2016 Year-End Tax Planning Letter

Dear Clients and Friends,

As we near the close of 2016, you should consider a year-end tax planning strategy. This letter will highlight some of the planning opportunities and challenges for individuals and business regarding federal taxes.

For the last couple of years, year-end tax planning has been affected by uncertainty over whether Congress would pass year-end tax legislation. Given that 2016 is an election year, the passage of any tax legislation before the end of the year is highly unlikely. Therefore, tax laws in effect for 2016 will not likely be changing before year end.

Before I get to specific suggestions, here are a couple of important considerations to keep in mind:

- Effective tax planning requires considering both this year and next year – at least. Without a multiyear outlook, you cannot be sure maneuvers intended to save taxes on your 2016 return will not backfire and cost additional money in the future.

- Maximizing, within overall general planning, the character of income (for example qualified dividends and capital gains), that is subject to preferential, lower tax rates than ordinary income

- Taking advantage of special incentive provisions of the Internal Revenue Code when available such as Section 179 expensing, bonus depreciation and various credits related to different business or personal activities.

- Be on the alert for Alternative Minimum Tax (AMT) in all of your planning because what may be a great move for regular tax purposes may create or increase an AMT problem. There is a good chance you will be hit with AMT if you deduct a significant amount of state and local taxes, claim multiple dependents, exercise incentive stock options, or recognize a large capital gain this year.

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- Be aware that limits and deductible amounts change each year. Here are the 2016 limits:

Standard Deduction	
Single or married filing separately	$6,300
Married filing jointly or surviving spouse	$12,600
Head of household	$9,300
Exempting Amount	$4,050
Flexible Spending Account Limitation	$2,600
Health Savings Account Limitation	
Single	$3,350
Family	$6,750
401(k) Limitation	$18,000
Plus catch-up contribution for age 50 & over, if permitted by employer plan	$6,000
Estate Tax Exemption	$5,430,000
Foreign Earned Income Exclusion	$100,800

The following is a few tax-saving ideas to get you started on your tax planning strategy.

1 - Year-end Investment Moves

Depending on your taxable income, the 2016 federal income tax rates on long-term capital gains and qualified dividends are 0%, 15%, and 20%, with the maximum 20% rate affecting taxpayers with taxable income above $415,050 for single taxpayers, $466,950 for married joint-filing couples, and $441,000 for heads of households. High-income individuals can also be hit by the 3.8% NIIT, which can result in a marginal long-term capital gains/qualified dividend tax rate as high as 23.8%. Still, that is substantially lower than the top regular tax rate of 39.6% (43.4% if the NIIT applies).

Holding on Longer Can Lower Your Taxes. If you hold appreciated securities in taxable accounts, owning them for at least one year and a day is necessary to qualify for the preferential long-term capital gains tax rates. In contrast, short-term gains are taxed at your regular rate, which can be as high as 39.6% (43.4%, if the NIIT applies). Be sure to consider this when evaluating your investment portfolio. Whenever possible, try to meet the more-than-one-year ownership rule for appreciated securities held in your taxable accounts. (Of course, while the tax consequences are important, they should not be the only consideration for making a buy or sell decision.)

Sell the Right Shares. Generally, when you sell stock or mutual fund shares, the shares you purchased first are considered sold first, which is good news if you are trying to qualify for the long-term capital gain rate. But, there may be situations where you're better off selling shares that have been held a year or less rather than those held longer. Selling recently purchased shares at little or no gain (because you purchased them at a higher price) may be better than selling shares held for more than one year if that sale would produce a significant gain. Whenever you want to sell shares other than those you purchased first, you must properly notify your broker as to the specific shares you want sold.

Harvest Capital Losses. Biting the bullet and selling some loser securities (currently worth less than you paid for them) before year-end can also be a tax-smart idea. The resulting capital losses will offset capital gains from other sales this year, including high-taxed short-term gains from securities owned for one year or less. For 2016, the maximum rate on short-term gains is 39.6%, and the 3.8% NIIT may apply too, which can result in an effective rate of up to 43.4%. However, you don't need to worry about paying a high rate on short-term gains that can be sheltered with capital losses (you will pay 0% on gains that can be sheltered).

If capital losses for this year exceed capital gains, you will have a net capital loss for 2016. You can use that net capital loss to shelter up to $3,000 of this year's high-taxed ordinary income ($1,500 if you're married and file separately). Any excess net capital loss is carried forward to next year.

Selling enough loser securities to create a bigger net capital loss that exceeds what you can use this year might also make sense. You can carry forward the excess capital loss to 2017 and beyond and use it to shelter both short-term gains and long-term gains recognized in those years.

Secure a Deduction for Nearly Worthless Securities. If you own any securities that are all but worthless with little hope of recovery, you might consider selling them before the end of the year so you can capitalize on the loss this year. You can deduct a loss on worthless securities only if you can prove the investment is completely worthless. Thus, a deduction is not available, as long as you own the security and it has any value at all. Total worthlessness can be very difficult to establish with any certainty. To avoid the issue, it may be easier just to sell the security if it has any marketable value. As long as the sale is not to a family member, this allows you to claim a loss for the difference between your tax basis and the proceeds (subject to the normal rules for capital losses and the wash sale rules restricting the recognition of loss if the security is repurchased within 30 days before or after the sale).

2 - Maximizing Deductions. One way to reduce your 2016 tax liability is to look for additional deductions. Here's a list of suggestions:

Make Charitable Gifts of Appreciated Stock. If you have appreciated stock that you've held more than a year and you plan to make significant charitable contributions before year-end, keep your cash and donate the stock (or mutual fund shares) instead. You will avoid paying tax on the appreciation, but will still be able to deduct the donated property's full value. If you want to maintain a position in the donated securities, you can immediately buy back a like number of shares. (This idea works especially well with no load mutual funds because there are no transaction fees involved.)
However, if the stock is now worth less than when you acquired it, sell the stock, take the loss, and then give the cash to the charity. If you give the stock to the charity, your charitable deduction will equal the stock's current depressed value and no capital loss will be available. Also, if you sell the stock at a loss, you can't immediately buy it back as this will trigger the wash sale rules. This means your loss won't be deductible, but instead will be added to the basis in the new shares.

Maximize the Benefit of the Standard Deduction. For 2016, the standard deduction is $12,600 for married taxpayers filing joint returns. If you are single, the amount is $6,300 (unless you qualify as head of household, in which case it's $9,300). Currently, it looks like these amounts will be about the same for 2017. If your total itemized deductions are normally close to these amounts, you may be able to leverage the benefit of your deductions by bunching deductions in every other year. This allows you to time your itemized deductions so that they are high in one year and low in the next. You claim actual expenses in the year they are bunched and take the standard deduction in the intervening years.

For instance, you might consider moving charitable donations you normally would make in early 2017 to the end of 2016. If you're temporarily short on cash, charge the contribution to a credit card—it is deductible in the year charged, not when payment is made on the card. You can also accelerate payments of your real estate taxes or state income taxes otherwise due in early 2017. But, watch out for the AMT, as these taxes are not deductible for AMT purposes.

Manage Your Adjusted Gross Income (AGI). Many tax breaks are only available to taxpayers with AGI below certain levels. Some common AGI-based tax breaks include the child tax credit (phase-out begins at $110,000 for married couples filing jointly and $75,000 for heads-of-households), the $25,000 rental real estate passive loss allowance (phase-out range of $100,000–$150,000 for most taxpayers), and the exclusion of social security benefits ($32,000 threshold for married joint filers; $25,000 for most other filers). Also, for 2016 taxpayers with AGI over $311,300 for married joint filers, $259,400 for singles, and $285,350 for heads-of-households begin losing part of their personal exemptions and itemized deductions. Accordingly, strategies that lower your income or increase certain deductions might not only reduce your taxable income, but also help increase some of your other tax deductions and credits. Managing your AGI can also help you avoid (or reduce the impact of) the 3.8% net investment income tax that potentially applies if your AGI exceeds $250,000 for joint returns, $200,000 for unmarried taxpayers.

Managing your AGI can be somewhat difficult, since it is not affected by many deductions you can control, such as deductions for charitable contributions and real estate and state income taxes. However, you can effectively reduce your AGI by increasing “above-the-line” deductions, such as those for IRA or self employed retirement plan contributions. For sales of property, consider an installment sale that shifts part of the gain to later years when the installment payments are received or use a like-kind exchange that defers the gain until the exchanged property is sold. If you’re age 70½ or older, consider making charitable contributions from your IRA, as discussed below. If you own a cash-basis business, delay billings so payments aren’t received until 2017 or accelerate payment of certain expenses, such as office supplies and repairs and maintenance, to 2016. Of course, before deferring income, you must assess the risk of doing so.

3 - Year-end Moves for Seniors Age 701/2 Plus

Make Charitable Donations from Your IRA. IRA owners and beneficiaries who have reached age 701/2 are permitted to make cash donations totaling up to $100,000 per individual IRA owner per year—$200,000 per year maximum on a joint return if both spouses make QCDs of $100,000—to IRS-approved public charities directly out of their IRAs. These so-called *Qualified Charitable Distributions,* or QCDs, are federal-income-tax-free to you, but you get no itemized charitable write-off on your Form 1040. That's okay because the tax-free treatment of QCDs equates to an immediate 100% federal income tax deduction without having to worry about restrictions that can delay itemized charitable write-offs. It also reduces your AGI. QCDs have other tax advantages, too. Contact us if you want to hear about them. Be careful—to qualify for this special tax break, the funds must be *transferred directly* from your IRA to the charity.

Take Your Required Retirement Distributions. Individuals with retirement accounts must generally take withdrawals based on the size of their account and their age every year after they reach age 701/2. Failure to take a required withdrawal can result in a penalty of 50% of the amount not withdrawn. There's good news though—QCDs discussed above count as payouts for purposes of the required distribution rules. This means, you can donate all or part of your 2016 required distribution (up to the $100,000 per individual IRA owner limit on QCDs) and convert taxable required distributions into tax-free QCDs.

Also, if you turned age 701/2 in 2016, you can delay your 2016 required distribution to 2017. However, waiting until 2017 will result in two distributions in 2017—the amount required for 2016 plus the amount required for 2017. While deferring income is normally a sound tax strategy, here it results in bunching income into 2017. Thus, think twice before delaying your 2016 distribution to 2017—bunching income into 2017 might throw you into a higher tax bracket or have a detrimental impact on your tax deductions.

Maximize Contributions to 401(k) Plans. If you have a 401(k) plan at work, it's just about time to tell your company how much you want to set aside on a tax-free basis for next year. Contribute as much as you can stand, especially if your employer makes matching contributions. You give up "free money" when you fail to participate to the max for the match.

Adjust Your Federal Income Tax Withholding. If it looks like you are going to owe income taxes for 2016, consider bumping up the federal income taxes withheld from your paychecks now through the end of the year. When you file your return, you will have to pay any taxes due less the amount paid in and/or withheld. However, as long as your total tax payments (estimated payments plus withholdings) equal at least 90% of your 2016 liability or, if smaller, 100% of your 2015 liability (110% if your 2015 adjusted gross income exceeded $150,000; $75,000 for married individuals who filed separate returns), penalties will be minimized, if not eliminated.

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4 - Year-end Moves for Your Business

Take Advantage of Tax Breaks for Purchasing Equipment, Software, and Certain Real Property.

If you have plans to buy a business computer, office furniture, equipment, vehicle, or other tangible business property or to make certain improvements to real property, you might consider doing so before year-end to capitalize on the following generous tax breaks:

Section 179 Deduction. Under the Section 179 deduction privilege, an eligible business can claim

significant first-year depreciation write-offs for the cost of new and used equipment, software additions, and qualified costs for restaurant buildings and improvements to interiors of retail and leased nonresidential buildings. For tax years beginning in 2016, the maximum Section 179 deduction is $500,000, but this amount is reduced to the extent qualified purchases exceed $2,010,000 for 2016. Also, limits apply to the amount that can be deducted for most vehicles.

Note: Watch out if your business is already expected to have a tax loss for the year (or be close) before considering any Section 179 deduction, as you cannot claim a Section 179 write-off that would create or increase an overall business tax loss. Please contact us if you think this might be an issue for your operation.

First-year Bonus Depreciation. Above and beyond the Section 179 deduction, your business can claim first-year bonus depreciation equal to 50% of the cost of most new (not used) equipment and software placed in service by December 31 of this year. For a new passenger auto or light truck that's used for business and is subject to the luxury auto depreciation limitations, 50% bonus depreciation increases the maximum first-year depreciation deduction by $8,000 for vehicles placed in service this year.

Note: First-year bonus depreciation deductions can create or increase a Net Operating Loss (NOL) for your business's 2016 tax year. You can then carry back a 2016 NOL to 2014 and 2015 and collect a refund of taxes paid in those years. Please contact us for details on the interaction between asset additions and NOLs.

Evaluate Inventory for Damaged or Obsolete Items. Inventory is normally valued for tax purposes at cost or the lower of cost or market value. Regardless of which of these methods is used, the end-of-the-year inventory should be reviewed to detect obsolete or damaged items. The carrying cost of any such items may be written down to their probable selling price (net of selling expenses). [This rule does not apply to businesses that use the Last in, First out (LIFO) method because LIFO does not distinguish between goods that have been written down and those that have not.]

To claim a deduction for a write-down of obsolete inventory, you are not required to scrap the item. However, in a period ending not later than 30 days after the inventory date, the item must be actually offered for sale at the price to which the inventory is reduced.

5 - Review Your Health Insurance Costs and Coverage

Make Sure You Have Adequate Health Insurance Coverage. If you and your family don't have adequate medical coverage (referred to as minimum essential coverage), you may be subject to a penalty. Medical insurance provided by your employer or through an individual plan purchased through a state insurance marketplace generally qualifies as adequate coverage. The penalty amount varies based on the number of uninsured members of your household and your household income. If you have three or more uninsured household members, the penalty may be $2,085 or more for 2016, depending on your household income. This amount will likely be slightly higher in 2017.

Take Advantage of Flexible Spending Accounts (FSAs). If your company has a healthcare and/or dependent care FSA, before year-end you must specify how much of your 2017 salary to convert into taxfree contributions to the plan. You can then take tax-free withdrawals next year to reimburse yourself for out-of-pocket medical and dental expenses and qualifying dependent care costs. Watch out, though, FSAs are "use-it-or-lose-it" accounts—you don't want to set aside more than what you'll likely have in qualifying expenses for the year.

If you currently have a healthcare FSA, make sure you drain it by incurring eligible expenses before the deadline for this year. Otherwise, you'll lose the remaining balance. It's not that hard to drum some things up: new glasses or contacts, dental work you've been putting off, or prescriptions that can be filled early.

Consider a Health Savings Account (HSA). If you are enrolled in a high-deductible health plan and don't have any other coverage, you may be eligible to make pre-tax or tax deductible contributions to an HSA of up to $6,750 for a family coverage or $3,350 for individual coverage—plus an extra $1,000 if you will be 55 or older by the end of 2016. Distributions from the HSA will be tax free as long as the funds are used to pay unreimbursed qualified medical expenses. Furthermore, there's no time limit on when you can use your contributions to cover expenses. Unlike a healthcare FSA, amounts remaining in the HSA at the end of the year can be carried over indefinitely.

Conclusion

Through careful planning, it's possible your 2016 tax liability can still be significantly reduced, but don't delay. The longer you wait, the less likely it is that you'll be able to achieve a meaningful reduction. The ideas discussed in this letter are a good way to get you started with year-end planning, but they're no substitute for personalized professional assistance. Please contact me if you have any questions or for additional strategies on reducing your tax bill.