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Matheney Stees & Associates
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CERTIFIED PUBLIC ACCOUNTANTS AND ADVISORS

2016 YEAR-END INCOME TAX PLANNING LETTER

INTRODUCTION

Although tax planning is a 12-month activity, year-end is traditionally the time to review tax strategies from the past and to revise them for the future. Year-end has also become a time when there is an increasing need to take a careful look at what's changed within the tax law itself since the beginning of the year. Opportunities and pitfalls within these recent changes – as they impact each taxpayer's unique situation—should not be overlooked. This is particularly the case during year-end 2016. Here are some of the many consideration that taxpayers should review as year-end 2016 approaches. The first part of the letter deals with individual tax planning and the latter part (begins on page 6) deals with planning for businesses.

PLANNING FOR INDIVIDUALS

Year-end planning should start with data collection and a review of prior year returns. This includes losses or other carryovers, estimated tax payments, and items that were unusual. Conversations about next year should include review of any plans for significant purchases or dispositions, as well as any possible life changes. Alternative minimum tax (AMT) liability also needs to be explored since it may affect single taxpayers with adjusted gross income (AGI—the number at the bottom of the front page of Form 1040) greater than $93,150 or married taxpayers with AGI greater than $196,300. Potential liability for the net investment income tax and the additional Medicare Tax should also be looked at if you are single and your AGI exceeds $200,000 or married with AGI above $250,000.

Monitoring AGI at year end can also pay dividends in qualifying for a number of tax benefits. Often tax savings can be realized by lowering income in one year at the expense of realizing a bit more in the other: in this case, either 2016 or 2017. Some of those tax benefits that get phased out depending upon the taxpayer's AGI level include:

- itemized deductions
- personal exemptions
- education savings bond interest exclusion
- maximum child's income on parent's return (form 8814):
- medical savings account adjustments
- education credits
- student loan interest deduction
- adoption credits
- maximum Roth IRA contributions
- maximum IRA contributions for individuals

There are many *traditional* year-end tax planning strategies that can help lower your 2016 taxable income, and postpone the payment of your taxes to later years. Therefore, we are sending you this letter to remind you of these time-tested, year-end planning strategies. This letter also highlights *new* tax planning opportunities available to individuals because of recent law changes. The first segment of this letter highlights the individual tax breaks, many of which have been permanently extended.

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To help you locate items of interest, we have divided the planning ideas into the following topics:

- Extended Selected Individual Tax Breaks
- Adjusting Taxable Income (accelerating or postponing)
- Tax Planning For Investment Income (Including The 3.8% NIIT)
- Miscellaneous Planning Opportunities

Caution! Tax planning strategies suggested in this letter may subject you to AMT. For example, many deductions are not allowed for AMT purposes, such as: personal exemptions, the standard deduction, state and local income taxes, and real estate taxes. Also, the AMT can be triggered by taking large capital gains, having high levels of dividend income, or exercising incentive stock options. You cannot properly evaluate a particular planning strategy without calculating your overall tax liability (including AMT and any state income tax) with and without that strategy.

EXTENDED SELECTED INDIVIDUAL TAX BREAKS

The Protecting Americans from Tax Hikes Act of 2015 (PATH Act), enacted immediately before the start of 2016, permanently extended many tax incentives that were previously temporary, removing for the first time in many years the year-end concern over whether these incentives will be extended either retroactively for the current year or prospectively into the coming year. Not all of these "extenders" provisions were extended beyond 2016, however; and some were modified in the process. Others were extended for up to five years, deferring to "tax reform" a more lasting solution. Here's a list of the major changes made by the PATH Act, especially focused on how they impact year-end transactions:

- *permanent* American Opportunity Tax Credit
- *permanent* teachers' $250 "classroom" expense deduction
- *permanent* state and local sales tax deduction election, in lieu of state income taxes
- *permanent* exclusion for direct charitable donation of IRA funds of up to $100,000
- *permanent* 100-percent gain exclusion on qualified small business stock
- *permanent* conservation contributions benefits
- five-year solar energy property
- nonbusiness energy property credit through 2016
- fuel cell motor vehicle credit through 2016
- mortgage insurance premium deduction through 2016
- tuition and fees deduction through 2016

ADJUSTING TAXABLE INCOME

Deferring income into 2017 is a good idea if you believe that your marginal tax rate for 2017 will be equal to or less than your 2016 marginal tax rate. In addition, deferring income into 2017 could increase various credits and deductions for 2016 that would otherwise be phased out as your adjusted gross income increases.

Deferring Income

Deferring taxable income from 2016 to 2017 may reduce your exposure to higher tax brackets or other taxes (AMT or the Net Investment Income Tax). It may also reduce 2016 taxable income by reclaiming phased-out deductions. If, after considering these factors, you believe that deferring taxable income into 2017 will save you taxes, consider the following strategies:

- If you are self-employed and use the cash method of accounting, consider delaying year-end billings to defer income until 2017.

- If you plan to sell certain appreciated property in 2016, you might be able to defer the gain until later years by taking back a promissory note instead of cash. If you qualify for installment treatment, the gain will generally be prorated over the term of the note and is taxed to you as you collect the principal payments. This is called reporting your gain on the "installment method."

Income acceleration/deferral

Taxpayers using the cash method basis of accounting (almost all individual taxpayers) can defer or accelerate income using a variety of strategies. These may include:

- sell appreciated assets
- receive bonuses before January
- sell outstanding installment contracts
- redeem U.S. Savings Bonds
- accelerate debt forgiveness income
- avoid mandatory like-kind exchange treatment

Deduction acceleration/deferral

- Accelerating "Above-The-Line" Deductions. As a cash method taxpayer, you can generally accelerate a 2017 deduction into 2016 by "paying" it in 2016. "Payment" typically occurs in 2016 if a check is delivered to the post office, if your electronic payment is debited to your account, or if an item is charged on a *third-party* credit card (e.g., Visa, MasterCard, Discover, American Express) in 2016. Above-the-line deductions include: alimony paid, deductible IRA or self-employed retirement contributions, student loan interest, job-related moving expenses, HSA contributions, penalties on early withdrawal of savings, and self-employed health insurance costs.
- Accelerating Itemized Deductions Into 2016. Although "itemized" deductions (i.e., below-the-line deductions) do not reduce your AGI, they still may provide valuable tax savings. Itemized deductions generally include charitable contributions, state and local income taxes, property taxes, medical expenses, unreimbursed employee travel expenses, home mortgage interest, and gambling losses (to the extent of gambling income). However, if your itemized deductions fail to exceed your standard deduction in most years, you are not receiving maximum benefit for your itemized deductions. You could possibly reduce your taxes over the long term by bunching the payment of your itemized deductions in alternate tax years. This may produce tax savings by allowing you to itemize deductions in the years when your expenses are bunched, and use the standard deduction in other years.

TAX PLANNING FOR INVESTMENT INCOME

Planning With The 3.8% Net Investment Income Tax (NIIT)

The NIIT generally applies to the traditional types of investment income, such as interest, dividends, **rent**, annuities, royalties, and capital gains. However, the 3.8% NIIT also applies to "business" income that is taxed to a "passive" owner (as discussed in more detail below) unless the "passive" income is subject to S/E taxes. If you believe that the 3.8% NIIT may apply to you, consider the following planning techniques:

- Roth IRAs (Including Roth IRA Conversions). Tax-free distributions from a Roth IRA are exempt from the 3.8% NIIT, and do not increase your AGI (so will not increase your exposure to the 3.8% tax). Therefore, these tax-favored features should be factored into any analysis of whether you should contribute to a Roth IRA. However, if you are considering converting a traditional IRA into a Roth, the income triggered in the year of conversion would increase your AGI and, therefore, may increase your exposure to the 3.8% NIIT on your net investment income. If you want a Roth conversion to be effective for 2016, you must transfer the amount from the regular IRA to the Roth IRA no later than

December 31, 2016. Whether you should convert your traditional IRA to a Roth IRA can be an exceedingly complicated issue, so make sure you consider all the factors. Please call our firm if you want help in making this decision.

- Business Income of Passive Owners May Trigger NIIT. For purposes of NIIT, net investment income includes operating business income that is taxed to a "passive" owner (unless the operating income constitutes self-employment income). For this purpose, an owner is considered "passive" in a business activity if the owner is "passive" under the passive loss limitation rules that have been around for years. For example, you are deemed to materially participate (i.e., you are not "passive") if you spend more than 500 hours during the year working in the business. If you have other "passive" activities generating losses, you may prefer to remain passive in an activity producing income so that the activity's income may be used to absorb the passive losses. These rules are complicated and require a thorough review of your particular situation to develop the most tax-wise strategy.

Traditional Year-End Planning With Capital Gains and Losses

Generally, net capital gains (both short- term and long-term) are potentially subject to the NIIT. This could result in an individual who is taxed in the 39.6% ordinary income tax bracket paying tax on his or her net long-term capital gains at a 23.8% rate (i.e., the maximum capital gains tax rate of 20% plus the 3.8% NIIT). This individual's net short-term capital gains could be taxed as high as 43.4% (i.e., 39.6% plus 3.8%). Consequently, traditional planning strategies involving the timing of your year-end sales of stocks, bonds, or other securities are more important than ever.

Planning With Zero Percent Tax Rate for Capital Gains and Dividends

Long-term capital gains and qualified dividends that would be taxed (if ordinary income) in the 15% or lower ordinary income tax bracket, are taxed at a zero percent rate. Taxpayers who have historically been in higher tax brackets but now find themselves between jobs, recently retired, or expecting to report higher-than-normal business deductions, may temporarily have income low enough to take advantage of the zero percent rate for 2016. If you are experiencing any of these situations, please call our firm to discuss this zero percent tax rate for long-term capital gains and qualified dividends.

Making the Most of Capital Losses

If your stock sales to date have created a net capital loss exceeding $3,000, consider selling enough appreciated securities before the end of 2016 to decrease your net capital loss to $3,000. Stocks that you think have reached their peak would be good candidates. All else being equal, you should sell the short-term gain (held 12 months or less) securities first. This will allow your net capital loss (in excess of $3,000) to offset your short-term capital gain, while preserving favorable long-term capital gain treatment for later years. However, your net short-term capital gains can be used to free up a deduction for any interest you have paid on your margin account. If you eliminate your short-term capital gains by recognizing your short-term capital losses, you may be restricting your ability to deduct your investment interest. Remember to consider the wash-sale rule when selling stocks to incur capital losses. If you buy substantially identical securities within 30 days before or after a sale, your loss will be suspended. This rule can apply in surprising ways: selling a mutual fund at a loss within 30 days of the date a dividend is reinvested; or buying shares in your IRA when you sold shares of the same stock out of your taxable investment account.

Miscellaneous Planning Opportunities

Life Events

Life events such as marriage, birth or adoption of a child, a new job or the loss of a job, and retirement, all impact year-end tax planning. A change in filing status will affect tax liability. The possibility of significant changes and/ or significant or unusual items of income or loss should be part of a year-end tax strategy. Additionally, taxpayers need to take a look into the future, into 2017, and predict, if possible, any events that could trigger significant income, losses or deductions.

Retirement Strategies

Taxpayers may want to take a look at a number of different provisions in anticipation of retirement, at the point of retirement, or after retirement. Many of these provisions have opportunities and deadlines associated with the concept of taxable year. Among others, these include:

- Contributions to employer plans. These should be maximized to reduce taxable income.
- IRA rollovers to employer plans. If you are over age 70½ and still working, you may want to consider this strategy to eliminate requirements to take minimum distributions from your IRA.
- Strategic use of IRAs and "required minimum distributions." If you don't currently need your IRA money in retirement, consider purchasing a longevity annuity inside your IRA. If you have unusually low taxable income in 2016, consider taking additional distributions to minimize taxes.
- Timing Roth IRA conversions and reconversions to maximize your retirement nest egg.

Affordable Care Act Compliance

The Affordable Care Act (ACA) imposes new requirements on individuals and tightens or eliminates some tax incentives. Year-end planning for individuals with regards to the ACA is more prospective than retrospective. If you or a family member did not have health coverage for at least 9 months of 2016, you may be subject to the penalty. That penalty will be at least $695 per adult but may be as high as 2.5% of your household income that exceeds your tax return filing threshold. You should also be aware that if your employer is reimbursing you for your individual health insurance premiums, they may not be in compliance with ACA.

Other

- Relief for late IRA rollovers. The IRS unveiled a new self-certification procedure for taxpayers who inadvertently miss the 60-day time limit for certain retirement plan distribution rollovers.
- Make sure that you do not make more than one IRA rollover in any year. The Tax Court has held that the one-per-year rollover rule applies to the individual instead of to each IRA.
- Make sure that you "spend" all of your flexible spending account (FSA) amounts.
- Review your financial position and estate plan to determine if you want to take advantage of gifting options this year.
- Review withholding from your W-2 or retirement distributions. If you think you'll be affected by the 0.9% Medicare surtax on earned income (earnings over $200,000), you might need to boost your withholding. Boosting withholding can also help you avoid an underpayment penalty. Generally, you won't owe this if you have 90% of your 2016 tax bill withheld or 100% of what you owed for 2015 (110% if your 2015 AGI was more than $150,000). You can have more withheld from your November and December paychecks (submit a new W-4) or a year-end retirement payout. You can also have tax withheld from social security payments, but are unlikely to have that change implemented before year-end.

PLANNING FOR BUSINESSES

As businesses approach year end, each has a unique opportunity to save additional taxes through taking a variety of strategic steps. Businesses seeking to maximize tax benefits through 2016 year-end tax planning may want to consider several general strategies, such as use of traditional timing techniques for income and deductions, and the role of the tax extenders (those made permanent and those expiring at the end of 2016), as well as strategies targeted specifically to their particular business.

As in past years, planning is uncertain because of the expiration of at least some popular but temporary tax breaks. Also added to the mix is the far-reaching Affordable Care Act (ACA) and whatever changes to 2017 the new Congress and Administration may make to the Tax Code.

TAX LAW CHANGES

Changes to the tax laws in 2016 made by new IRS regulations and other guidance should also be considered in assessing year-end strategies for 2016. And year-end tax savings can be found in avoiding penalties, by knowing how to comply with some of the IRS's news rules and regulations.

PATH Act Extenders

The Protecting Americans from Tax Hikes Act of 2015 (PATH Act), enacted at the end of 2015, made ***permanent*** many business-related provisions that had been up for renewal, including:

- the 100-percent gain exclusion on qualified small business stock;
- the reduced, five-year recognition period for S corporation built-in gains tax;
- 15-year straight-line cost recovery for qualified leasehold improvements, restaurant property and retail improvements;
- charitable deductions for the contribution of food inventory and others;
- enhancements to research credit and
- most significant, especially for small businesses, Code Sec. 179 expensing deduction.

Five-year Extensions

The PATH Act extended several business-related provisions available for five-years, under the expectation that general tax reform will consider a more permanent fate. Among these provisions, bonus depreciation and the Work Opportunity Credit have widespread applicability. Notably, in addition to extending bonus depreciation, a number of modifications have been made that:

- reduce the bonus rate from 50 percent to 40 percent for property placed in service in 2018 and to 30 percent for property placed in service in 2019 (for 2016 and again for 2017 it remains at 50 percent);
- replaces the bonus allowance for qualified leasehold improvement property with a bonus allowance for additions and improvements to the interior of any nonresidential real property, effective for property placed in service after 2015;
- reduces the $8,000 bump-up in the first year luxury car depreciation cap for passenger automobiles on which bonus depreciation is claimed to $6,400 for passenger automobiles placed in service in 2018 and $4,800 for passenger automobiles placed in service in 2019, and only if the taxpayer does not generally elect out of bonus depreciation; and
- extends long-term accounting method relief for bonus depreciation claimed on property placed in service in 2015 through 2019.

Revised Repair Regulations

For 2016 year-end planning, qualifying for new safe harbors: de minimis expensing safe harbor for assets costing $2,500 or less, and a remodel-refresh safe harbor for certain retail establishments or restaurants allowing the taxpayer to expense 75% of the cost as currently deductible repair and maintenance expense.

Business Use of Vehicles

The 2016 standard mileage rate is 54 cents-per-mile. Vehicle depreciation limits for passenger autos, trucks and vans first placed in service in 2016 are comparable to the rates in 2015. Sport utility vehicles and pickup trucks with a gross vehicle weight rating (GVWR) in excess of 6,000 pounds continue to be exempt from the luxury vehicle depreciation caps, but are limited to a $25,000 Code Sec. 179 expense deduction. Most dealers are aware which vehicles are exempt, but it is prudent to have them prove the exemption to you.

If your company provides employees with company-owned cars, the company is required to include the value of the personal use of the car in the employees' W-2 income. However, this is not required if the employee reimburses the company for the personal use. If your company does not report the employee's personal use as W-2 income and the employee does not reimburse the company for the personal use, the IRS says the company's deductions (for depreciation, gas, tires, insurance, etc.) are lost to the extent of the personal use. In addition, the IRS will include any unreimbursed personal use in the employee's income even if the company is not allowed a deduction for the personal use portion.

Affordable Care Act

Despite several delays and legislative tweaks, the basic structure of the ACA for businesses, both large and small, generally remains intact. Small businesses are not unaffected by the ACA and should take the ACA into account in year-end planning. Some incentives under the ACA, including health reimbursement arrangements can help maximize tax savings for small businesses. Information reporting under the ACA continues to challenge all businesses. ***You should also be aware that if you are reimbursing your employees for their individual health insurance premiums, you are probably not in compliance with ACA and the penalty for this practice is $100 per day per employee ($36,500 annually per employee).*** Please call us if you want assistance remedying this situation.

Revised Deadlines

The due date for filing W-2's and 1099-MISC forms with the federal government (and many states) is now January 31. This is a significant change from February 28 (manual filing) or March 31 (electronic filing) and will greatly impact the workload for both employers and firms who prepare these returns. If you issue these forms in your business, it will be critical to have this information to your preparer no later than January 10. The due date for having W-2's and 1099's issued to recipients remains at January 31.

The due date for filing partnership returns (Form 1065) was modified for years beginning in 2016. Partnership returns are now due March 15 (for calendar-year taxpayers) instead of April 15. The staggered due date was recommended not only to enable taxpayers to receive Schedule K-1 information in time to meet their initial filing deadlines, but also to help even out the workflow faced by tax preparers. Our opinion is that this may result in more extensions for both partnership and individual returns as many firms now know that 1065's will not be filed by the deadline and are creating a process to extend substantially all of these returns and prepare them after the time crunch of tax season. You may find out as early as January that the 1065 has already been extended. ***If you receive a K-1 from a firm other than ours, do not be surprised if you wind up having to extend your individual return.***

S Corporation Owners Should Check Stock & Debt Basis before Year-End

If you own S corporation stock and you think your S corporation will have a tax loss this year, you should contact us as soon as possible. These losses will not be deductible on your personal return unless and until you have adequate "basis" in your S corporation. Any pass-through loss that exceeds your "basis" in the S corporation will carry over to succeeding years. You have basis to the extent of the amounts paid for your stock (adjusted for net pass-through income, losses, and distributions), plus any amounts you have ***personally*** loaned to your S corporation. If an S corporation anticipates financing losses through borrowing from an outside lender, the best way to ensure the shareholder gets debt basis is to: Have the shareholder personally borrow the funds from the outside lender, and then have the shareholder formally loan the borrowed funds to the S corporation. A shareholder cannot get debt basis by merely guaranteeing a third-party loan to the S corporation.

Deductions for Business Expenses Paid by Partners

Historically, the IRS has ruled that a partner may deduct business expenses ***paid on behalf*** of the partnership ***only if*** there is an agreement (preferably in writing) between the partner and the partnership providing that those expenses are to be paid by the partner, and that the expenses will not be reimbursed by the partnership. If you are a partner paying unreimbursed expenses on behalf of your partnership, you should have a written agreement with the partnership providing that those expenses are to be paid by you, and that the expenses will not be reimbursed by the partnership.

FINAL COMMENTS

We expect the election to change the tax landscape significantly—expect significant tax reform in 2017—but it will not impact 2016 taxes. Tax law is constantly changing due to new legislation, cases, regulations, and IRS rulings. Our firm closely monitors these changes. In addition, if you have questions, please call us before implementing any planning ideas discussed in this letter, or if you need additional information. Please contact us if you are interested in a tax topic that we did not discuss.