2016 YEAR-END TAX PLANNING FOR INDIVIDUALS

There is very little a taxpayer can do to change their estimated tax liability once the calendar year closes. While little happened in the way of tax legislation in 2016, some beneficial tax provisions will expire this year (explained in greater detail, below). You may benefit from these and other tax breaks by using certain strategies to minimize your federal tax liability. A year-end review of your tax affairs may therefore uncover tax planning opportunities.

Tax Rates

For 2016, the top tax rate of 39.6 % will apply to incomes over $415,050, ($466,950 for taxpayers married, filing jointly). High-income taxpayers are also subject to the 3.8 % net investment income tax and possibly the 0.9 % Medicare surtax, as well.

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.

There are potential strategies to reduce the effect of the AMT. Deferring income or maximizing contributions to a tax-deferred retirement plan (e.g., 401(k)) or tax-deferred health savings account can lower the adjusted gross income, thereby reducing the consequences of the excluded deductions.

Additionally, a business owner with a qualifying home office can accelerated business and related expenses (e.g., a portion of your property taxes, mortgage interest, etc.) allocable to Schedule C. The lower net business income will further reduce the adjusted gross income.

Avoiding the Net Investment Income Tax

The *net investment income tax* (NIIT) is a 3.8 % tax levied on certain net investment income above $200,000 ($250,000 for married, filing jointly). 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.

The NIT therefore increases the top tax rate for qualified dividend income increases from 20% to 23.8%. If you are subject to the tax, or think that you may be, the following actions may help to reduce the tax liability.

(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. You may also gift the property to another person who is not subject to the NIIT and the donee will report the income.

(2) *Replace stocks with state and municipal 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) *Classification as a real estate professional.* 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 non-passive and thus escapes the NIIT.

(4) *Defer gain recognition by installment sale.* 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) *Maximized unrecognized capital losses.* Since capital losses can offset capital gains for NIIT purposes, consider whether it makes sense to sell any losing stocks (keeping in mind the related transaction costs).

(6) *Defer gain recognition with a like-kind exchange.* If you have appreciated real property to dispose of and are not considered a real estate professional, a like-kind exchange will defer any gain recognition and therefore avoid recognizing additional NIIT income.

The NIIT does not apply to a trade or business unless (1) a passive activity with respect to the taxpayer, or (2) it consists of trading financial instruments or commodities.

<u>Liability for the 0.9 % Medicare Tax</u>

An additional Medicare tax of 0.9 % is imposed on wages, compensation, and self-employment income in excess $200,000 ($250,000 for married, filing jointly). The threshold amount for self-employment income 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 0.9 % additional tax on only $75,000 of self-employment income.[1] The additional Medicare tax is not tax deductible.

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 have combined income in excess $250,000 and have not made enough tax payments to cover the additional 0.9 % 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 expected 0.9 % tax. Otherwise, an underpayment of tax penalty may apply.

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 up to $4,000 of qualified education expenses paid during the year.

New Compliance Requirement for Claiming Educational Tax Credits

Beginning in 2016, a taxpayer must have received a Form 1098-T in order to claim an American Opportunity or lifetime learning credit or a deduction for education-related tuition and fees. This form reports qualified tuition and related expenses received by the educational institution and is 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 by January 31, 2017 from the educational institution to which you made payments.[2]

The form only reports qualified tuition and related expenses, in which case there may be a discrepancy between the amounts 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 not reported on Form 1098-T.

Retirement Plan Considerations

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

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[1] $145,000 - $70,000 (the $200,000 threshold - $130,000 in wages).

[2] 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.

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.

Contributions to an individual retirement account (IRA) may be deductible if certain requirements are met. For taxpayers less than 50 years of age, the maximum contribution amount for 2016 is $5,500 and $6,500 for taxpayers between 50 and 70 ½.[3]

Even if you are not eligible for the deduction, contributing after-tax money to an IRA may be advantageous because it will allow you to convert a 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.

The decision to accelerate tax recognition by converting a traditional IRA to a Roth IRA can be evaluated with some simple calculations. The amount converted as ordinary income is subject to ordinary income but any subsequent earnings are tax free.

A new tax regulation allows a taxpayer to rollover the after-tax amounts in a traditional 401(k), 403(b), or 457 plan to a Roth IRA with no tax consequences (in most cases). 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 must be considered before initiating any trades or transactions.

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. Taxpayers must file a FinCEN Report 114, Report of Foreign Bank and Financial Accounts 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 contact our office to discuss further.

The deadline for filing the form is April 15.[4] The due date is automatically extended until June 15 for tax payers living abroad, with a

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[3] Contributions exceeding the maximum amount are subject to a 6.0 % excise tax.
[4] Congruent with the individual income tax deadlines, a six-month extension is available

similar four-month extension until October 15.

Penalty for Failing to Carry Health Insurance

Under the U.S. Affordable Care Act, there is a penalty (the "shared responsibility payment") for not having health insurance coverage. Taxpayers may be liable for this penalty if you or any of your dependents were uninsured any month in 2016. The penalty is 2.5 % of your 2016 household income exceeding the filing threshold or $695 per adult, whichever is higher ($347.50 per uninsured dependent under 18), up to $2,085 total per family.

Last Year for Certain Energy-Related Credits

The following energy-related credits expire at the end of 2016:

(1) *Nonbusiness Energy Property Tax Credit*. Taxpayers are entitled to an energy property tax credit when making certain energy efficiency improvements during the year. The credit is equal to 10.0% of the amounts 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 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.

(2) *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% of the cost 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.

(3) *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.
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> Taxpayers who acquired a qualified plug-in electric drive motor vehicle during the year 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 Children

Gifting appreciated stock to a college age child can shift income to a lower tax bracket and therefore reduce the related tax burden. For example, a child with earned income taxed at the lowest two income brackets will pay no tax on capital gains generated from the stock sale.

If the child has little or no earned income, however, the so-called "kiddie tax" would subject the unearned income to the parent or donors higher tax rate.

Deferring Income and Accelerating Deductions

Deferring Income into 2017. A taxpayer expecting 2017 income to be significantly less than 2016 may benefit from deferring the income and paying tax at a future, lower tax rate.

Deferring income can include: (1) collecting a year-end bonus in January; (2) postponing the sale of appreciated property; (3) using an installment agreement to defer scheduled income until 2017 or later; (4) delaying the exercise of any stock options; and (5) consider making investments in deferred annuities.

Accelerating Deductions. A taxpayer with an expected decrease in income next year can offset higher income this year by paying deductible expenses before year-end.

Some options include: (1) prepaying property taxes; (2) making January mortgage payments; (3) paying annual state income taxes; (4) aggregating insurance co-pay or uninsured medical expenses if doing so exceeds the threshold for itemized deductions; (5) making charitable contributions; (6) selling securities with un recognized losses; and (7) maximizing the benefit of a health savings account.

Accelerating Income and Deferring Deductions

Accelerating Income into 2016. On the other hand, taxpayers expecting to have higher income in 2017 will want to consider accelerating the income for tax purposes if the effective rate is also expected to increase.

Options for accelerating income include: (1) harvesting gains from your investment portfolio keeping in mind the 3.8 % NIIT (*see above)*; (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) self-employed taxpayers with receivables can collect these amounts before year end; and (5) settle any outstanding lawsuits or insurance claims that will generate income this year.

Likewise, deductible expenses can be deferred into 2017 by, for example: (1) postponing year-end charitable contributions, property tax payments, and medical and dental expense payments (and other itemized deductions) until next year; and (2) postponing the sale of any loss-generating property.

Regardless of expected income changes, reminder to 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 will have until then – check with your employer).

Life Events and Miscellaneous Other Items

Certain life events can also affect your tax situation. A more thorough evaluation is needed in the event of marriage or divorce, new children or a death in the family, and changes to employment (including retirement). Please contact the office if your family expects any of these changes in order to arrange your tax affairs appropriately.

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. I look forward to our working together in the new year.

Best regards,

James Hastings
Law Office of James Hastings PC