CPA

Client Tax Letter

Tax Saving and Planning Strategies *from your* Trusted Business Advisor[sm]

October/November/ December 2016

More Certainty for Year-End Tax Planning

Recently, year-end tax planning has been challenging. Many tax code provisions expired, and it was uncertain whether they would be renewed, with Congress' action potentially not coming until extremely late in the year.

Th ngs are different in 2016. The Protecting Americans from Tax Hikes (PATH) Act of 2015 was signed into law late last year, not only renewing some expired benefits but making them permanent. Other expired tax provisions were extended for multiple years.

The efore, relatively few tax planning issues will be up in the air as the calendar turns to the fourth quarter of 2016. You'll know, for example, that state and local sales tax can be deducted, instead of state and local income tax, if that's a better choice. If you're older than age 70½, or nearing that age, you can make philanthropic plans with the assurance that charitable donations directly from IRAs are permissible.

The ncreased assurance that certain tax benefits will be available makes year-end planning more effective. In this issue of the *CPA Client Tax Letter*, we will highlight some of the major provisions of the PATH Act that can help you make good decisions.

Keep in mind that the November elections have yet to be decided, as of this writing. We will have a new president in 2017, changes in Congress, and the likelihood that revisions in tax law will be proposed. The efore, you should end 2016 with a plan to use current tax benefits, including those deemed to be "permanent," while they're available. ■

Year-End Planning for Itemized Deductions

For 2016, the standard deduction is $6,300 for single taxpayers (and for married persons filing separately) and $12,600 for married couples filing jointly. For heads of household, the standard deduction is $9,300. People who have reached age 65 by year-end can take an additional standard deduction of $1,250, if married, or $1,550, if not married. Taxpayers who are blind also get this additional standard deduction.

Example 1: Stan and Kate Th mpson are both 68 years old; they file a joint tax

continued on page 2

What's Inside

Avoiding a Soaking

From 2010 to 2014, the average residential floo claim was more than $39,000, much greater than the average floo insurance policy premium of about $700 per year.

continued from page 1

return. The r standard deduction for 2016 is the basic $12,600 for couples filing jointly plus $1,250 for Stan and $1,250 for Kate, for a total of $15,100. (If one of them was blind, that amount would increase by $1,250, to $16,350.)

The e standard deductions are claimed by most taxpayers. However, you also have the opportunity to itemize deductions on Schedule A of Form 1040 when you file your income tax return. If the total of your itemized deductions exceeds your standard deduction, you can save tax by itemizing.

Example 2: In example 1, the Th mpsons had a standard deduction of $15,100. If the amounts they could deduct on Schedule A, for medical and dental expenses; taxes paid; interest paid; charitable gifts; casualty and theft losses; job expenses; and miscellaneous deductions total $15,000, this couple will be better off by not itemizing and taking the standard deduction. On the other hand, if that total is $16,000, the Th mpsons should file Schedule A and increase their tax deduction by $900: $16,000 instead of $15,100.

For effective year-end planning, estimate your potential itemized deductions for 2016 well in advance of December 31. If you see you will benefit by itemizing, you may decide to accelerate certain payments into 2016. In many cases, the extra payments will be fully deductible. Conversely, if you are far below the standard deduction amounts, you won't get any tax benefit from, for example, writing a modest check to charity. You may decide to postpone the donation until sometime in 2017, when you might be itemizing and get a tax benefi from your contribution.

Our office can meet with you before year-end to go over your records and indicate whether you should make tax saving payments by year-end, in the expectation of itemizing deductions. ■

Year-End Planning for Deducting Taxes Paid

As mentioned on page 1, a new law makes the sales tax deduction permanent. Keep in mind that you deduct sales tax *instead* of state and any local income tax. You can't deduct both sales and income taxes.

The new provision obviously will benefit taxpayers who live in Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming, none of which has state income tax. If you live in such a state and it pays for you to itemize, you can deduct sales tax you paid.

Residents of other states who itemize their deductions must decide whether to deduct sales or income tax.

Example 1: As the year-end nears, Tara Lane calculates how much state income tax she will wind up paying in 2016. Th t includes amounts withheld from her income and any estimated tax payments. Suppose the total will be $5,000. If Tara will have paid more than $5,000 in sales tax for the year, she should deduct sales tax on her federal return. Otherwise, she should take her $5,000 state income tax deduction.

To calculate her sales tax payments, Tara can check her receipts for the year. Lacking complete records, Tara can use the Optional Sales Tax Tables provided by the IRS in the instructions to Schedule A. Still another option is to use the IRS Sales Tax Deduction Calculator, at https://apps.irs.gov/app/stdc/, which calculates the amount of the deduction based on the tables for you.

The igher your income (including tax-exempt interest income and certain other inflows), the more sales tax you'll be assumed to have paid using the tables. Regardless of your income, however, you add the amount of tax you paid for motor vehicles (leased or purchased), aircraft, boats, residences, or home building materials to the amount from the IRS tables to determine your total allowable sales tax deduction. If all the allowable sales tax deduction amount exceeds the income tax deduction amount, deduct the sales tax rather than the income tax.

Th t's where year-end planning for sales tax can come in. Buy big-ticket

Trusted Advice

Local Benefits Tax

- Many states and counties impose local benefit taxes for improvements to property.
- These taxes might be assessments for streets, sidewalks, and sewer lines.
- You cannot deduct these taxes. However, you can increase the cost basis of your property by the amount of the assessment, which may result in a lower tax on an eventual sale of your property.
- Local benefits taxes are deductible if they are for maintenance or repair, or interest charges related to those benefits.

Did You Know?

A majority of 401(k) plans offer only one source of investment advice to participants. However, it appears that plan sponsors are starting to reconsider this approach. Some sponsors are adding new forms of advice: 27% are likely to start offering access to an adviser and 25% are likely to give participants access to one-on-one advice from a third party.

Source: Market Strategies International items before year-end if the tax on those items will be deductible. If a deduction is unlikely, you might decide to postpone the purchase until 2017.

Beyond sales tax

If you decide to deduct state and local income tax payments rather than sales tax, you might choose to accelerate estimated state and local income tax payments due in early 2017 to late 2016, increasing the deductible amount for this year. Similarly, you may be able to move scheduled property tax payments from 2017 to 2016 for an earlier deduction. Both of those tactics, though, may raise your tax bill if you'll owe the alternative minimum tax (AMT). Our office can let you know how the AMT would affect prepaying state or local taxes. ■

Year-End Planning for Charitable Donations

The ATH Act, passed at the end of 2015, exempts certain IRA-to-charity transfers from income tax. For most people, moving money from an IRA to a charity is a taxable withdrawal, subject to income tax. However, once you reach age 70½, such transactions may be untaxed as a Qualified Charitable Distribution (QCD).

QCDs are now a permanent tax code provision. Everyone who passes the age test can donate up to $100,000 a year from a traditional IRA to one or more charities. A QCD generally must go directly from the IRA to an eligible charity. (Transfers to donor advised funds can't be considered QCDs.)

At first glance, QCDs seem to be a wash. You won't report taxable income, but you also won't get a tax deduction for the donation. Drilling down, though, QCDs may offer tax savings to many seniors.

Itemizing not necessary

Among the beneficiaries from QCDs are the many taxpayers who don't itemize deductions.

Example 1: Victor and Wendy Young are both age 65 or older, so they qualify for a standard deduction of $15,100 in 2016, as explained previously in this issue. The Youngs have paid off their home mortgage, so they don't have deductible interest expenses. In retirement, the couple's income has dropped, reducing the state income tax they pay. Consequently, the Youngs do not have enough deductions to make itemizing worthwhile, so they will take the standard deduction.

Assume that the Youngs typically make $4,000 of charitable donations during the year-end holiday season. Taxpayers taking the standard deduction get no tax benefit from charitable contributions; therefore, if Wendy Young is age 68, she will get no benefit from charitable gifts.

However, suppose that Victor Young is 72 and is eligible for QCDs. Taxpayers older than 70½ must take required minimum distributions (RMDs) from traditional IRAs; assume Victor's RMD for 2016 is $10,000. The ouple would owe tax on that $10,000 RMD on their joint tax return. However, Victor can make their usual $4,000 of charitable donations directly from his IRA, as tax-free QCDs.

Th se QCDs will count towards Victor's RMD, so he'll only have to take the $6,000 balance in taxable distributions from his IRA, not $10,000. The efore, the Youngs will save tax by using QCDs. Th y'll retain the $4,000 that would have passed from their checking account to charity, to spend, invest, or use for family gifts.

Adjusting income down

QCDs also can help taxpayers who itemize deductions by reducing their adjusted gross income (AGI).

Example 2. Mary North, age 75, who has a $20,000 RMD this year, plans to itemize deductions. Th t RMD would increase Mary's AGI by $20,000, as reported on page 1 of her tax return.

Suppose that Mary will make $15,000 of deductible charitable contributions at year-end 2016. If Mary makes those donations from her regular checking account, the deduction for them would be included in itemized deductions on page 2 of her tax return, without affecting her reported AGI.

Instead, Mary makes her $15,000 of year-end donations as QCDs, reducing her taxable RMD to $5,000, instead of $20,000. By doing so, Mary effectively reduces her reported AGI by $15,000. A lower AGI may provide tax savings throughout Mary's tax return. She might qualify for a larger itemized medical and dental deduction, for instance, or a larger itemized miscellaneous deduction.

Planning ahead

Although QCDs are limited to people age 70½ or older, the fact that they are now permanent can affect year-end planning for younger people as well. Taxpayers in their 60s, for example, might defer some donations to the future, when they can get the tax

continued on page 4

continued from page 3

benefits of QCDs. Th t's especially true for those who don't itemize deductions, or those who plan large donations and also expect large RMDs.

Taxpayers younger than 70½ also may wish to reconsider year-end Roth IRA conversions. (See the article on Retirement Tax Planning in this issue.) One reason for converting some or all of a traditional IRA to a Roth IRA is to reduce or avoid RMDs because Roth IRA owners never have required distributions. However, year-end Roth IRA conversions will add to your tax bill for 2016 at your highest marginal tax rate.

Some people may decide to forgo a Roth IRA conversion and leave money to grow in their traditional IRA, tax-deferred. Once age 70½ is reached and QCDs are permitted, traditional IRA dollars can go to charity, untaxed, as QCDs. Th s will reduce the amount of AGI that otherwise would be reported from RMDs. Our office can help you plan for the impact of QCDs on your charitable planning, now and in the future.

Beyond QCDs

If QCDs don't play a role in your plans, traditional strategies for year-end donations still apply. It often makes sense to donate appreciated securities to charity, rather than write checks. When you donate appreciated securities held for more than a year, you'll get a deduction for the current value of those securities and avoid paying tax on the unrealized gains.

Donating appreciated securities to many charities can create paperwork headaches, though, so you might want to make those donations through a donor advised fund for the same tax benefit. Donor advised funds are offered by many financial firms and community organizations. ■

Year-End Planning for Medical Deductions

The ATH Act of 2015 is not the only recent tax law affecting year-end planning this year. One provision of the Affordable Care Act, passed back in 2010, comes into play now. For taxpayers age 65 or older, it may pay to incur optional medical expenses by December 31, 2016.

Under the Affordable Care Act, the threshold for deducting unreimbursed medical and dental outlays was raised in 2013 from 7.5% to 10% of AGI. However, the 7.5% hurdle was kept in place for four years for taxpayers 65 or older. (Only unreimbursed medical bills greater than the threshold can be deducted.)

Example 1: Owen Palmer, age 63, has an AGI of $100,000 in 2016 and $9,500 in medical bills. For Owen, the deductibility threshold is $10,000 (10% of $100,000), so he'll get no medical deduction.

Example 2: Owen's neighbor Rona Sanders, has the same $100,000 AGI and $9,500 in medical bills. However, Rona is 67, so her threshold is only $7,500 (7.5% of $100,000). The efore, Rona can deduct $2,000 of her medical costs.

Starting in 2017, the 10% threshold will apply to everyone. The efore, seniors have an incentive to increase their medical outlays if they'll reach the lower percentage this year. Once you've cleared the relevant hurdle, all medical costs will be fully deductible.

Premiums included

You might be surprised at how many expenses can be classed as medical deductions. Medicare Part B premiums, for example, count as potentially deductible medical expenses. Th t's true even if you have those premiums withheld from the Social Security payments that are deposited into your bank accounts each month. The s me is true for any premiums paid for Medicare Part D prescription drug plans and for money you spend directly on prescription drugs as well as for premiums paid for Medicare Supplement (Medigap) policies.

In addition, money spent on long-term care (LTC) insurance policies probably will be deductible, up to certain age-based limits. For 2016, policyholders age 41-50 can include LTC premiums up to $730 as medical expenses. The eductible amount increases to $1,460 for taxpayers age 51-60, $3,900 for taxpayers age 61-70 able to include LTC premiums, and $4,870 for taxpayers age 71 or older.

Sooner rather than later

For effective year-end tax planning, it pays to estimate your possible medical expenses for 2016 early in the fourth quarter. If you think you'll be near or greater than the 7.5% or 10% threshold for tax deductions, push certain medical and dental expenses into November and December. Buy prescription eyeglasses, get physical exams, and so on if they'll likely be tax deductible. If you're nowhere near the 7.5% or 10% levels, consider deferring health care costs until 2017, when your total outlays may reach tax deductible territory. ■

Year-End Retirement Tax Planning

Many people save money for retirement in a traditional IRA. The unds might have come from annual IRA contributions, or from rolling over an employer sponsored retirement account such as a 401(k). Either way, the dollars in your traditional IRA are probably pretax, so they'll be taxed on withdrawal.

You can leave the money in your traditional IRA for ongoing tax deferral. However, you might need cash now, especially if you're retired or have had unexpected expenses. In another scenario, you may expect your traditional IRA to be extremely large by the time you reach age 70½ and RMDs begin. Th se RMDs might be so large that they'll be heavily taxed in a high bracket.

The efore, you might want to take withdrawals from your traditional IRA before year-end 2016, so they'll count in this year's taxable income. With savvy planning, you can minimize the tax bite by staying within your current tax bracket.

Example 1: Greg and Heidi Jackson's taxable income last year was $100,000. Th y expect their taxable income to be about the same this year. In 2016, the 25% bracket goes up to $151,900. Th s, the Jacksons can take as much as $50,000 from their traditional IRAs before December 31 this year, without moving into a higher tax rate. Th y might withdraw, say, $20,000 from their IRAs, pay $5,000 in tax at a 25% rate, and have $15,000 left for other purposes.

The right spot

If you're taking money from a traditional IRA, the best time may be between ages 59½ and 70½. After age 59½, the 10% early withdrawal penalty won't apply; before 70½, you won't be subject to RMDs, which will restrict your flexibility about IRA withdrawals.

If you're younger than 59½, you still might avoid the 10% penalty by qualifying for an exception. Several exceptions are available, including one for higher education expenses.

Example 2: Suppose Greg and Heidi Jackson from example 1 are both younger than 59½. If they take $20,000 from their IRAs this year, as indicated in that example, a $2,000 (10% of $20,000) penalty will be added to their $5,000 (25%) tax bill. However, if the Jacksons pay at least $20,000 in 2016 for their daughter's college bills, they can take that $20,000 from their IRAs and owe the 25% income tax but not the penalty.

Canny conversions

After withdrawing funds from a traditional IRA at a low tax, un-penalized rate, you can use the after-tax dollars to pay college bills or for living expenses in retirement. If there is no immediate need for cash, you can move the money into a Roth IRA. After five years and age 59½, all withdrawals from a Roth IRA will be tax-free.

Converting traditional IRA money to a Roth IRA will trigger income tax. Th t might not be a major issue if you're staying in the 15%, 25%, or 28% tax brackets. However, if you convert too much, you could wind up moving into a higher bracket and paying more income tax than you'd like.

Fortunately, the tax code offers a solution to this potential problem. You can recharacterize (reverse) a Roth IRA conversion, in whole or in part, by October 15 of the following year, and owe tax only on the amount that stays in the Roth IRA.

Example 3: In the previous examples, Greg and Heidi Jackson expect to have around $100,000 in taxable income this year. The r 25% tax bracket goes up to $151,900 in 2016. The acksons, hoping to convert as many dollars as possible at the 25% tax rate, convert $50,000 of Greg's IRA to a Roth IRA by year-end 2016.

When the Jacksons prepare their income tax return for 2017, they learn that their 2016 taxable income was higher than expected. Not including the Roth IRA conversion, their taxable income was $118,500. A full $50,000 Roth IRA conversion would put part of the conversion amount into the 28% bracket, generating more tax than the Jacksons want to pay.

In this situation, the Jacksons could recharacterize enough of Greg's Roth IRA conversion to wind up with a $33,400 conversion, retroactively. Th y would use up the full 25% tax bracket while the recharacterized dollars would return to Greg's traditional IRA, untaxed. If you are interested in this type of lookback fine tuning, our office can help you with a year-end Roth IRA conversion and a possible 2017 recharacterization.

Beyond IRAs

The 2016 ontribution limit for 401(k) plans is $18,000 per participant plus $6,000 if you're 50 or older by year-end. If you

continued on page 6

continued from page 5

are not maximizing your 401(k) contributions and wish to put more into the plan this year for increased tax deferral, contact your plan administrator. Meanwhile, keep in mind that many retirement plans impose RMDs after age 70½. Make sure you’re withdrawing at least the minimum amount, if you’re required to do so, in order to avoid a 50% penalty on any shortfall. ■

Year-End Business Tax Planning

The ATH Act’s many provisions also include a permanent increase in the amounts allowed under IRC Section 179, which permits rapid deduction (expensing) of funds spent for business equipment. For 2015, expensing up to $500,000 of equipment was allowed with no phaseout beginning at $2 million of purchases. For 2016, the infl tion adjusted amount is $2,010,000. In addition, the PATH Act makes permanent the treatment of off- he-shelf computer software as Sec. 179 property.

The ottom line is that small companies can confidently purchase equipment and software this year. As long as total outlays don’t top $2.01 million, expenses up to $500,000 can be deducted for 2016 rather than spread over several years. To qualify for the IRC Section 179 tax break, the equipment or software must be purchased, financed or leased, and placed into service by December 31. The eduction will equal the full purchase price.

For companies that spend more on equipment than the IRC Section 179 deduction allows, the PATH Act’s extension of “bonus depreciation” may help. For 2016 as well as 2017, a taxpayer may generally deduct 50% of qualifying equipment’s cost (reduced by the amount of any Sec. 179 expense deduction taken for the cost of the equipment). However, bonus depreciation applies only to new equipment while the first-year IRC Section 179 deduction applies to new and used equipment.

Paperwork now, payment later

The e d of the year is also a good time to review your company’s retirement plan situation. If you have one, should you make a change? If you don’t have a company-sponsored retirement plan, do you want to establish one? Such a plan not only will benefit your employees, it will enable you to put aside funds for your own retirement on a tax-favored basis.

Today, a 401(k) can be considered the “standard” company plan. Many prospective employees expect to have a 401(k) at work, so offering such a plan may enable you to attract good people and retain valued workers. Contributions generally are funded by the employees themselves, but many companies provide matching contributions in some form.

December 31 is the deadline for establishing a 401(k) plan for 2016, assuming your company uses a calendar year. Employee contributions for 2016 must be withheld from 2016 paychecks and must be sent to the relevant financial firm as soon as possible. Employer contributions, deductible for 2016, can be made up to the company’s tax return due date, including extensions.

A variation of the basic 401(k) is often known as the solo 401(k) or the individual 401(k). Other names may apply. However the plan is titled by the financial firm involved, it is open only to business owners and their spouses who are employed by the company. For 2016, the maximum contribution to a solo 401(k) is $53,000 per participant, if certain conditions are met, or $59,000 for those age 50 or older. Basic 401(k) plans have contribution limits of $18,000 or $24,000 before any employer match.

Again, the deadline for establishing a solo 401(k) in 2016 is December 31 of this year. Some tax deductible contributions may be made up to the tax return deadline, including extensions, in 2017.

Beyond 401(k)s

Other retirement plans for small businesses also have a December 31 deadline for signing the forms to receive tax benefits in 2016. The e plans also have an extended due date for making contributions. They include profi sharing plans, which are funded by the employer. Profit sharing plans may motivate employees to help the company’s earnings grow. Annual employer contributions are discretionary, so companies aren’t locked in.

Yet another option is a defined benefit plan, which can provide a traditional life-long pension. The e plans are offered mainly by public employers and some large companies, but small firms also may benefit. The best prospects might be companies where the principal is, say, 50 or older, with few employees. In such situations, the business may make extremely large, tax-deductible contributions to the principal’s retirement account. Again, the plan must be established by December 31 for 2016 tax benefits.

Our office can help you choose among various retirement plans for your business and let you know about any year-end deadlines. ■

The *CPA Client Tax Letter* (ISSN 1066-1867) is prepared by AICPA staff for the clients of its members and other practitioners. The *Tax Letter* carries no official authority, and its contents should not be acted upon without professional advice. Printed in the U.S.A. Sidney Kess, CPA, JD, Editor. For AICPA customer service call 888.777.7077 or visit *www.cpa2biz.com*.