrelated individuals more than 37½ years younger than the giver, known as “skip persons.” The GST tax is levied in addition to the gift and estate taxes. Like the applicable exclusion for the gift and estate taxes, the GST tax exemption is now $5.49 million (indexed to inflation) per individual, and twice that for a couple.

NO STEP-UP?

If the estate tax is eliminated, it’s unclear what will happen to the “step-up” in cost basis for most assets when their owner dies. Under current law, the cost basis of each asset is adjusted up (or down) to its fair market value at the time of the owner’s death. Today, all inheritors get this benefit, whether or not the estate is large enough to be subject to estate tax. If cost basis steps up, as is often the case, the inheritors pay less capital gains tax when they sell the asset.

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Loss of the step-up could create significant difficulties for anyone who inherits a highly appreciated asset.

No step-up in cost basis at death is repealed, elderly homeowners would face a difficult choice. They could sell their home during their life to obtain a tax break of up to $250,000 or $500,000 on the capital gain, but be forced to move. Or, they could remain in their home but leave their heirs with a huge tax bill.

10Assets that do not receive a step-up include individual retirement accounts (IRAs) and annuities.
The capital gain would reflect the difference between the home’s fair market value on the date of death and the decedents’ cost basis: the original purchase price plus the cost of improvements made over the years. If the home was purchased decades earlier, as is often the case, the price paid may be a tiny share of its current fair market value.

And if the decedents didn’t keep good records over the decades of the cost of home improvements, as is often true, they won’t be able to include those expenses in the cost basis. It’s unclear whether Congress or the White House took these anomalies into account in creating their plans.

TRANSFER TAX REFORM: WHAT YOU CAN DO

It’s not clear that repeal of these transfer taxes is high enough on the Republicans’ wish list to be enacted in 2017. Consequently, some commentators recommend that Americans “wait and see” what happens with the tax laws before taking action.

We disagree. If interest rates were declining—or even flat—waiting to see how all this plays out might be a viable strategy. But interest rates aren’t declining or flat; they are trending up from extremely low levels. That matters, because many planning strategies are most effective in low-interest-rate environments, such as now.

There are several different ways to transfer wealth tax-efficiently. Generally, they involve transferring assets temporarily into an irrevocable trust or another estate-planning vehicle, while retaining the right to receive back the value of those assets in the future, with interest. If the assets grow faster than the interest that accrues to the donor, the trust keeps and reinvests the excess. The donor retains the obligation to pay income taxes on behalf of the trust and its beneficiaries, rather than passing that burden on to the recipients.

Over time, such strategies can shift a mountain of wealth for the benefit of younger generations, with little or no gift tax, no estate tax, and if properly structured, no GST tax. The family’s senior generation need not give away current wealth to accomplish tremendous estate-tax savings. Instead, they give away the future growth of existing assets.

Under such a plan, if the tax laws “zig,” repealing transfer taxes, the family can shift to a more aggressive wealth transfer strategy that takes advantage of favorable changes in the law. If the tax laws “zag,” leaving current transfer tax law unchanged, or if transfer tax repeal is only temporary, the family will already have locked in today’s low interest rates in a way that’s likely to produce substantial benefits over time.

“The Foxes Choose a SLAT,” a case study based on real Bernstein clients, shows how such a strategy could work.
The Foxes Choose a SLAT

Steve and Edie Fox are 50-year-old entrepreneurs with a substantial portfolio from the recent sale of a company they built, as well as continuing interests in several others. They have been following the news about tax proposals and hope that the estate tax will be eliminated but aren’t counting on it.

The Foxes would like to do something to manage their tax risk but feel that their three children—ages 6, 10, and 15—are much too young to be exposed to considerable wealth. The couple has a basic testamentary estate plan that calls for establishing a credit shelter trust when either Steve or Edie dies for the benefit of the surviving spouse and children. Small gifts to children and charity aside, the Foxes have not considered transferring wealth during their lifetimes.

If the first death occurred today, the credit shelter trust under this plan would receive $5.49 million, the full applicable exclusion amount allowable under current law, and remove those assets from the estate of the surviving spouse. The survivor would inherit the remainder of the estate in another trust for his or her benefit.

Our analysis of the Fox family finances determined that they can easily afford to give away some of their portfolio’s future growth. With the approval of their estate-planning attorney, we proposed that Steve create a particular kind of irrevocable trust, called a “spousal lifetime access trust,” or SLAT. Edie will be a co-trustee and the primary beneficiary of the trust; the children will be contingent beneficiaries (Display 4).

Because Edie, not the children, is the primary beneficiary of the trust during her lifetime, the trust is essentially identical to the credit shelter trust. In effect, the new plan just accelerates the creation and funding of the credit shelter trust in their existing estate plan.

However, the plan has an additional wrinkle aimed at capturing the benefit of today’s very low interest rates, which are expected to rise. Instead of funding the trust with a direct gift of assets, Steve will sell some marketable stocks to the trust. In exchange, Steve will receive a promissory note that pays interest at today’s low applicable federal rate (AFR), an IRS-determined rate that is based on current Treasury yields of about 2%.

**DISPLAY 4: HOW AN INSTALLMENT SALE TO A GRANTOR SLAT WORKS**

Potential benefit to trust and its beneficiaries equals post-transfer growth of assets given, plus growth of assets sold in excess of interest payable. For illustrative purposes only; this is not an advertisement and does not constitute an endorsement of any particular wealth transfer strategy.

Source: Bernstein
The trust will pay Steve an interest installment each year, and upon maturity in nine years, the trust will repay the note. The trustee will retain and reinvest any capital that remains after meeting the annual interest payments and repaying the note from the portfolio’s total return. At least for now, the trust will be drafted so that Steve, rather than the trust or its beneficiaries, will be responsible for paying all trust income taxes.

In this case, Steve chose to fund the installment sale with marketable securities, but this strategy also works well with other assets, such as closely held business interests.

THE BENEFITS
One of the great benefits of a SLAT is that it makes it possible for a couple to transfer the future growth of assets without losing access to that growth.

If properly drafted, assets held in the new trust will not be subject to estate tax at Steve’s or Edie’s death, and the trust assets will not be subject to the claims of Steve’s, Edie’s, or the children’s future creditors. If Edie remarries and divorces after Steve’s death, the trust would also be safe from her second husband’s claims.

Under the laws of most states, the trust can be drafted so that the children receive little or no information about the trust until they become primary beneficiaries under rules specified in the trust instrument—which could be well after they become adults.

The trust does give Edie a way to make the children (or their children) the primary beneficiaries. Under a mechanism called a “special (or limited) power of appointment,” Edie can exercise the power of appointment to “promote” the children to be primary beneficiaries, if and when she decides the children are ready to assume the responsibilities of wealth.

There is no requirement that the children receive distributions from the trust at any particular age—or for that matter, any trust distributions at all, if the trustee determines that they don’t need the money.

And as long as the primary beneficiary of a SLAT is still alive, the trustee can distribute trust property to the beneficiary spouse, bringing those funds back onto the marital balance sheet, if the couple needs them.

LIMITATIONS AND RISKS
At this point, you may be wondering, “Can Edie create a similar trust for Steve?” She can, as long as the trust for Steve’s benefit is not substantially identical to the trust for Edie’s benefit. In estate-planning lingo, the two trusts cannot be “reciprocal.” Your estate planning attorney can explain how different the two trusts need to be.

Divorce is a risk, however: Steve might not want Edie (rather than the kids) to get the money, if he was worried about divorce. We recommended the SLAT in this case because Steve and Edie said their marriage is secure. If Steve were concerned about even a distant possibility of divorce, his attorney could build safeguards into the trust document to ensure that, ultimately, the children and future generations would get the lion’s share of the benefits.

Death of the spousal beneficiary is also a risk. It can be mitigated with life insurance or other mortality-hedging strategies.
EVALUATING THE LIKELY OUTCOMES

There are various ways to fund a SLAT, including direct gifts. Among the principal alternatives we examined are using a nine-year term grantor retained annuity trust (GRAT), a series of short-term rolling GRATs, and an installment sale.

From a purely financial standpoint, the short-term rolling GRAT strategy looks most attractive, as shown in Display 5, which illustrates the range of assets we would expect to remain in the SLAT nine years after transferring $1 million into each of three different strategies.

But rolling GRATs are quite complicated and work best when funded with marketable stocks, not other assets, such as business interests. More to the point given current tax law uncertainty, a GRAT is not easily unwound.

In contrast, an installment sale to a SLAT or another irrevocable grantor trust can be terminated easily. If the Foxes used an installment sale strategy to move assets to a SLAT on Monday, and changed their minds on Tuesday, the trustee could repay the note (plus one day’s interest) and collapse the transaction; the couple would be right back where they started, minus attorney’s fees.

If Steve sold assets to the SLAT, and a few months later, the federal estate and gift taxes were repealed, Steve could forgive the promissory note, complete the gift, and take advantage of the (perhaps temporary) elimination of the gift tax to move the assets off the couple’s balance sheet.

And if tax law remains essentially unchanged for many years? No problem. The Foxes can keep the sale-and-loan structure in place for the full nine years, taking full advantage of today’s low-interest-rate environment.

Given the Foxes’ particular assets and current uncertainty about the tax environment, the Foxes and their estate tax attorney agreed it would make most sense to use an installment sale to transfer assets to a SLAT.

**DISPLAY 5: TRADING OFF FORECASTED FINANCIAL OUTCOMES AND FLEXIBILITY**

Range of Remainder Values per $1 Million Contributed—Year 9

$ Millions, Real

<table>
<thead>
<tr>
<th>Probability</th>
<th>Term GRAT*</th>
<th>Short-Term Rolling GRATs †</th>
<th>Installment Sale ‡</th>
</tr>
</thead>
<tbody>
<tr>
<td>5%</td>
<td>$1.06</td>
<td>$1.45</td>
<td>$1.40</td>
</tr>
<tr>
<td>10%</td>
<td>$0.26</td>
<td>$0.56</td>
<td>$0.41</td>
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<td>50%</td>
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</tr>
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<td>90%</td>
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<td></td>
</tr>
<tr>
<td>95%</td>
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<td></td>
</tr>
</tbody>
</table>

*“Term GRAT” assumes nine-year annuity term; GRAT is zeroed-out; Section 7520 rate is 2.6%; annuity payments increase by 20% each year.
†“Short-Term Rolling GRATs” assumes a series of two-year GRATs; each GRAT is zeroed-out; initial Section 7520 rate is 2.6%. Subsequent GRATs are funded with annuities from existing GRATs; Section 7520 rate for each subsequent GRAT is determined using Bernstein’s wealth forecasting model. For each GRAT, any assets remaining at the end of the annuity term are transferred to an irrevocable grantor trust.
‡“Installment Sale” assumes assets are sold to an irrevocable grantor trust in exchange for a nine-year promissory note, bearing interest at 2.1% payable annually, with a balloon payment of principal upon maturity. Creditworthiness is assumed to be provided by existing trust assets or guarantees, rather than through a gift of “seed capital.” Based on Bernstein’s estimates of the range of returns for the applicable capital markets over the next nine years. All portfolios invest in globally diversified equities. Data do not represent past performance and are not a promise of actual future results or an actual range of future results. Asset values represent the estimated liquidation value net of capital gains tax, assuming top federal tax rates. See Note on the Bernstein Wealth Forecasting System at the end of this paper for details.

Source: Bernstein
NOTE ON THE BERNSTEIN WEALTH FORECASTING SYSTEM
The Bernstein Wealth Forecasting System™ seeks to help investors make prudent decisions by estimating the long-term results of potential strategies. It uses the Bernstein Capital Markets Engine to simulate 10,000 plausible paths of return for various combinations of portfolios. For taxable accounts, it takes the investor’s tax rate into consideration. Additional information on Bernstein’s Wealth Forecasting System is available upon request.

NOTE ON THE BERNSTEIN CAPITAL MARKETS ENGINE
The Bernstein Capital Markets Engine is a Monte Carlo model that simulates 10,000 plausible paths of return for each asset class and inflation and produces a probability distribution of outcomes. The model does not draw randomly from a set of historical returns to produce estimates for the future. Instead, the forecasts (1) are based on the building blocks of asset returns, such as inflation, yields, yield spreads, stock earnings, and price multiples; (2) incorporate the linkages that exist among the returns of various asset classes; (3) take into account current market conditions at the beginning of the analysis; and (4) factor in a reasonable degree of randomness and unpredictability.

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