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YEAR-END TAX PLANNING 2016

Dear Clients and Friends:

For the first time in many years many favorable tax provisions were extended through the **P**rotecting **A**mericans from **T**ax **H**ikes Act of 2015 (the **PATH** Act). This will help to relieve some of the uncertainty over whether many tax incentives will be extended or expired late in the year giving little or no time to make planning decisions. Not all provisions were extended past 2016, some were extended for two years, others for five years and some were made permanent. Our firm will be monitoring closely any significant tax legislation that occurs before the end of the year. As a firm we always put our best efforts forward to help all of our clients to prepare for what ever changes come our way.

The term "Tax Planning" refers to the timing and method of reporting Income, Gains, Expenses, and Deductions. Usually the goal is to defer the payment of tax by accelerating deductions and deferring the recognition of income.

The purpose of this letter is to provide awareness of some of the tax provisions that may apply to you and to give some ideas of how to possibly reduce your 2016 tax burden. These items may not all be relevant to your specific tax situation. Therefore, we suggest you check with us before taking action on any of these ideas.

The technical information here is purposely brief, no final decisions should be made without our consultation. Please be advised that any federal or state tax advice contained in this communication, including attachments and enclosures, is not intended or written to be used, and may not be used, for the purpose of (i) avoiding tax related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax related matters addressed herein.

The Affordable Care Act

With the health insurance mandates required by the "affordable care act" in place as of January 1st 2014, it is important for employers and individual taxpayers to understand

The Affordable Care Act (Continued)

their respective requirements. Contact our office if you have any questions or need information.

The legislation known as the Affordable Care Act (ACA) has some key provisions that may have implications for higher income tax payers. These provisions summarized below could have federal tax consequences for some taxpayers.

- Net Investment Income Tax – a 3.8% tax for Individuals, Estates, and Trusts that have Investment Income above certain MODIFIED ADJUSTED GROSS INCOME threshold amounts as follows: Married Filing Jointly - $250,000, Single - $200,000, Head of Household -$200,000, and Married Filing Separately - $125,000. Net Investment Income includes but is not limited to: Interest, Dividends, capital gains, royalties, and rental Income.

- Additional Medicare Tax – a .9% additional Medicare tax applies to wages and SE Income that exceeds a threshold amount based on an Individual's filing status as follows: Married Filing Jointly - $250,000, Single - $200,000, Head of Household -$200,000, and Married Filing Separately - $125,000.

New Tax Provisions and Notes

In the summer of 2015 Congress passed, and President Barack Obama subsequently signed, legislation that modified the due dates for several common tax returns. These changes are generally effective for taxable years starting after Dec. 31, 2015 ***(2016 tax returns prepared during the 2017 tax filing season)***. The new due dates for the return types are as follows:

RETURN TYPE	***DUE DATE***	***EXTENDED DUE DATE***
Partnerships (Form 1065)	**March 15th** (Formerly April 15th)	September 15th (same as previous)
S-Corporation (Form 1120S)	March 15th (Same as previous)	September 15th (same as previous)
Estate & Trust (Form 1041)	April 15th (Same as previous)	**September 30th** (Formerly Sept. 15th)
C-Corporation (Form 1120)	**April 15th** (Formerly March 15th)	September 15th (same as previous)
Exempt Organization (Form 990)	May 15th (Same as previous)	**November 15th** (Formerly Aug. 15th)

Note: Starting with 2016 tax returns, all other C corps besides Dec. 31 and June 30 year-ends (including those with other fiscal year-ends) will be due on the 15th of the 4th month after the year-end. A six-month extension is allowed from that date.

The top ordinary-income tax rate in 2016 is 39.6%. The 39.6% rate kicks in when taxable income exceeds $415,050 for singles, $441,000 for head of households, $466,950 for married couples filing jointly, and $233,475 for Married taxpayers Filing Separately.

New Tax Provisions and Notes (continued)

The capital gains rate for the individuals in the top tax rate (39.6%) is 20%. The 15% capital gains rate applies to the 25%, 28%, 33%, and 35% tax brackets AND A ZERO PERCENT rate for the 15% and 10% tax brackets.

The itemized deduction phase-out for certain taxpayers who exceed certain adjusted gross income thresholds are as follows: $259,400 for singles, $285,350 for head of households, $311,300 for married couples filing jointly and $155,650 for Married taxpayers Filing Separately.

The American Opportunity tax Credit has been extended permanently by the PATH Act. This Credit provides a maximum credit of up to $2,500 per year, with 40% of the credit refundable. The credit is for all four years of college and allows qualifying expenses to include required course materials. There are still income phase out ranges. ***Taxpayer's must now have a Form 1098-T to claim the credit.***

The PATH Act permanently extended the $250 above the line deduction for elementary and secondary school teachers out of pocket classroom expenses. It also indexes the $250 deduction for inflation however no increase has been made for 2016.

The PATH Act extended the exclusion from gross income for the cancelation of qualified principal residence indebtedness through 2016

The PATH Act reinstates and makes permanent the exclusion from gross income for ***qualified charitable distributions directly from an IRA***. This can be used to satisfy your RMD requirements. The exclusion may not exceed $100,000 per taxpayer per year.

Individual Tax Provisions That Expire At End of 2016 and Have Not Yet Been Renewed for 2017 *(at the time of this writing)*

- Above the line deduction for qualified tuition and related expenses
- Deduction for mortgage insurance premiums
- Credit for non-business energy property (windows, doors, insulation, etc.)
- Exclusion from income the Cancelation of Debt from principal residence.

Individual Tax Planning

Tax Planning Basic framework

Traditionally, tax planning has focused on accelerating deductions into the current year and deferring income into future years. But, depending on your specific situation, this may not produce the best tax outcome for the future. The basic framework to help shape your overall income tax planning in 2016 may be follows:

- If you expect to be in a *higher* income tax bracket in 2017, consider accelerating income into 2016 and deferring deductions to 2017.

- If you are forecasting a *lower* income tax bracket in 2015, reverse the strategy: Consider deferring income to 2017 and accelerating deductions to 2016.

The smart timing of income and expenses can reduce your tax liability, and poor timing can unnecessarily increase it. Remember every taxpayer has a different situation we will work with you to see what best suits your needs.

For the 2016 tax year the long term capital gain tax rate for taxpayers in the 10 and 15 percent federal tax bracket is once again zero. There has been some confusion about this provision however. The zero percent tax rate applies to the portion of capital gains that falls between the taxpayer's ordinary income and the top 15 percent federal tax bracket. For 2016 the maximums for the 15 percent tax bracket are as follows: married filing jointly - $75,300, single individuals or married filing separately - $37,650 and head of household - $50,400. If you have a capital gain or anticipate incurring a capital gain do all in your power to get your taxable income low enough to qualify for the zero percent rate. We have strategies that can help you do this.

Worthless Stocks and Bonds if you own stocks or bonds that became worthless this year please be sure to provide us with the cost and purchase dates so that we can take any allowable deduction.

Defer bonus and salary if your employer will allow the payments to be made in January 2017. Then the money will not be taxed until next year. In many situations this will still be deductible by your employer in the current (2016) year.

Consider holding stock and bond sales until after Jan. 1 since gains and losses are determined on the trade date. Defer selling stock that will incur a gain until the next year. Likewise, if you have stock that will incur a loss sell it prior to year end in order to off set any gains that you have incurred during the year. Keep in mind that losses exceeding gains will only be allowed a $3,000 deduction and the remaining will be carried to future years. Also, favorable capital gain rates are applicable when you have held the property for greater than 1 year. **The last trading day for 2016 is Friday December 30**,

Individual Tax Planning (Continued)

However this may be a short trading day so be sure if you are looking to sell stock at a loss your trade gets in on time, we recommend not waiting to the last day. Keep in mind the wash sale rule which prevents you from taking a loss on a security if you buy a substantially identical security within 30 days before or after you sell the security that created the loss.

Roth IRA conversions are permitted without being subject to modified adjusted gross income limitations. Converting your traditional IRA to a Roth IRA will increase your taxable income in 2016, However future qualified Roth IRA distributions are not taxable and unlike traditional IRAs, Required Minimum Distributions from Roth accounts are not mandatory.

Remember you can withdraw funds without penalty from traditional IRAs beginning at age 59½. In some cases, penalty exceptions apply when you're under age 59½.
If you are considering trading stocks, bonds, mutual funds for the sole purpose of rebalancing your portfolio consider doing it within your IRA or 401(k) plan because sales you make within your retirement accounts are free of tax as opposed to non-retirement portfolios, which will be subjected to capital gains tax.

Please be aware of a provision pertaining to IRA roll overs that was in place as of January 1, 2015. Previously if you had multiple IRA accounts you were allowed to use the 60-day rule (withdrawing from an IRA and holding the funds for up to 60 days before putting it in to/rolling it to another IRA account) for each IRA owned by the taxpayer. This let you use the 60 day rule multiple times per year if you had multiple IRA's. effective January 1, 2015 you are only allowed to use the 60-day rule once per year. The penalty for ignoring this rule is immediate recognition of the entire account balance in current year income as well as a 10% early withdrawal penalty if you are under 59½. Trustee to Trustee transfers (institution to institution) are unlimited.

Set up and fund a Health Savings Account (HSA) If you're covered by qualified high-deductible health insurance, a Health Savings Account allows 2016 contributions of pretax income (or deductible after-tax contributions) up to $3,350 for self-only coverage and $6,750 (up from $6,650 for 2015) for family coverage. Moreover, account holders age 55 and older can contribute an additional $1,000. HSAs bear interest or are invested and can grow tax-deferred similar to an IRA. Withdrawals for qualified medical expenses are tax-free, and you can carry over a balance from year to year.

Flexible Savings Accounts (FSA) You can redirect pretax income to an employer-sponsored Flexible Spending Account up to an employer-determined limit (not to exceed $2,550 for 2016). The plan pays or reimburses you for qualified medical expenses. With limited exceptions, you have to make your election before the start of the plan year. What you don't use by the end of the plan year, you generally lose. If you have an HSA, your FSA is limited to funding certain "permitted" expenses.

Individual Tax Planning (Continued)

Make the maximum contributions to retirement plans whether employer sponsored or individually created.

Make charitable donations with appreciated stock. The fair market value is used to determine the value of the donation and there is no tax on the difference between your cost in the stock and the fair market value of the stock. If the fair market value of the stock is less than your cost in the stock then consider selling it to recognize a loss.

Tax Considerations for the Self-Employed

Review your tax basis in partnerships or S-Corporations that may have a current loss. If tax basis is insufficient to claim the loss you may need to make a capital contribution to the business in order to claim the loss in the current year.

Dispose of passive activities with suspended losses. When a passive activity has suspended losses, the losses become deductible in the year the activity is sold.

Consider an installment sale of property rather than collecting all proceeds in the current year.

Send out invoices in late December <u>if you are a cash basis taxpayer</u>. By doing this you will most likely be collecting the money in January deferring the reporting of income until the next year.

Acquire and place equipment into service the PATH Act permanently set the Code Sec. 179 expensing limit at $500,000. Limitations apply if total expenditures exceed $2,000,000. Both amounts are now indexed for inflation (there is no adjustment for inflation in 2016 for the expensing limit, the limit will be $500,000).

Set up a retirement plan. The deduction is allowed on the current year return as long as it is funded prior to the filing of your tax return in the next year. However depending on the plan some allow a deduction up to the extended due date and others need to be timely filed. So, if you are usually on extension be careful. Before setting up any plan you should consult with us to be sure the particular plan fits your situation.

Employ your minor children to perform administrative tasks. You can avoid social security taxes on the wages and shift the income to a lower tax bracket. (This also lets the children establish IRA’s to gain significant future benefits.)

Consider your eligibility for a home office deduction in 2013 the IRS announced an optional safe harbor method that allows a maximum deduction of $1,500.

Tax Considerations for Business Entities

Cell Phones – The new law removes strict substantiation requirements for cell phones and similar devices used in business and treats employee use as a tax-free fringe benefit.

Start-up costs – Businesses can elect to deduct start-up costs (certain expenses incurred before the business opens its doors) to a set dollar limit in their first year of operation. The maximum deduction for qualified costs of starting a business is $5,000. The phase out threshold is $50,000.

Acquire and place equipment into service the PATH Act permanently set the Code Sec. 179 expensing limit at $500,000. Limitations apply if total expenditures exceed $2,000,000. Both amounts are now indexed for inflation (there is no adjustment for inflation in 2016 for the expensing limit the limit will be $500,000).

Inventory – The IRS continues to place an increased emphasis on actual physical inventory on hand at December 31. Please make sure to physically count your inventory, retain the records, and provide us with the accurate total cost of the inventory on hand at December 31, 2016. In the event of an audit you must be able to provide copies of the physical count sheets. We are placing an increased emphasis upon obtaining correct year end physical inventory amounts.

Evaluate your eligibility for the Domestic Production Activities Deduction

Establish a retirement plan

Trade in fully depreciated business assets instead of selling them at a gain.

Corporate Minutes – We want to remind you to make sure that your corporate minutes are maintained on an annual basis. The minutes are to be maintained by the officers of the corporation. Maintaining the corporate minutes only applies to C and S corporations, LLC's have no such requirement.

Consider the status of any final estimated tax payment requirements. A penalty for under payment could be costly.

If you currently provide health insurance to employees on an after tax basis consider setting up a pre-tax Section 125 "premium only" health insurance plan. Your entity benefits by saving on payroll tax expense and the employees get their health insurance contribution on a pre-tax basis.

Business Tax Provisions That were extended through 2016

- ***The Research credit*** was made permanent by the PATH Act.
- ***Work opportunity credit*** was extended through 2019 by the PATH Act.
- $500,000 ***Section 179 Deduction*** was made permanent by the PATH Act.
- ***Bonus depreciation*** was extended under a phase down schedule through 2019 by the PATH Act (50% for 2016 & 2017, 40% for 2018 and 30% in 2019).
- Special rules for ***qualified small business stock*** was made permanent by the PATH Act.
- Reduction in ***S-Corporation recognition period*** for built in gains tax was made permanent by the PATH Act.
- 15 year straight line cost recovery for ***qualified leasehold***, restaurant, and retail improvements was made permanent by the PATH Act.

Alternative Minimum Tax ***(more and more taxpayers being hit)***

We have seen more taxpayers being subjected to Alternative Minimum Tax (AMT) in recent years. Once considered a tax on the wealthy, it is now reaching more middle class taxpayers because the AMT tax brackets and exemptions have not been indexed for inflation, and the AMT eliminates many regular tax deductions. If your tax is higher under the AMT rules than under the regular tax, you must pay the AMT.

In years that you are subject to the alternative minimum tax (AMT), your deductions may be limited. If you anticipate being subject to AMT in either 2016 or 2017, consider timing those deductible expenditures that are limited under the AMT regime to maximize deductibility.

AMT Income Triggers need to be considered before you take action to time income or expenses. It is imperative to determine whether you're already likely to be subject to the AMT, or whether the actions you're considering might trigger it. Many deductions used to calculate regular tax aren't allowed under the AMT (See Below) and thus can trigger AMT liability. Some income items also might trigger or increase AMT liability:

- Long-term capital gains and dividend income, even though they're taxed at the same rate for both regular tax and AMT purposes,
- Accelerated depreciation adjustments and related gain or loss differences when assets are sold, and
- Tax-exempt interest on certain private-activity municipal bonds.

Finally, in certain situations **Incentive Stock Option (ISO)** exercises can trigger significant AMT liability.

Alternative Minimum Tax (Continued)

Deductions that may trigger AMT for taxpayers, such as those who live in states that have high personal property tax rates and high real estate taxes, are particularly exposed

to AMT. Other AMT risk factors include, large un-reimbursed employee business expenses, large miscellaneous deductions, large number of personal exemptions (big families) and high medical expenses.

The AMT makes year-end planning more difficult. By reducing regular tax through deductions, deferral and tax rate reductions, the AMT exposure has increased. We have the ability to run projections based on individual circumstances to determine if an early paid estimate or deduction would provide a tax benefit for you.

Tax planning should consider multiple years to be the most effective. While in some situations a credit for prior year AMT may be available against tax in a subsequent year, there is no guarantee that the AMT will ever be recovered.

Gift and Estate Tax

The estate tax exclusion amounts for 2016 is $5,450,000 with a maximum rate of 40%. If a spouse dies after 2011 without using all of the exclusion available for estate tax purposes the estate of the surviving spouse may be able to use the unused exclusion on the survivors estate tax return. This has been referred to as *"portability"*.

The federal annual exclusion for gifts in 2016 is once again $14,000 to any individual. If you are married and your spouse consents, the annual exclusion can actually be $28,000. This provides an extremely good opportunity to transfer income-producing assets to heirs who may be in a lower income tax bracket.

If you are making gifts to limit or reduce future estate taxes and you have reached the annual exclusion, you need to be sure that payments of tuition and medical expense for that individual are not subject to gift tax. There is an unlimited exclusion for amounts paid directly to the qualified educational institution for tuition (not books, fees, etc.) and amounts paid directly to health care providers for medical expenses.

Summary

Remember we are here to help you. Tax planning is an ongoing process. Saving taxes is generally a good strategy, but making a bad business, investment or personal decision just to save some tax dollars is never a good strategy. The biggest mistake that clients make is making a transaction with tax implications first and then informing the tax advisor after the fact. Post-transaction planning usually offers fewer solutions with less value. The tax laws are constantly evolving. As a firm we spend considerable resources In order to provide the most relevant and up to date information to get the greatest benefit for all our clients.

The information contained in this letter only summarizes a fraction of the expertise we have to offer. Please give us a call to review or consider any of the above mentioned strategies or to find out if there are other ways in which we can provide tax savings. Most strategies need to be implemented before the year-end and once we have passed into the next year it will be too late. Not all of these strategies apply to each individual situation, so it is important to consult with us prior to making any decisions.

Our firm would like to extend our thanks to all our clients for their continued patronage. We as firm appreciate and value each one of our clients and look forward to providing high quality service into the future.

The entire staff at Donald E. Graves CPA, LLC wishes you and your family a safe and happy holiday season!