

Year-End Tax Planning for 2016 (Individuals)

Dear Client,

It is getting to be that time of year where we should meet to review your tax situation for 2016. Proper year-end planning can help alleviate any unnecessary tax burden. While little happened in the way of tax legislation in 2016, there are certain tax breaks from which you may benefit and certain strategies that can be employed to help minimize taxable income and your federal tax liability.

For 2016, the top tax rate of 39.6 percent will apply to incomes over \$415,050 (single), \$466,950 (married filing jointly and surviving spouse), \$233,475 (married filing separately), and \$441,000 (heads of households). However, high-income taxpayers are also subject to the 3.8 percent net investment income tax and/or the .9 percent Medicare surtax. Finally, as discussed below, there are several tax breaks which expire this year. If you think you may qualify for any one of them, we should nail down what actions need to be taken to get a jump on them before they disappear.

Retirement Plans Considerations

Fully funding your company 401(k) with pre-tax dollars will reduce current year taxes, as well as increase your retirement nest egg. For 2016, the maximum 401(k) contribution you can make with pre-tax earnings is \$18,000. For taxpayers 50 or older, that amount increases to \$24,000.

If you have a SIMPLE 401(k), the maximum pre-tax contribution for 2016 is \$12,500. That amount increases to \$15,500 for taxpayers age 50 or older.

If certain requirements are met, contributions to an individual retirement account (IRA) may be deductible. For taxpayers under 50, the maximum contribution amount for 2016 is \$5,500. For taxpayers 50 or older but less than age 70 1/2, the maximum contribution amount is \$6,500. Contributions exceeding the maximum amount are subject to a 6 percent excise tax. Even if you are not eligible to deduct contributions, contributing after-tax money to an IRA may be advantageous because it will allow you to later convert that traditional IRA to a Roth IRA. Qualified withdrawals from a Roth IRA, including earnings, are free of tax, while earnings on a traditional IRA are taxable when withdrawn.

If you already have a traditional IRA, we should evaluate whether it is appropriate to convert it to a Roth IRA this year. You'll have to pay tax on the amount converted as ordinary income, but subsequent earnings will be free of tax. And if you have a traditional 401(k), 403(b), or 457 plan that includes after-tax contributions, a new rule allows you to generally rollover these after-tax amounts to a Roth IRA with no tax consequences. A rollover of a SIMPLE 401(k) into a Roth IRA may also be available. As with all tax rules, there are qualifications that apply to these rollovers that we should discuss before you take any actions.

Alternative Minimum Tax

The alternative minimum tax (AMT) continues to burden more than just high-income taxpayers; middle-income taxpayers can also be affected. Certain deductions taken on your personal tax return - such as personal exemptions, state income taxes, property taxes, miscellaneous itemized deductions - cannot be deducted in calculating the AMT.

If it looks like you may be subject to the AMT this year, we should discuss what actions can be taken to reduce your exposure. Since the calculation of the AMT begins with adjusted gross income, lowering your adjusted gross income by maximizing contributions to a tax-deferred retirement plan (e.g., 401(k)) or tax-deferred health savings account may be appropriate. Additionally, if you use your home for business, related expenses (e.g., a portion of your property taxes, mortgage interest, etc.) allocable to Schedule C will also reduce your adjusted gross income.

Avoiding the Net Investment Income Tax

A 3.8 percent tax applies to certain net investment income of individuals with income above a threshold amount. The threshold amounts are \$250,000 (married filing jointly and qualifying widow(er) with dependent child), \$200,000 (single and head of household), and \$125,000 (married filing separately). In general, investment income includes, but is not limited to: interest, dividends, capital gains, rental and royalty income, non-qualified annuities, and income from businesses involved in trading of financial instruments or commodities. Thus, while the top tax rate for qualified dividend income is generally 20%, the top rate on such income increases to 23.8% for a taxpayer subject to the net investment income tax.

If it appears you may be subject to the net investment income tax (NIIT), the following actions may help avoid the tax. We should discuss whether any of these options make sense in light of your financial situation.

(1) Donate or gift appreciated property. By donating appreciated property to a charity, you can avoid recognizing the appreciation for income tax purposes and for net investment income tax purposes. Or you may gift the property so that the donee can sell it and report the income. In this case, you'll want to gift the property to individuals that have income below the \$200,000 (single) or \$250,000 (couples) thresholds.

(2) Replace stocks with state and local bonds. Interest on tax-exempt state and local bonds are exempt from the NIIT. In addition, because such interest income is not included in adjusted gross income, it can help keep you below the threshold for which the NIIT applies.

(3) If you are in the real estate business, we should review the criteria for being classified as a real estate professional. If you meet these requirements, your rental income is considered nonpassive and thus escapes the NIIT.

(4) If you intend to sell any appreciated assets, consider whether the sale can be structured as an installment sale so the gain recognition is spread over several years.

(5) Since capital losses can offset capital gains for NIIT purposes, consider whether it makes sense to sell any losing stocks, but keeping in mind the transaction costs associated with selling stocks.

(6) If you have appreciated real property to dispose of and are not considered a real estate professional, a like-kind exchange may be more advantageous. By deferring the gain recognition, you can avoid recognizing income subject to the NIIT.

Because the NIIT does not apply to a trade or business unless (1) the trade or business is a passive activity with respect to the taxpayer, or (2) the trade or business consists of trading financial instruments or commodities, we may want to look at ways in which a venture you are involved with could qualify as a trade or business. However, such classification could have Form 1099 reporting implications whereas personal payments are not reportable.

Liability for the .9 Percent Medicare Tax

An additional Medicare tax of 0.9 percent is imposed on wages, compensation, and self-employment income in excess of a threshold amount. The threshold amounts are \$250,000 (joint return or surviving spouse), \$125,000 (married individual filing a separate return), and \$200,000 (all others). However, the threshold amount is reduced (but not below zero) by the amount of the taxpayer's wages. Thus, a single individual who has \$145,000 in self-employment income and \$130,000 of wages is subject to the .9 percent additional tax on \$75,000 of self-employment income (\$145,000 - \$70,000 (the \$200,000 threshold - \$130,000 in wages)). No tax deduction is allowed for the additional Medicare tax.

For married couples, employers do not take a spouse's self-employment income or wages into account when calculating Medicare tax withholding for an employee. If you and your spouse will exceed the \$250,000 threshold in 2016 and have not made enough tax payments to cover the additional .9 percent tax, you can file Form W-4 with the IRS before year end to have an additional amount deducted from your paycheck to cover the additional .9 percent tax. Otherwise, underpayment of tax penalties may apply.

New Compliance Requirement for Claiming Educational Tax Credits

Beginning in 2016, in order to claim an American Opportunity or lifetime learning credit or a deduction for education-related tuition and fees, you must have received a Form 1098-T. The form reports qualified tuition and related expenses received by the educational institution. The information reported on this form will be matched against the information reported to the IRS. If you have educational expenses eligible for the credit

or deduction, you should receive Form 1098-T from the educational institution to which you made payments by January 31, 2017.

While the form is supposed to report the aggregate amount of payments received by the educational institution, there is a one year transition period where institutions may report the amount billed for 2016 rather than the amount paid.

Because the form only reports qualified tuition and related expenses, you may see a discrepancy between the amounts you paid and the amounts reported. This is due to the fact that certain expenses, such as fees for room, board, insurance, medical expenses, transportation, etc. are not considered qualified tuition and related expenses and thus are not reported on Form 1098-T.

Foreign Bank Account Reporting

If you have an interest in a foreign bank accounts, it must be disclosed; failure to do so carries stiff penalties. You must file a Report of Foreign Bank and Financial Accounts (FBAR) if: (1) you are a U.S. resident or a person doing business in the United States; (2) you had one or more financial accounts that exceeded \$10,000 during the calendar year; (3) the financial account was in a foreign country; and (4) you had a financial interest in the account or signatory or other authority over the foreign financial account. If you are unclear about the requirements or think they could possibly apply to you, please let me know.

The deadline for filing the form was moved up and it is now due April 15. However, a six-month extension is available. If an individual is abroad, the due date is automatically extended until June 15, with an additional four-month extension available until October 15.

Penalty for Failing to Carry Health Insurance

Under Obamacare, there is a penalty, known as the "shared responsibility payment," for not having health insurance coverage. You may be liable for this penalty if you or any of your dependents didn't have health insurance for any month in 2016. The penalty is 2.5 percent of your 2016 household income exceeding the filing threshold or \$695 per adult, whichever is higher, and \$347.50 per uninsured dependent under 18, up to \$2,085 total per family. Depending on your income, you may be eligible for an exemption from the penalty.

Lower AGI Limitation on Medical Expense Deductions for Individuals 65 or Older

You can deduct medical and dental expenses that exceed a certain percentage of your adjusted gross income (AGI) for the year. In 2016, that percentage is 10 percent for most taxpayers. However, that floor is reduced to 7.5 percent if you or your spouse have turned 65 before the end of the year. Because that reduced AGI floor is scheduled to end after 2016, if this lower limitation applies to you for 2016, you should determine

whether you can accelerate any medical expenses expected to be incurred in 2017 into 2016.

Deduction for Qualified Tuition and Related Expenses

If your modified adjusted gross income (MAGI) does not exceed a certain amount, 2016 is the last year that you may deduct qualified education expenses paid during the year for yourself, your spouse, or your dependents. You can deduct up to \$4,000, \$2,000, or \$0 of tuition and fees paid, depending on the amount of your modified adjusted gross income (MAGI). The \$4,000 limit applies if your MAGI does not exceed \$65,000 (\$130,000 on a joint return). The \$2,000 limit applies if your MAGI exceeds \$65,000 (\$130,000 on a joint return) but does not exceed \$80,000 (\$160,000 on a joint return). No deduction is allowed if your MAGI exceeds \$80,000 (\$160,000 on a joint return).

Exclusion of Income Relating to Discharge of Indebtedness on a Principal Residence

If there was a discharge of qualified debt relating to your principal residence in 2016, you can exclude such debt from income. This is the last year this tax break is available.

Deduction for Mortgage Insurance Premiums

If you paid qualified mortgage insurance this year, it is deductible as qualified residence interest. The insurance must have been paid in connection with acquisition debt for a qualified residence. No deduction is available for amounts paid or accrued after December 31, 2016.

Last Year for Certain Energy-Related Credits

The following energy-related credits expire at the end of 2016. If you think you may be eligible to take any of these credits, we should discuss that when we meet.

Nonbusiness Energy Property Tax Credit. You are entitled to an energy property tax credit if you made certain energy efficiency improvements during the year. The credit is equal to 10 percent of the amounts you paid for residential energy property expenditures (such as electric heat pumps, central air conditioners, and certain water heaters that achieve specified efficiency ratings), and is equal to the amounts you paid for qualified energy efficiency improvements (such as insulation, exterior windows and skylights, exterior doors, and certain types of roofs) installed during the tax year. There are various limitations, based on the type of property purchased, with a total \$500 lifetime limitation on this credit.

Residential Energy Efficient Property Credit. You may be entitled to claim a credit for expenditures made in 2016 on residential energy efficient property. The credit is equal to the sum of 30 percent of what you paid for certain solar electric property, solar water heating property, fuel cell property, small wind energy property, and geothermal heat

pump property. While the credit for expenditures made for qualified fuel cell property is limited to \$500 for each one-half kilowatt of capacity of the property, the amounts of the other qualified expenditures eligible for the credit are not limited.

Credits for Certain Motor Vehicles and Vehicle-Related Property. Various credits are available for certain energy efficient vehicles. A credit is available through 2016 for vehicles propelled by chemically combining oxygen with hydrogen and creating electricity (i.e., fuel cell vehicles). This credit potentially applies to four separate categories of vehicles: (1) fuel cell vehicles, (2) advanced lean burn technology vehicles, (3) hybrid vehicles and (4) alternative fuel vehicles.

The base credit is \$4,000 for vehicles weighing 8,500 pounds or less. Heavier vehicles can get up to a \$40,000 credit, depending on their weight. An additional \$1,000 to \$4,000 credit is available to the extent a vehicle's fuel economy exceeds certain fuel economy standards.

Additionally, the purchase of certain refueling property for alternative fuel vehicles may be eligible for a credit of 30 percent of the cost of such property. The credit is limited to \$1,000.

Finally, if you acquired a qualified plug-in electric drive motor vehicle during the year, you may be eligible for a credit of up to \$7,500. This generally applies to large four-wheel electric vehicles. A separate credit applies to qualified two- or three-wheeled plug-in electric vehicles.

Gifting Appreciated Stock to Kids

If you have children, particularly college age kids, we should consider if there is any income that can be shifted to them so that the tax on the income is paid at the child's tax rate. One strategy is gifting appreciated stock to the child. Where a child has earned income and is taxed at the bottom two income brackets, capital gains generated on the stock sale are taxed at 0 percent, instead of the 15 percent or more that the parent would pay. However, if the child has little or no earned income, the kiddie tax could be a factor. In this case, you will want to limit the child's unearned income to \$2,100 or less for 2016 in order to avoid having your top tax rate apply to the child's income.

Accelerating Income into 2016

Depending on your projected income for 2017, it may make sense to accelerate income into 2016 if you expect 2017 income to be significantly higher. Options for accelerating income include: (1) harvesting gains from your investment portfolio, keeping in mind the 3.8 percent NIIT; (2) converting a retirement account into a Roth IRA and recognizing the conversion income this year; (3) taking IRA distributions this year rather than next year; (4) if you are self-employed and have clients with receivables on hand, try to get them to pay before year end; and (5) settle any outstanding lawsuits or insurance claims that will generate income this year.

Deferring Income into 2017

If it looks like you may have a significant decrease in income next year, it may make sense to defer income into 2017 or later years. Some options for deferring income include: (1) if you are due a year-end bonus, having your employer pay the bonus in January 2017; (2) if you are considering selling assets that will generate a gain, postponing the sale until 2017; (3) delaying the exercise of any stock options; (4) if you are planning on selling appreciated property, consider an installment sale with larger payments being received in 2017; and (5) consider parking investments in deferred annuities.

Deferring Deductions into 2017

If you anticipate a substantial increase in taxable income, it may be advantageous to push deductions into 2017 by: (1) postponing year-end charitable contributions, property tax payments, and medical and dental expense payments, to the extent deductions are available for such payments, until next year; and (2) postponing the sale of any loss-generating property.

Accelerating Deductions into 2016

If you expect a decrease in income next year, accelerating deductions into the current year can offset the higher income this year. Some options include: (1) prepaying property taxes in December; (2) making January mortgage payment in December; (3) if you owe state income taxes, making up any shortfall in December rather than waiting until the return is due; (4) since medical expenses are deductible only to the extent they exceed 10 percent (7.5 percent for individuals age 65 before the end of the year) of adjusted gross income, bunching large medical bills not covered by insurance into one year to help overcome this threshold; (5) making any large charitable contributions in 2016, rather than 2017; (6) selling some or all loss stocks; and (7) if you qualify for a health savings account, setting one up and making the maximum contribution allowable.

Life Events and Miscellaneous Other Items

Certain life events can also affect your tax situation. If you got married or divorced, had a birth or death in the family, lost or changed jobs, or retired during the year, we need to discuss the tax implications of these events.

Other miscellaneous items to consider are the following:

(1) Spend any remaining health flexible spending account balances before year end (unless your employer allows you to go until March 15, 2017, in which case you'll have until then). You should check with your employer to see if they give employees the optional grace period to March 15.

(2) If you rent out a vacation home, we should review at the number of days it was used for business versus pleasure to see if there are ways to maximize tax savings with respect to that property.

Please call me at your convenience so we can set up an appointment to discuss the above options and determine whether your tax withholdings and/or estimated tax payments are sufficient for your expected 2016 taxable income.

Sincerely,

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