Sentinel

Personal Financial Management Ideas

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A Not-So-Small Business Keeps Growing

By Larry M. Elkin, CPA, CFP®

Fifteen years ago, I moved my business into a new headquarters, reorganized the company and wrote in our newsletter about my succession plans to keep Palisades Hudson going at some future time when I would no longer be present to run it.

A few days later, an envelope arrived from a longtime client and good friend. He had clipped out the article, enclosed it with some other correspondence, and written across the top: “You’re only 44!”

George is still a good friend, and he’s still with our firm. So am I, although I’m not 44 anymore. I still believe it is a good idea to let employees, clients and the world at large know how I propose to have Palisades Hudson continue when we reach the point — still in the fairly distant future, I hope, but certainly 15 years closer — where I am no longer on the scene. A time of transition is as good a time as any to share that information.

This is another of those times. This month, after 24 years in Westchester County, New York (first in Hastings on Hudson and these past 15 in Scarsdale), we moved our Northeast office to Stamford, Connecticut. At the same time, the official headquarters of the firm was relocated to Fort Lauderdale, Florida, where my colleague Shomari Hearn opened our first branch office in 2005.

Shomari has just been promoted to managing vice president, the first member of our staff ever to reach that level. He continues to be based in Fort Lauderdale, and I now spend more time in Florida than in the Northeast. Jeffrey Howard, our administrative manager in charge of technology, is also based there. The headquarters designation is partly an acknowledgment that Florida and Latin America are dynamic markets that are important to the future of our business, and partly a reflection of where our major strategic decisions increasingly are made.

My current plan is to remain active in the business, although in an evolving role (company founders, like old generals, should allow themselves to fade away), until I am about 75 years old. But life is an uncertain venture, and long-range plans have a way of changing — or being changed for us by circumstances we cannot control. It is important for staff, clients and others who rely on our business (our landlords count themselves in that group) to know that the firm will have continuity of leadership if my tenure is cut short.

Shomari is positioned to provide that continuity when we need it. He has been with us since 1998, making him our longest-tenured client service staffer, and he has played an enormous role in coaching and developing our professional staff. He started in New York, moved to Florida in 2005 and became a vice president in 2012. For the past five years, he has been in charge of firmwide service quality, staff development and securities law compliance.

Two of our veteran client service managers, Paul Jacobs and Eric Meermann, are joining our executive team as vice presidents. Eric is the “station chief” in charge of the Northeast office, and he also heads our new Entertainment and Sports Team and our business valuation practice. Paul, who is based in Atlanta, is our chief investment officer and head of our investment committee.

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Post-Election Tax Planning

By Rebecca Pavese, CPA

Good tax planning happens year-round, with an eye on the future. But when there has been a political shift as major as that represented by our recent national elections, taxpayers may find the idea of looking forward unusually daunting.

No one can know exactly what President-elect Donald Trump and Congress will do after Inauguration Day. Campaign promises do not always translate into policy, though given that the executive and legislative branches both will be in the hands of the Republican Party, it is reasonable to expect less political gridlock than we have seen in recent years. Taxpayers and tax preparers would be wise to consider the potential for major changes in 2017 and beyond.

Potential Tax Changes

Based on Trump's campaign, his stated goals regarding tax policy are to simplify our current system and to reduce individual and corporate tax burdens. He has suggested a few methods for going about this, though of course Congress, rather than the president, will actually decide on any changes to the tax code.

Trump's plan would reduce the number of income tax brackets from seven to three, taxed at 12, 25 and 33 percent. If implemented, this proposal would either preserve or lower the rates for everyone but the very lowest bracket under our current system. His reforms mirror those proposed by House Republicans earlier in 2016, suggesting that legislators may have an appetite for following this plan or a similar one in the near future.

These plans to change the overall taxation structure would also lower taxes on investment income in some cases. While long-term capital gains rates are not slated to change, as part of his pledge to scrap the Affordable Care Act, Trump has pledged to repeal the net investment income (NII) surtax, potentially eliminating the 3.8 percent tax for high-income taxpayers. The president-elect also intends to adjust the way that Pease limitations (which reduce itemized deductions for high-income taxpayers) and income-based personal exemption phaseouts apply. If he is successful, all of this will mean that capital losses will be effectively worth less in the future than in 2016.

Estate planners have long advised clients to consider paying gift taxes in the present to reduce future estate taxes. This advice, however, is likely to fall by the wayside, as it seems probable that the estate tax's days are numbered. In his campaign, Trump expressed enthusiasm for repealing transfer taxes outright and replacing them with a tax on capital gains over $10 million on assets held until death and a ban on contributions of appreciated assets to private charities. Whether the estate tax is replaced with this, with something else or with nothing, it seems unlikely to remain in its current form. Taxpayers may find it prudent to hold off on taxable major gifts designed to reduce future estate tax obligations, at least until Congress makes up its mind.

Trump expressed a variety of other opinions on the campaign trail that may affect tax planning should Congress endorse them. These include eliminating the alternative minimum tax (AMT) for individual taxpayers; limiting itemized deductions; eliminating all personal exemptions, as well as the head-of-household filing status; and increasing the standard deduction. He has called on legislators to cut the corporate tax rate from 35 percent to 15 percent, including for "pass-through" income, which is currently taxed at the owners' rate instead. Repeal of the Affordable Care Act, in whole or in part, is also bound to create a variety of tax consequences.

Additionally, Trump has asked Congress to create Dependent Care Savings Accounts, which would allow for tax-favored saving to pay for the care of children and elderly dependents. He has said individuals should be able to deduct child care and elder care expenses and that lawmakers should create incentives for businesses to provide on-site child care. Trump has also encouraged Congress to create tax incentives to promote infrastructure investment.

The details of such programs, if they come to pass, remain to be hashed out by lawmakers. As with any incoming administration, taxpayers cannot assume any promised change will happen right away, or at all, in the form first described. In our current situation, though, the downside risk of assuming that individual tax rates will drop or that transfer taxes will decrease or disappear is minimal.

Changes In 2016

While the recent election results will obviously shape tax planning for years to come, taxpayers should not forget some notable tax changes that took effect in 2016.

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INVESTMENT FOCUS

Where Do Interest Rates Go From Here?

By Paul Jacobs, EA, CFP®

The direction of interest rates is notoriously difficult to predict, and with economic uncertainty rising around the world, it isn't getting any easier.

After years of interest rates hitting new lows, they quickly jumped after the November elections. While the magnitude of the jump was not huge, the move was widely attributed to Donald Trump being elected president. Based on Trump's promises on the campaign trail, many investors expect a combination of economic growth, infrastructure spending and increased government borrowing to lead to higher inflation and, in turn, higher interest rates.

Of course, the global bond market is enormous and fluctuates based on more than the current news cycle. That market is estimated to be more than $100 trillion, with the U.S. bond market making up less than half of the total. The amount of bonds traded on a daily basis is a tiny fraction of the market's total value, and changing expectations can lead to big moves in interest rates fairly quickly.

While bond markets may be more volatile during the Trump presidency than they have been over the last several years, investors must not overreact as interest rates fluctuate. When considering just how much volatility to expect, and how to avoid losing money along the way, it is important to look back at the historical movements of interest rates and the bond market.

A Historical Perspective On Interest Rates

Because interest rates and bond prices move in opposite directions, investors need to think about interest rates when deciding on a strategy for their bond portfolios. Here are three recent examples that we believe are useful.

First, from 1977 to 1981, the Federal Reserve increased the federal funds rate from below 5 percent to 20 percent to stop inflation from spiraling out of control. Long-term rates also spiked during this period, and many bond investors who decided to sell bonds before they matured saw double-digit losses. However, after 1981, interest rates descended steadily, with some ups and downs along the way, until the present. Bond investors who locked in high rates profited handsomely, and falling rates steadily boosted bond returns for decades.

Second, from June 2004 to June 2006, the Federal Reserve steadily pushed the federal funds rate higher in 0.25 percent increments, from 1 percent to 5.25 percent. Because investors widely expected the increases and the Fed communicated its plan ahead of time, the U.S. bond market remained calm throughout this period and provided positive returns. Inflation remained tame throughout. Interestingly, longer-term interest rates rose only slightly during this time. While this was a calm period, illustrating that bond investors can still profit during periods of rising rates, it also preceded the financial crisis of 2008-09. In hindsight, many investors blamed the Federal Reserve for lowering rates to 1 percent in the first place, which led to a real estate bubble and aggressive borrowing.

Finally, from December 2008 to December 2015, the Federal Reserve kept the federal funds rate at near-zero levels to stimulate the economy during and after the financial crisis. Long-term rates fell to new lows during this time, with some short-lived upturns along the way. Bond investors who chose not to "fight the Fed" were rewarded. Fears of deflation appeared from time to time, but prices rose slightly overall during the period.

Investors can learn several lessons from these historical examples, but the first and most important is to be wary of inflation. While it has been quite some time since we have seen significant inflation in the United States, it can be hard to stop, not to mention painful, once it gets going. Seeing

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interest rates in the U.S. triple, quadruple or more in response to inflation may be hard to imagine, but it has happened before and it could happen again. While the Fed would like to raise rates gradually, as it did between 2004 and 2006, if inflation starts climbing too fast, the central bank may have to raise rates more rapidly, which could choke off economic growth and lead to increased market volatility.

Two scenarios in particular are most likely to lead to higher inflation. The first is a labor shortage, in which employers would have no choice but to increase wages, then raise prices to offset those new higher wages. The second is a system shock, such as the U.S. oil embargo in the 1970s. When the supply of goods is overwhelmed by demand, prices can quickly spike, leading to broader inflation setting in. Either or both of these scenarios could play out in the next five years as a result of labor shortages or increasing protectionism in the form of tariffs or trade wars with other countries.

One more lesson is that investment markets, not the Federal Reserve, control long-term rates. Sometimes the federal funds rate and long-term rates move in the same direction, and sometimes they don't. It is important to try to understand the direction of both, especially when they move in opposite directions.

Finally, investors need to understand that, after 35 years of falling rates, it is mathematically impossible for bonds to provide the same level of returns that they have since 1981. Bonds still have a place in a diversified portfolio, but investors should temper their expectations going forward.

The Impact Of Foreign Bond Markets

When thinking about U.S. interest rates, investors must also consider what is happening in bond markets around the world. In the last few years, we have seen negative interest rates take hold in many countries as foreign central banks pushed rates below zero in an attempt to further stimulate their economies. With trillions of dollars of global bonds now trading with negative yields, investors cannot ignore this phenomenon.

Negative rates do not appear likely in the U.S. anytime soon, and for now, it looks as though rates will rise, not drop. But while many academics previously considered zero to be the natural floor for interest rates, we have seen that this is no longer the case. If the U.S. experiences an economic recession before rates have a chance to rise significantly, it is possible that we could eventually see stimulus measures that include negative rates.

Negative rates do not appear likely in the U.S. anytime soon, and for now, it looks as though rates will rise, not drop.

Even if we never see negative rates at home, investors still need to understand the implications that come with trillions of dollars of debt with negative yields abroad. As our interest rates rise, our debt will become more attractive to foreign investors, and many of them could pile into U.S. bonds, pushing yields back down again. If foreign countries relax their stimulus efforts and allow interest rates to climb, the change should make it easier for U.S. rates to climb as well.

Where Rates Go From Here, And What To Do About It

At Palisades Hudson, our investment committee has spent a significant amount of time discussing interest rates and bond investments, both before and after the November election. We do not believe the country is headed for a repeat of 1977-81, but we also do not expect interest rates to stay low forever. We continue to monitor domestic inflation and negative interest rates abroad, and we expect both to have a major impact on the direction of interest rates here.

The cost of being wrong about interest rates can be significant if an investor is overly aggressive and rates rise. At Palisades Hudson, we recommend investing in bonds to reduce volatility in an investment portfolio and to generate interest income. Therefore, we do not recommend taking outsize risks in a bond portfolio. The potential downside is too great, and the potential returns are not enough to justify the risk.

As always, investors should remain diversified when building a bond portfolio. We recommend balancing bond exposure across multiple issuer types, including tax-exempt municipal bonds, corporate bonds, asset-backed securities and U.S. government bonds. The core of our bond portfolios is investments in short-term, high-quality

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For instance, amid the uncertainty of upcoming tax reform, it is worth remembering that the Protecting Americans From Tax Hikes (PATH) Act passed in December 2015. The PATH Act made permanent a variety of temporary tax benefits, including the election to deduct state and local sales taxes, a variety of education-related incentives and the American Opportunity Tax Credit for higher education. Notably, it also made permanent a provision that allows taxpayers age 70$^1/_2$ or older to make tax-free charitable distributions directly from an IRA, lowering their adjusted gross incomes (AGI) in the process. Though many of these benefits have been around for some years, 2016 was the first year that taxpayers could take advantage of the certainty that they will be available in the future.

Unmarried couples who jointly own property also won a victory when the Internal Revenue Service acquiesced to an appeals court decision in the case of a California couple who each deducted interest on $1.1 million of mortgage debt secured by a property they jointly owned. Now cohabiting couples who own their home, whether domestic partners or simply long-term roommates, will not run the risk that the IRS will argue that they are effectively married for purposes of the limits on mortgage debt deduction.

The IRS also instituted a mechanism to help taxpayers who inadvertently miss the 60-day window to roll over retirement account assets. Taxpayers who miss the window for one of 11 fairly wide-ranging reasons, including misplaced checks or family bereavement, will be able to submit a form letter to the retirement account custodian explaining the delay. This will keep many taxpayers from paying significant costs associated with what is often a "foot fault," one that Congress clearly did not expect to wipe out retirement savings for the average taxpayer.

One potential upcoming change could have a big impact or very little, depending on whether gift and estate taxes go away: the new regulations relating to family limited partnerships and family limited liability companies. The proposed regulations, which were slated for enactment in early 2017, would limit the use of valuation discounts on interests in such entities for the purpose of transfer taxes. The rules may be scrapped by the new administration or, if the estate tax is repealed, they may simply become irrelevant. Those who hold interests in family entities should pay attention to the state of this rule for the time being.

While tax planning involves keeping an eye on the future, that does not mean it requires clairvoyance. The basic principles of sound tax planning, such as keeping good records, taking maximum advantage of deductions to which you are entitled and considering the timing of income you can accelerate or delay, will always remain relevant, regardless of who occupies the Capitol or the White House.

Big changes are probably coming. But that does not mean most taxpayers will have to make radical changes of their own.

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bond funds that should maintain their value regardless of interest rate fluctuations. We also recommend low-risk arbitrage strategies and bond investments that stand to do well during periods of rising rates, such as floating-rate bond funds.

It is important to hedge against the risk of rising rates, but it is also important to hedge against the risk of rates remaining low for the long term. Investors may find it appropriate to invest a portion of a bond portfolio in intermediate-term bonds with higher yields to generate higher returns if rates stay low or rise gradually.

The Fed's goal is to gradually raise rates in the future without interrupting economic growth, similar to the period between 2004 and 2006, and we believe this is a real possibility. Historically, inflation in the U.S. has averaged about 3 percent, and the Fed would like to eventually move the federal funds rate to around this level. One would hope that intermediate-term rates would stabilize a few percentage points higher than the fed funds rate, which would compensate investors for the additional risk of lending for longer periods of time.

There is little margin for error here, and the risk of overshooting these targets is great. We remain concerned about the risk of rapidly rising inflation, and investors who are waiting to see more inflation before they adjust their portfolios may not be able to react before it is too late. Bond investors should hope for the best but prepare for the worst, and invest accordingly.

...*Growing*

When I wrote about succession planning 15 years ago, Shomari and Eric were young associates on our staff, and Paul was still attending New York University. Now they bring expertise, experience and intimate knowledge of our clients and staff into our senior management, but they are a couple of decades younger than me. I like the idea of bringing younger energy, along with ample experience, into our leadership team.

A company is more than just a collection of titles, skills and experiences, however. At the highest level, every business can be divided into ownership and management. Ownership determines the goals of the business and the philosophy that drives how those goals will be achieved, such as the balance between short- and long-term profit and the degree to which retaining employees within the business "family" will be emphasized. Management develops and implements strategies to accomplish ownership's goals. A business that has a single owner-founder, like ours, may for a time combine those functions in a single person, but eventually they need to be sorted out if the business is to carry on across generations.

Fifteen years ago, my daughters were still children. I never expected either of them to work in the business; I wanted them to find the occupations that gave them the most satisfaction, rather than to automatically follow my path. Although I hoped they might one day be willing to take on ownership's responsibilities, it was too soon in 2002 to know whether they would. So the plans I made at that time contemplated other arrangements.

Now my daughters are grown. They have their own careers in other fields, as I expected, but they are also interested in becoming part of our firm's future. Beginning next year, they will join me; my wife, Linda (who has been our firm's director of marketing and human resources since 1995); and Shomari on a newly established management board. Paul, Eric and other managers and future executives will work with the board so Palisades Hudson can remain a family-owned firm, even when the actual management passes from me to nonfamily executives who have grown up within the business. An extended period of service alongside their parents on this board is intended to provide my daughters with the experience they will need to maintain our firm's culture when Linda and I are retired. I hope to have about 15 years to gradually work through this succession process, but it could certainly be accelerated if circumstances warrant.

SHOMARI HEARN

PAUL JACOBS

ERIC MEERMANN

LINDA ELKIN

MELINDA KIBLER

REBECCA PAVESE

Shomari and Eric have been part of our investment committee since it was formed about a decade ago. Now they will rotate off the committee, and their places will be taken by client service managers Melinda Kibler and Rebecca Pavese. Melinda is based in Fort Lauderdale, and Rebecca is our Atlanta station chief. Shomari is also transferring his Fort Lauderdale station chief responsibilities to Anthony Criscuolo, a South Florida native who joined Palisades Hudson as a summer intern in 2007 and as a full-time associate when he graduated from the University of Florida the next year. This passing of the baton is another sign of how far we have come in these past 15 years. Back then, we had just a single office in Westchester; now we are in a position to have recruited, developed and promoted a senior manager to lead our practice in another part of the country. Although I still consider us a small firm — we have about 25 employees overall — we have client service offices in five states, including Texas and Oregon.

When I wrote that article in 2002, America was in the midst of the dot-com crash, and the rubble still had not been cleared from the World Trade Center site. A lot has happened since then, and we are obviously on the threshold of what will likely be another turbulent presidential administration, to say

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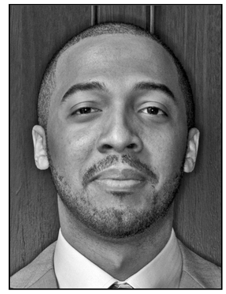
the least. No business can expect to prosper if it cannot adapt to changing environments. I don't believe that fundamental philosophies — such as our decision not to accept compensation from anyone other than our clients — need to change, but the way those philosophies are executed must evolve with the times.


ANTHONY CRISCUOLO


JEFFREY HOWARD


ASHLEY BELL


AMY LABURDA

When I started our firm in 1993, my first clients had amassed wealth in old-line industries such as forest products and utilities. In the 21st century, wealth is likely to be created through the act of creation itself. The world my children are inheriting values intellectual property at least as much as physical property.

This is why in recent years we have emphasized working with those who develop, improve and license ideas — patents, copyrights, images, endorsements and some of their physical embodiments, such as real estate development. This is one of the main reasons we created an Entertainment and Sports Team to help people who create and own such property to preserve and manage it. Businesses such as film, television and music are changing fast. Then again, nowadays, what business isn't? We continue to work with doctors, attorneys, corporate executives and small-business owners, of course, but we have also discovered that people in the creative fields need and value what we can do for them. So also do international clients, who are facing an increasingly complex and not-always-welcoming financial and political environment. We had an international practice 15 years ago, but it is much larger today and is especially prominent in our Florida office.

Creativity is part of our business model, too — so much so that we have our own in-house editorial manager, Amy Laburda, and a newly promoted graphics and design manager, Ashley Bell. They give us the capability to produce books such as *Looking Ahead: Life, Family, Wealth and Business After 55*, which we published two years ago, and to produce a variety of content for our website and on social media. Having great ideas based on extensive knowledge is not very useful unless you know how to communicate those ideas. I think we have always been good at this, but we want to keep getting better and to take advantage of all the new ways that are available to reach interested audiences.

It's been a great ride these past 24 years. I'm glad I have been able to share it with my wife and other colleagues who have taken it along with me, and with many longtime friends and clients like George, and with Sentinel readers like you. All of us at Palisades Hudson wish you a happy and prosperous 2017.

Visit Us Online

EDITOR'S NOTE: Can't wait until April for the next issue of *Sentinel*? You don't have to. In every month that we don't publish a full quarterly issue, we offer a full-text *Sentinel* article on our website, which you'll find at *www.palisadeshudson.com*.

Recent topics have included personal liability insurance, maritime taxes, how to finance a new car and more. To make it even easier, we'll gladly send you a monthly email to remind you of new posts, as well as a digest of the best of our other online content. Sign up securely at *www.palisadeshudson.com/get-sentinel*.

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And if you don't already, please join us on our blog, "Current Commentary." Since 2009, we've shared a post every business day explaining and reacting to current events, cultural news and business topics. Visit our website to see our latest posts or to subscribe to our daily email.

If you have feedback on any of our posts, leave a comment or drop us a line at *info@palisadeshudson.com*. We'd love to hear from you.

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Duly Noted

Court Permits Deduction For Executive MBA. Taxpayers can deduct the cost of education that maintains or improves skills required in their current professions, but not those that qualify them for a new trade or business. The Internal Revenue Service disallowed deductions claimed by Alex Kopaigora for the Executive MBA program at Brigham Young University. Kopaigora commuted on weekends to the Provo, Utah, campus from Los Angeles, where he was a hotel accounting manager before losing his job partway through the program. The IRS claimed Kopaigora's unemployment meant he could not qualify for the deductions, but the Tax Court disagreed. It also found that Kopaigora's MBA was not a prerequisite for the new management job he obtained after completing the program. *Alex Kopaigora and Elizabeth S. Kopaigora v. Commissioner,* T.C. Summ. Op. 2016-35.

A New 'Safe Harbor' For Charitable Remainder Annuity Trusts. The Treasury Department has provided sample language that drafters can use to prevent a charitable remainder annuity trust (CRAT) from running afoul of a requirement that could disallow favorable tax treatment. CRATs pay fixed-dollar amounts to noncharitable beneficiaries for a period of time before transferring the remainder to charity. Administrators must apply a "probability of exhaustion" test to minimize the risk that the principal is eliminated before charities receive any money. However, the new language avoids the need to apply that test. The language requires the trust to terminate early and distribute remaining principal to charity if, at any point, the discounted current value of the remainder interest drops below 10 percent of the original principal. *Rev. Proc. 2016-42.*

No, You Can't Deduct Your Aston Martin (Unless Your Name Is Bond). Gary Roy provided technical writing services to aerospace companies in the Los Angeles area through his company, eMedia, Inc. In 2012, Roy purchased an Aston Martin Vantage vehicle for about $75,000, going with the nameplate favored by movie hero James Bond. Roy claimed depreciation and other expense deductions for the car, asserting that he used it exclusively for business purposes. But neither the IRS nor the Tax Court was impressed with the records Roy provided to support his assertions, with the court adding that "we find it very unlikely that he did not use it for occasional personal excursions." The deductions were denied and an accuracy-related penalty was imposed. *Gary Frederick Roy v. Commissioner,* T.C. Summary Op. 2016-77.

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