



2016-2017

# TAX PLANNING GUIDE

*Year-round strategies to make the tax laws work for you.*

PROVIDED BY: **LUMSDEN McCORMICK**

Cyclorama Building | 369 Franklin Street | Buffalo, NY 14202  
p: 716.856.3300 | f: 716.856.2524 | [www.LumsdenCPA.com](http://www.LumsdenCPA.com)

**Comprehensive. Proactive. Accessible.**

# Are you doing everything you can to save tax?

**K**eeping your tax liability to a minimum is key to your overall financial health. Fortunately, there are some tried and true ways to help you achieve that goal. Below are tax-reduction strategies for individuals and businesses. Check off those that may apply to your situation:

## Personal strategies

- Accelerating or deferring income
- Maximizing or bunching deductions
- Watching out for AMT triggers
- Contributing to a retirement plan
- Donating to charity
- Claiming all possible exemptions and credits
- Taking child-related breaks
- Timing capital gains and losses
- Planning for retirement distributions
- Participating in a Flexible Spending Account
- Taking advantage of education savings plans
- Making timely estimated tax payments
- Incorporating tax planning into your estate plan

## Business strategies

- Selecting a tax-advantaged business structure
- Claiming all credits for which you're eligible
- Deducting all eligible business expenses
- Accelerating or deferring income
- Using a tax-smart depreciation method
- Considering a cost segregation study
- Qualifying expenditures as repairs
- Taking advantage of the expensing provision
- Maximizing vehicle-related deductions
- Choosing tax-saving employee benefits to offer
- Setting up a retirement plan
- Using a net operating loss to your tax advantage
- Incorporating tax planning into your exit plan

We would welcome the opportunity to help you minimize your 2016 tax liability. Please call us today to talk about ways to put these and other strategies to work for you.

# For tax planning, the only certainty is uncertainty

Last December, many valuable tax breaks were made permanent by the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act). As a result, tax planning in 2016 is a little easier than it has been in recent years.

But there are some tax breaks that the PATH Act only temporarily extended, in many cases only through Dec. 31, 2016. And, even though many tax law provisions are now “permanent,” this simply means that they don’t have expiration dates. With tax reform still on Congress’s agenda and a new President entering the White House in 2017, some major changes could be on the horizon.

So in your 2016 planning, don’t count on the tax regime remaining the same indefinitely. In other words, the only certainty in tax planning is uncertainty.

What does this all mean? Tax planning in 2016 is as important as ever. This guide provides an overview of some key tax provisions you need to be aware of and offers a variety of strategies for minimizing your taxes. But there isn’t space to touch on all of the available tax-saving opportunities. So please contact your tax advisor to learn exactly which strategies will work best for you.

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## Timing income and deductions to your tax advantage

Usually it makes tax sense to accelerate as many deductible expenses into the current tax year as you can and defer income to the next year to the extent possible. This can reduce current-year tax, deferring tax to future years. In some cases it may even permanently lock in tax savings. But there are also situations where this strategy could be costly. To time income and deductions to your tax advantage, you must consider the potential impact on your particular situation.

### Alternative minimum tax

When timing income and deductions, first consider the AMT — a separate tax system that limits some deductions and disallows others, such as:

- State and local income tax deductions,
- Property tax deductions, and
- Miscellaneous itemized deductions subject to the 2% of adjusted gross income (AGI) floor, including investment advisory fees and unreimbursed employee business expenses.

It also treats certain income items differently, such as incentive stock option exercises. You must pay the AMT if your AMT liability exceeds your regular tax liability. See Chart 7 on page 31 for AMT rates and exemptions, and work with your tax advisor to project whether you could be subject to the AMT this year or next. You may be able to time income and deductions to avoid the AMT, or at least reduce its impact.

### Home-related breaks

Consider both deductions and exclusions:

**Property tax deduction.** Before paying your bill early to accelerate this itemized deduction into 2016, review your AMT situation. If you're subject to the AMT this year, you'll lose the benefit of the deduction for the prepayment.

**Mortgage interest deduction.** You generally can deduct interest on up to a combined total of \$1 million of mortgage debt incurred to purchase,

build or improve your principal residence and a second residence. Points paid related to your *principal* residence also may be deductible.

**Home equity debt interest deduction.** Interest on home equity debt used for any purpose (debt limit of \$100,000) may be deductible. So consider using a home equity loan or line of credit to pay off credit cards or auto loans, for which interest isn't deductible and rates may be higher. **Warning:** If home equity debt isn't used for home improvements, the interest isn't deductible for AMT purposes.

**Mortgage insurance premium deduction.** This has been extended through Dec. 31, 2016. If you can afford to make additional principal payments this year so you won't have to maintain mortgage insurance next year, you may want to do so.

**Home office deduction.** If your use of a home office is for your employer's benefit and it's the only use of the space, you generally can deduct a portion of your mortgage interest, property taxes, insurance, utilities and certain other expenses, and the depreciation allocable to the space. Or you may be able to use the simplified option for claiming the deduction. (Contact your tax advisor for details.) For employees, home office expenses are a miscellaneous itemized deduction, and you'll enjoy a tax benefit only if these expenses plus your other miscellaneous itemized expenses exceed 2% of your AGI. (If you're self-employed, see page 21.)

**Rental income exclusion.** If you rent out all or a portion of your principal residence or second home for less than 15 days, you don't have to report the income. But expenses directly associated with the rental, such as advertising and cleaning, won't be deductible.

**Home sale gain exclusion.** When you sell your principal residence, you can exclude up to \$250,000 (\$500,000 for married couples filing jointly) of gain if you meet certain tests. **Warning:** Gain that's allocable to a period of "nonqualified" use generally isn't excludable.

**Home sale loss deduction.** Losses on the sale of any personal residence aren't deductible. But if part of your home is rented out or used exclusively for your business, the loss attributable to that portion may be deductible.

**Debt forgiveness exclusion.** This break for homeowners who received debt forgiveness in a foreclosure, short sale or mortgage workout for a principal residence is scheduled to expire Dec. 31, 2016.

**Energy-related breaks.** A wide variety of breaks designed to encourage energy efficiency and conservation have been extended through Dec. 31, 2016. Consult your tax advisor for details.

## Charitable donations

Donations to qualified charities are generally fully deductible for both regular tax and AMT purposes, and they may be the easiest deductible expense to time to your tax advantage. For large donations, discuss

with your tax advisor which assets to give and the best ways to give them. For example:

**Appreciated stock.** Appreciated publicly traded stock you've held more than one year can make one of the best charitable gifts. Why? Because you can deduct the current fair market value and avoid the capital gains tax you'd pay if you sold the property. **Warning:** Donations of such property are subject to tighter deduction limits. Excess contributions can be carried forward for up to five years.

**CRTs.** For a given term, a charitable remainder trust pays an amount to you annually (some of which generally is taxable). At the term's end, the CRT's remaining assets pass to one or more charities. When you fund the CRT, you receive an income tax deduction. If you contribute appreciated assets, you also can minimize and defer capital gains tax. You can name someone other than yourself as income beneficiary or fund the CRT at your death, but the tax consequences will be different.

## Tax-advantaged saving for health care

You may be able to save taxes by contributing to one of these accounts:

**HSA.** If you're covered by qualified high-deductible health insurance, you can contribute pretax income to an employer-sponsored Health Savings Account — or make deductible contributions to an HSA you set up yourself — up to \$3,350 for self-only coverage and \$6,750 for family coverage for 2016. Plus, if you're age 55 or older, you may contribute an additional \$1,000. HSAs can bear interest or be invested, growing 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.

**FSA.** You can redirect pretax income to an employer-sponsored Flexible Spending Account up to an employer-determined limit — not to exceed \$2,550 in 2016. The plan pays or reimburses you for qualified medical expenses. What you don't use by the plan year's end, you generally lose — though your plan might allow you to roll over up to \$500 to the next year. Or it might give you a 2½-month grace period to incur expenses to use up the previous year's contribution. If you have an HSA, your FSA is limited to funding certain "permitted" expenses.

## Medical expense deduction

If your medical expenses exceed 10% of your AGI, you can deduct the excess amount. Eligible expenses may include:

- Health insurance premiums,
- Long-term-care insurance premiums (limits apply),
- Medical and dental services, and
- Prescription drugs.

Mileage driven for health care purposes — at 19 cents per mile for 2016 — also can be deducted.

## Case Study I

### Benefiting from the sales tax deduction

Luke tells his tax advisor that he's thinking about buying a new car. He asks if there's any tax advantage to doing so this year. His tax advisor explains that the PATH Act permanently extended the break, allowing taxpayers to take an itemized deduction for state and local *sales* taxes in lieu of state and local *income* taxes. The deduction is always valuable to those who reside in states with no or low income tax, and it can also benefit taxpayers in other states who purchase a major item, such as a car or boat. But because the break is now permanent, there's no urgency to make a large purchase this year to take advantage of it.

Luke's advisor estimates that Luke's state and local income tax liability for 2016 will be \$3,000 and that, based on what he expects to spend on his car, the sales tax would also be \$3,000. That may sound like a wash, but the advisor reminds Luke that, if he elects to deduct sales tax, he can deduct all of the sales tax he pays during the year, not just the tax on the car purchase. His deduction, other than the amount for the car, can be determined by using an IRS sales tax calculator.

Consider bunching nonurgent medical procedures (and any other services and purchases whose timing you can control without negatively affecting your or your family's health) into one year to exceed the 10% floor. Taxpayers age 65 and older enjoy a 7.5% floor through 2016 for regular tax purposes but are subject to the 10% floor for AMT purposes. These taxpayers might particularly benefit from bunching expenses into 2016 to take advantage of the lower floor before it expires.

If one spouse has high medical expenses and a relatively lower AGI, filing separately may allow that spouse to exceed the AGI floor and deduct some medical expenses that wouldn't be deductible if the couple filed jointly.

### Limit on itemized deductions

If your AGI exceeds the applicable threshold, certain deductions are reduced by 3% of the AGI amount that exceeds the threshold (not to exceed 80% of otherwise allowable deductions). For 2016, the thresholds are \$259,400 (single), \$285,350 (head of household), \$311,300 (married filing jointly) and \$155,650 (married filing separately).

If your AGI is close to the threshold, AGI-reduction strategies (such as contributing to a retirement plan or HSA) may allow you to stay under it. If that's not possible, consider the reduced tax benefit of the affected deductions before implementing strategies to accelerate or defer deductible expenses. The limitation doesn't apply, however, to deductions for medical expenses, investment interest, or casualty, theft or wagering losses. ❖



## Family and education tax breaks make raising kids less costly

**R**aising children and helping them pursue their educational goals — or pursuing your own — can be highly rewarding. But it also can be expensive. Fortunately, a variety of tax breaks can offset some of the costs.

### Child and adoption credits

Tax credits reduce your tax bill dollar-for-dollar, so make sure you're taking every credit you're entitled to. For each child under age 17 at the end of the year, you may be able to claim a \$1,000 child credit. If you adopt in 2016, you may qualify for an adoption credit — or for an income exclusion under an employer adoption assistance program. Both are up to \$13,460 per eligible child. **Warning:** These credits phase out for higher-income taxpayers. (See Chart 1.)

### Child care expenses

A couple of tax breaks can help you offset these child care costs:

**Tax credit.** For children under age 13 or other qualifying dependents, you may be eligible for a credit for a percentage of your dependent care expenses. Eligible expenses are limited to \$3,000 for one dependent and \$6,000 for two or more. Income-based limits reduce the credit percentage but don't phase it out altogether. (See Chart 1.)

**FSA.** You can contribute up to \$5,000 pretax to an employer-sponsored child and dependent care Flexible Spending Account. The plan pays or reimburses you for these expenses.

### IRAs for teens

IRAs can be perfect for teenagers because they likely will have many years to let their accounts grow tax-deferred or tax-free. The 2016 contribution limit is the lesser of \$5,500 or 100% of earned income. A teen's *traditional* IRA contributions typically are deductible, but distributions will be taxed. *Roth* IRA contributions aren't deductible, but qualified distributions will be tax-free. Choosing a Roth IRA is



typically a no-brainer if a teen doesn't earn income that exceeds the standard deduction (\$6,300 for 2016 for single taxpayers), because he or she will likely gain no benefit from the ability to deduct a traditional IRA contribution. Even above that amount, the teen probably is taxed at a very low rate, so the Roth will typically still be the better answer.

If your children or grandchildren don't want to invest their hard-earned money, consider *giving* them up to the amount they're eligible to contribute. But keep the gift tax in mind. (See page 26.)

If they don't have earned income and you own a business, consider hiring them. As the business owner, you can deduct their pay, and other tax benefits may apply. **Warning:** The children must be paid in line with what you'd pay nonfamily employees for the same work.

### "Kiddie tax"

The "kiddie tax" applies to children under age 19 and to full-time students under age 24 (unless the students provide more than half of their own support from earned income). For children subject to the tax, any unearned income beyond \$2,100 (for 2016) is taxed at their parents' marginal rate, if higher, rather than their own typically low rate. Keep this in mind before transferring income-generating assets to them.

CHART 1

### Are you eligible for these 2016 tax breaks?

Tax break	Modified adjusted gross income phaseout range	
	Single filer	Joint filer
Child credit <sup>1</sup>	\$ 75,000 – \$ 95,000	\$ 110,000 – \$ 130,000
Adoption credit	\$ 201,920 – \$ 241,920	\$ 201,920 – \$ 241,920
Child or dependent care credit <sup>2</sup>	\$ 15,000 – \$ 43,000	\$ 15,000 – \$ 43,000
ESA contribution	\$ 95,000 – \$ 110,000	\$ 190,000 – \$ 220,000
American Opportunity credit	\$ 80,000 – \$ 90,000	\$ 160,000 – \$ 180,000
Lifetime Learning credit	\$ 55,000 – \$ 65,000	\$ 111,000 – \$ 131,000
Student loan interest deduction	\$ 65,000 – \$ 80,000	\$ 130,000 – \$ 160,000

<sup>1</sup> Assumes one child. The phaseout end is higher for families with more than one eligible child.

<sup>2</sup> The phaseout is based on AGI rather than MAGI. The credit doesn't phase out altogether, but the minimum credit percentage of 20% applies to AGIs above \$43,000.

## 529 plans

If you're saving for college, consider a Section 529 plan. You can choose a prepaid tuition program to secure current tuition rates or a tax-advantaged savings plan to fund college expenses:

- Although contributions aren't deductible for federal purposes, any growth is tax-deferred. (Some states do offer breaks for contributing.)
- Distributions used to pay qualified expenses (such as tuition, mandatory fees, books, supplies, computer equipment, software, Internet service and, generally, room and board) are income-tax-free for federal purposes and typically for state purposes as well, thus making the tax deferral a permanent savings.
- The plans usually offer high contribution limits, and there are no income limits for contributing.
- There's generally no beneficiary age limit for contributions or distributions.
- You can control the account, even after the child is of legal age.
- You can make tax-free rollovers to another qualifying family member.
- A special break for 529 plans allows you to front-load five years' worth of annual gift tax exclusions and make up to a \$70,000 contribution (or \$140,000 if you split the gift with your spouse).

The biggest downsides may be that your investment options — and when you can change them — are limited.

## ESAs

Coverdell Education Savings Accounts are similar to 529 savings plans in that contributions aren't deductible for federal purposes, but plan assets can grow tax-deferred and distributions used to pay qualified education expenses are income-tax-free. One of the biggest ESA advantages is that tax-free distributions aren't limited to college expenses; they also can fund elementary and secondary school costs. ESAs are worth considering if you want to fund such expenses or would like to have direct control over how and where your contributions are invested.

But the \$2,000 contribution limit is low, and it's phased out based on income. (See Chart 1 on page 7.) Amounts left in an ESA when the beneficiary turns age 30 generally must be distributed within 30 days, and any earnings may be subject to tax and a 10% penalty.

## Education credits and deductions

If you have children in college now, are currently in school yourself or are paying off student loans, you may be eligible for a credit or deduction:

**American Opportunity credit.** The tax break covers 100% of the first \$2,000 of tuition and related expenses and 25% of the next \$2,000 of expenses. The maximum credit, *per student*, is \$2,500 per year for the first four years of postsecondary education.

## Case Study II

### Tax-free savings for education add up

529 savings plans don't offer a federal deduction for contributions, and the plans come with a lot of restrictions. Are their tax-deferred growth and tax-free distributions really worth it? They can be — especially if you start early:

When Sophie is born, her parents fund a 529 savings plan with a \$5,000 contribution, and they put in another \$5,000 on her birthday each year through age 17.

When Sophie turns age 18, her plan will be worth \$163,800. And the \$73,800 of growth in her plan will be completely tax-free, as long as all distributions are used to pay for qualified education expenses.

#### Total contributions made by parents

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 \$90,000

#### Balance at age 18

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 \$163,800

**Note:** This example is for illustrative purposes only and isn't a guarantee of future results. The figures presume a 6% rate of return.

**Lifetime Learning credit.** If you're paying postsecondary education expenses beyond the first four years, you may benefit from the Lifetime Learning credit (up to \$2,000 *per tax return*).

**Tuition and fees deduction.** In some cases, deducting up to \$4,000 of qualified higher education tuition and fees will save more tax than a credit. This deduction has been extended through 2016.

**Student loan interest deduction.** If you're paying off student loans, you may be able to deduct the interest. The limit is \$2,500 *per tax return*.

**Warning:** Income-based phaseouts apply to these breaks. (See Chart 1 on page 7.) If your income is too high for you to qualify, your child might be eligible. But if your dependent child claims the credit, you must forgo your dependency exemption for him or her (and the child can't take the exemption).

### ABLE accounts

Achieving a Better Life Experience (ABLE) accounts offer a tax-advantaged way to fund qualified disability expenses for a beneficiary who became blind or disabled before age 26. For federal purposes, tax treatment is similar to that of Section 529 college savings plans. ❖



## Tax planning for your investments: What you need to know

**T**ax planning for investments demands careful thought. You must consider the tax consequences of your investments as you buy and sell, but not let tax concerns propel your investment decisions. Your investment goals, time horizon, risk tolerance, factors related to the investment itself, and fees and charges that apply to buying and selling securities also should come into play. Nevertheless, tax factors are important. Here's a look at what you need to know.

### Capital gains tax and timing

Although time, not timing, is generally the key to long-term investment success, timing can have a dramatic impact on the tax consequences of investment activities. Your long-term capital gains rate might be as much as 20 percentage points lower than your ordinary-income rate. The long-term gains rate applies to investments held for more than 12 months. The applicable rate depends on your income level and the type of asset. (See Chart 2 on page 13.)

Holding on to an investment until you've owned it more than a year may help substantially cut tax on any gain. Here are some other tax-saving strategies related to timing:

**Use unrealized losses to absorb gains.** To determine capital gains tax liability, realized capital gains are netted against any realized capital losses. Both long- and short-term gains and losses can offset one another. If you've cashed in some big gains during the year and want to reduce your 2016 tax liability, before year end look for unrealized losses in your portfolio and consider selling them to offset your gains.

**Avoid wash sales.** If you want to achieve a tax loss with minimal change in your portfolio's asset allocation, keep in mind the wash sale rule. It prevents you from taking a loss on a security if you buy a substantially identical security (or an option to buy such a security) within 30 days before or after you sell the security that created the loss. You can then recognize the loss only when you sell the replacement security.

Fortunately, there are ways to avoid triggering the wash sale rule and still achieve your goals. For example, you can immediately buy securities of a different company in the same industry or shares in a mutual fund that holds securities much like the ones you sold. Or, you can wait 31 days to repurchase the same security. Alternatively, before selling the security, you can purchase additional shares equal to the number you want to sell at a loss, and then wait 31 days to sell the original portion.

**Swap your bonds.** With a bond swap, you sell a bond, take a loss and then immediately buy another bond of similar quality and duration from a different issuer. Generally, the wash sale rule doesn't apply because the bonds aren't considered substantially identical. Thus, you achieve a tax loss with virtually no change in economic position.

**Mind your mutual funds.** Mutual funds with high turnover rates can create income that's taxed at ordinary-income rates. Choosing funds that provide primarily long-term gains can save you more tax dollars because of the lower long-term rates.

Also pay attention to earnings reinvestments. Unless you or your investment advisor increases your basis accordingly, you may report more gain than required when you sell the fund. Brokerage firms are required to track (and report to the IRS) your cost basis in mutual funds acquired during the tax year.

Finally, beware of buying equity mutual fund shares late in the year. Such funds often declare a large capital gains distribution at year end. If you own the shares on the distribution's record date, you'll be taxed on the full distribution amount even if it includes significant gains realized by the fund *before* you owned the shares. (See Case Study III.)

### Case Study III

#### Watch out for mutual fund capital gains distributions

Hector purchases 200 shares of an equity mutual fund on Dec. 1, 2016, at \$100 per share, for a total investment of \$20,000. The next week, the fund makes a capital gains distribution of \$15 per share. Hector ends up with capital gains of \$3,000, reportable on his 2016 return. It doesn't matter whether the actual value of the shares has increased or even decreased since Hector purchased them, or whether he reinvests the proceeds back into the same fund.

Why? The distribution itself is a taxable event. If capital gains distributions from the mutual fund are reinvested in the fund, the distribution itself doesn't change Hector's value in the fund. It simply increases the number of shares he owns, yet now at a lower per-share value.

**See if a loved one qualifies for the 0% rate.** The 0% rate applies to long-term gain that would be taxed at 10% or 15% based on the taxpayer's ordinary-income rate. If you have adult children in one of these tax brackets, consider transferring appreciated assets to them so they can sell the assets and enjoy the 0% rate. This strategy can be even more powerful if you'd be subject to the 3.8% NIIT (see page 13) and/or the 20% long-term capital gains rate if you sold the assets.

**Warning:** If the child will be under age 24 on Dec. 31, first make sure he or she won't be subject to the "kiddie tax." (See page 7.) Also, consider any gift tax consequences. (See page 26.)

## Loss carryovers

If net losses exceed net gains, you can deduct only \$3,000 (\$1,500 for married taxpayers filing separately) of the net losses per year against dividends or ordinary income (such as wages, self-employment and business income, and interest).

You can carry forward excess losses indefinitely. Loss carryovers can be a powerful tax-saving tool in future years if you have a large investment portfolio, real estate holdings or a closely held business that might generate substantial future capital gains.

Finally, remember that capital gains distributions from mutual funds can also absorb capital losses.

## Beyond gains and losses

With some types of investments, you'll have more tax consequences to consider than just gains and losses:

**Dividend-producing investments.** Qualified dividends are taxed at the favorable long-term capital gains tax rate rather than at your higher ordinary-income tax rate.

**Interest-producing investments.** Interest income generally is taxed at ordinary-income rates. So stocks that pay qualified dividends may be more attractive tax-wise than other income investments, such as CDs and taxable bonds. But nontax issues must be considered as well, such as investment risk, rate of return, and diversification.

**Bonds.** These also produce interest income, but the tax treatment varies:

- Interest on U.S. government bonds is taxable on federal returns but exempt by law on state and local returns.
- Interest on state and local government bonds is excludable on federal returns. If the bonds were issued in your home state, interest also may be excludable on your state return.
- Tax-exempt interest from certain private-activity municipal bonds can trigger or increase the AMT (see page 2) in some situations.
- Corporate bond interest is fully taxable for federal and state purposes.

## CHART 2

### What's the maximum capital gains tax rate?

Assets held	2016 <sup>1</sup>
12 months or less ( <i>short term</i> )	Taxpayer's ordinary-income tax rate
More than 12 months ( <i>long term</i> )	
■ 39.6% ordinary-income tax bracket	20%
■ 25%, 28%, 33% or 35% ordinary-income tax bracket	15%
■ 10% or 15% ordinary-income tax bracket	0%
<b>Some key exceptions</b>	
Long-term gain on collectibles, such as artwork and antiques	28%
Long-term gain attributable to certain recapture of prior depreciation on real property	25%

<sup>1</sup> In addition, the 3.8% NIIT applies to net investment income to the extent that modified adjusted gross income (MAGI) exceeds \$200,000 (singles and heads of households), \$250,000 (married filing jointly) or \$125,000 (married filing separately).

- Bonds (except U.S. savings bonds) with original issue discount build up “interest” as they rise toward maturity. You’re generally considered to earn a portion of that interest annually — even though the bonds don’t pay this interest annually — and you must pay tax on it.

**Stock options.** Before exercising (or postponing exercise of) options or selling stock purchased via an exercise, consult your tax advisor about the complicated rules that may trigger regular tax or AMT liability. He or she can help you plan accordingly.

### 3.8% NIIT

Taxpayers with modified adjusted gross income (MAGI) over \$200,000 per year (\$250,000 for joint filers and \$125,000 for married filing separately) may owe the net investment income tax, in addition to other taxes already discussed here. The NIIT equals 3.8% of the lesser of your net investment income or the amount by which your MAGI exceeds the applicable threshold. Net investment income can include capital gains, dividends, interest and other investment-related income. The rules are somewhat complex, so consult your tax advisor for more information.

Many of the strategies that can help you save or defer income tax on your investments can also help you avoid or defer NIIT liability. And because the threshold for the NIIT is based on MAGI, strategies that reduce your MAGI — such as making retirement plan contributions (see page 22) — could also help you avoid or reduce NIIT liability. ❖



## For an enviable financial statement, implement a robust tax plan

**R**unning a profitable business these days isn't easy. You have to operate efficiently, market aggressively and respond swiftly to competitive and financial challenges. But even when you do all of that, taxes may drag down your bottom line more than they should. Don't let that happen. Take steps like these — and work with your tax advisor — to make your tax bill as small as possible.

### Projecting income



Projecting your business's income for this year and next can allow you to time income and deductions to your advantage. It's generally — but not always — better to defer tax, so consider:

**Deferring income to next year.** If your business uses the cash method of accounting, you can defer billing for products or services at year end. If you use the accrual method, you can delay shipping products or delivering services.

**Accelerating deductible expenses into the current year.** If you're a cash-basis taxpayer, you may pay business expenses by Dec. 31, so you can deduct them this year rather than next. Both cash- and accrual-basis taxpayers can charge expenses on a credit card and deduct them in the year charged, regardless of when the credit card bill is paid.

**Warning:** Don't let tax considerations get in the way of sound business decisions. For example, the negative impact of these strategies on your cash flow might not be worth the potential tax benefit.

**Taking the opposite approach.** If it's likely you'll be in a higher tax bracket next year, accelerating income and deferring deductible expenses may save you more tax over the two-year period.



## Depreciation

For assets with a useful life of more than one year, you generally must depreciate the cost over a period of years. In most cases, the Modified Accelerated Cost Recovery System (MACRS) will be preferable to other methods because you'll get larger deductions in the early years of an asset's life.

But if you make more than 40% of the year's asset purchases in the last quarter, you could be subject to the typically less favorable midquarter convention. Careful planning can help you maximize depreciation deductions in the year of purchase.

Other depreciation-related breaks and strategies may be available:

**Section 179 expensing election.** This allows you to deduct (rather than depreciate over a number of years) the cost of purchasing eligible new or used assets, such as equipment and furniture. The expensing limit for 2015 had been \$25,000 — and the break was to begin to phase out dollar-for-dollar when total asset acquisitions for the tax year exceeded \$200,000 — but Congress revived the 2014 levels of \$500,000 and \$2 million, respectively, for 2015. Now these amounts are annually adjusted for inflation, and they're \$2.01 million and, still, \$500,000 for 2016. Additionally, the new law permanently includes off-the-shelf computer software on the list of qualified property. And, beginning in 2016, it adds air conditioning and heating units to the list. You can claim the election only to offset net income from a "trade or business," not to reduce it below zero to create a loss.

The break allowing Section 179 expensing for qualified leasehold-improvement, restaurant and retail-improvement property has also been made permanent. For 2015, a \$250,000 limit applied, but, beginning in 2016, the full Sec. 179 expensing limit applies.

**50% bonus depreciation.** This additional first-year depreciation for qualified assets expired Dec. 31, 2014, but it has now been extended through 2019. However, it will drop to 40% for 2018 and 30% for 2019.

Qualified assets include *new* tangible property with a recovery period of 20 years or less (such as office furniture and equipment), off-the-shelf computer software, water utility property and qualified improvement property. Beginning in 2016, the qualified improvement property doesn't have to be leased.

**Accelerated depreciation.** The break allowing a shortened recovery period of 15 years — rather than 39 years — for qualified leasehold-improvement, restaurant and retail-improvement property expired Dec. 31, 2014. However, it has now been made permanent.

**Tangible property repairs.** A business that has made repairs to tangible property, such as buildings, machinery, equipment and vehicles, can expense those costs and take an immediate deduction. But costs

incurred to acquire, produce or *improve* tangible property must be depreciated. Final IRS regulations released in late 2013 distinguish between repairs and improvements and include safe harbors for small businesses and routine maintenance. The final regs are complex and are still being interpreted, so contact your tax advisor for details.

**Cost segregation study.** If you've recently purchased or built a building or are remodeling existing space, consider a cost segregation study. It identifies property components that can be depreciated much faster, increasing your current deductions. Typical assets that qualify include decorative fixtures, security equipment, parking lots and landscaping.

## Vehicle-related deductions

Business-related vehicle expenses can be deducted using the mileage-rate method (54 cents per mile driven in 2016) or the actual-cost method (total out-of-pocket expenses for fuel, insurance, repairs and other vehicle expenses, plus depreciation).

Purchases of *new or used* vehicles may be eligible for Sec. 179 expensing. However, many rules and limits apply. For example, the normal Sec. 179 expensing limit generally applies to vehicles with a gross vehicle weight rating of more than 14,000 pounds. A \$25,000 limit applies to vehicles (typically SUVs) rated at more than 6,000 pounds.

Vehicles rated at 6,000 pounds or less are subject to the passenger automobile limits. For autos placed in service in 2016, the first-year depreciation limit is \$3,160. The amount that may be deducted under the combination of MACRS depreciation and Sec. 179 for the first year is limited under the luxury auto rules to \$11,160.

In addition, if a vehicle is used for business and personal purposes, the associated expenses, including depreciation, must be allocated between deductible business use and nondeductible personal use. The depreciation limit is reduced if the business use is less than 100%. If business use is 50% or less, you can't use Sec. 179 expensing or the accelerated regular MACRS; you must use the straight-line method.

## Section 199 deduction

The Section 199 deduction, also called the "manufacturers' deduction" or "domestic production activities deduction," is 9% of the lesser of qualified production activities income or taxable income. The deduction is also limited to 50% of W-2 wages paid by the taxpayer that are allocable to domestic production gross receipts.

The deduction is available to traditional manufacturers and to businesses engaged in activities such as construction, engineering, architecture, computer software production and agricultural processing. It isn't allowed in determining net self-employment earnings and generally can't reduce net income below zero. But it can be used against the AMT.

## Employee benefits

Offering a variety of benefits not only can help you attract and retain the best employees, but also may save tax:

**Qualified deferred compensation plans.** These include pension, profit-sharing, SEP and 401(k) plans, as well as SIMPLEs. You take a tax deduction for your contributions to employees' accounts. (For information on the benefits to employees, see page 22.) Certain small employers may also be eligible for a credit when setting up a plan. (See page 19.)

**HSAs and FSAs.** If you provide employees with a qualified high-deductible health plan (HDHP), you can also offer them Health Savings Accounts. Regardless of the type of health insurance you provide, you can offer Flexible Spending Accounts for health care. (See page 4.) If you have employees who incur day care expenses, consider offering FSAs for child and dependent care. (See page 6.)

**HRAs.** A Health Reimbursement Account reimburses an employee for medical expenses up to a maximum dollar amount. Unlike an HSA, no HDHP is required. Unlike an FSA, any unused portion can be carried forward to the next year. But only the employer can contribute to an HRA.

**Fringe benefits.** Some fringe benefits — such as employee discounts, group term-life insurance (up to \$50,000 annually per person), parking (up to \$255 per month), mass transit / van pooling (also up to \$255 per month for 2016, because Congress has made parity permanent) and health insurance — aren't included in employee income. Yet the employer can still receive a deduction for the portion, if any, of the benefit it pays and typically avoid payroll tax as well.

**Play-or-pay penalty risk.** The play-or-pay provision of the Affordable Care Act (ACA) imposes a penalty on “large” employers if just one full-time employee receives a premium tax credit. Premium tax credits are available to employees who enroll in a qualified health plan through a government-run Health Insurance Marketplace and meet certain income requirements — but only if:

- They don't have access to “minimum essential coverage” from their employer, or
- The employer coverage offered is “unaffordable” or doesn't provide “minimum value.”

The IRS has issued detailed guidance on what these terms mean and how employers can determine whether they're a “large” employer and, if so, whether they're offering sufficient coverage to avoid the risk of penalties.

## NOLs

A net operating loss occurs when a C corporation's operating expenses and other deductions for the year exceed its revenues. Generally, an NOL may be carried back two years to generate a refund. Any loss not absorbed is carried forward up to 20 years to offset income.

Carrying back an NOL may provide a needed influx of cash. But you can elect to forgo the carryback if carrying the entire loss forward may be more beneficial. This might be the case if you expect your income to increase substantially compared to the prior two years or tax rates to go up.

## Tax credits

Tax credits reduce tax liability dollar-for-dollar, making them particularly beneficial. The PATH Act has made permanent the research credit (see "What's New!" below) and extended but not made permanent other credits, including the Work Opportunity credit (see "What's New!" at right) and the following:

**Empowerment Zones.** Empowerment Zones are certain urban and rural areas where employers and other taxpayers qualify for special tax incentives, including a 20% credit for "qualified zone wages" up to \$15,000, for a maximum credit of \$3,000. The tax incentive expired Dec. 31, 2014, but it has been extended through Dec. 31, 2016.

**New Markets credit.** This credit has been extended through 2019. It gives investors who make "qualified equity investments" in certain low-income communities a 39% tax credit over a seven-year period.

### WHAT'S NEW!

#### The now-permanent research credit can net significant tax savings

The research credit (often called the "research and development" or "research and experimentation" credit) gives businesses an incentive to step up their investments in research — and now it's here to stay.

Businesses have long complained that the annual threat of extinction to the credit deterred them from pursuing critical research into new products and technologies. But the PATH Act permanently extends the credit.

Plus, beginning this year, businesses with \$50 million or less in gross receipts can claim the credit against AMT liability. And certain start-ups (in general, those with less than \$5 million in gross receipts) that haven't yet incurred any income tax liability can use the credit against their payroll tax.

While the credit is complicated to compute, the tax savings can prove significant.

## WHAT'S NEW!

### Work Opportunity credit reliable through 2019

The Work Opportunity credit for employers that hire from a “target group” has been extended through 2019, thanks to the PATH Act. Starting this year, the act also expands the target groups to include individuals who’ve been unemployed for 27 weeks or more.

The size of the tax credit depends on the hired person’s target group, the wages paid to that person and the number of hours that person worked during the first year of employment. The maximum tax credit that can be earned for each member of a target group is generally \$2,400 per adult employee. But the credit can be higher for members of certain target groups, up to as much as \$9,600 for certain veterans.

Employers aren’t subject to a limit on the number of eligible individuals they can hire. That is, if there are 10 individuals that qualify, the credit can be 10 times the listed amount.

Bear in mind that you must obtain certification that an employee is a target group member from the appropriate State Workforce Agency before you can claim the credit. The certification generally must be requested within 28 days after the employee begins work.

Certified Community Development Entities (CDEs) determine which projects get funded — often construction or rehabilitation real estate projects in “distressed” communities, using data from the 2006–2010 American Community Survey. Flexible financing is provided to the developers and business owners.

Two potentially valuable credits that never expired are:

**Retirement plan credit.** Small employers (generally those with 100 or fewer employees) that create a retirement plan may be eligible for a \$500 credit per year for three years. The credit is limited to 50% of qualified startup costs.

**Small-business health care credit.** The maximum credit is 50% of group health coverage premiums paid by the employer, provided it contributes at least 50% of the total premium or of a benchmark premium. For 2016, the full credit is available for employers with 10 or fewer full-time equivalent employees (FTEs) and average annual wages of less than \$25,900 per employee. Partial credits are available on a sliding scale to businesses with fewer than 25 FTEs and average annual wages of less than \$51,800. **Warning:** To qualify for the credit, online enrollment in the Small Business Health Options Program (SHOP) generally is required. In addition, the credit can be taken for only two years, and they must be consecutive. (Credits taken before 2014 don’t count, however.)

## Business structure

Income taxation and owner liability are the main factors that differentiate one business structure from another. (See Chart 3 to compare the tax treatments.) Many businesses choose entities that combine flow-through taxation with limited liability, namely limited liability companies (LLCs) and S corporations.

The top individual rate is higher (39.6%) than the top corporate rate (generally 35%), which might affect business structure decisions. For tax or other reasons, a structure change may be beneficial in certain situations, but there also may be unwelcome tax consequences.

Some tax differences between structures may provide tax planning opportunities, such as differences related to salary vs. distributions/dividends:

**S corporations.** Only income that shareholder-employees receive as salary is subject to employment taxes and, if applicable, the additional 0.9% Medicare tax, which generally applies to taxpayers with earned income exceeding the same thresholds as those for the NIIT. (See page 13.) To reduce these taxes, you may want to keep your salary relatively — but not unreasonably — low and increase your distributions of company income, because distributions generally aren't taxed at the corporate level or subject to the 0.9% Medicare tax or the 3.8% NIIT.

**C corporations.** Only income that shareholder-employees receive as salary is subject to employment taxes and, if applicable, the 0.9% Medicare tax. Nevertheless, you may prefer to take more income as salary (which is deductible at the corporate level) as opposed to dividends (which aren't deductible at the corporate level, yet are still taxed at the shareholder level and could be subject to the 3.8% NIIT) if the overall tax paid by both the corporation and you would be less.

**Warning:** The IRS is cracking down on misclassification of corporate payments to shareholder-employees, so tread carefully.

CHART 3

### Income tax differences based on business structure

Flow-through entity or sole proprietorship	C corporation
One level of taxation: The business's income flows through to the owner(s).	Two levels of taxation: The business is taxed on income, and then shareholders are taxed on any dividends they receive.
Losses flow through to the owner(s).	Losses remain at the corporate level.
The top individual tax rate is 39.6%.	The top corporate tax rate is generally 35% <sup>1</sup> , and the top rate on qualified dividends is 20%.

<sup>1</sup> See Chart 6 on page 30 for exceptions.



## Sale or acquisition

Whether you're selling your business or acquiring another company, the tax consequences can have a major impact on the transaction's success or failure.

Consider installment sales, for example. A taxable sale might be structured as an installment sale if the buyer lacks sufficient cash or pays a contingent amount based on the business's performance. An installment sale also may make sense if the seller wishes to spread the gain over a number of years — which could be especially beneficial if it would allow the seller to stay under the thresholds for triggering the 3.8% NIIT or the 20% long-term capital gains rate. But an installment sale can backfire on the seller. For example:

- Depreciation recapture must be reported as gain in the year of sale, no matter how much cash the seller receives.
- If tax rates increase, the overall tax could wind up being more.

With a corporation, a key consideration is whether the deal should be structured as an asset sale or a stock sale. If a stock sale is chosen, another important question is whether it should be a tax-deferred transfer or a taxable sale.

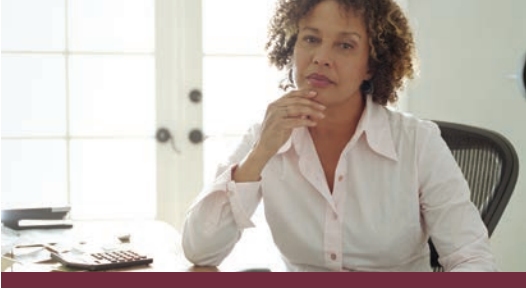
Of course, tax consequences are only one of many important considerations when planning a sale or acquisition.

## The self-employed

If you're self-employed, you can deduct 100% of health insurance costs for yourself, your spouse and your dependents. This above-the-line deduction is limited to your net self-employment income. You also can take an above-the-line deduction for contributions made to a retirement plan (see page 22) and, if you're eligible, an HSA (see page 4) for yourself.

You pay both the employee and employer portions of employment taxes on your self-employment income. The employer portion (6.2% for Social Security tax and 1.45% for Medicare tax) is deductible above the line.

And you may be able to deduct home office expenses (see page 3) from your self-employment income. ❖



## Build tax savings into your retirement planning

**W**hatever your age, you must plan carefully to help ensure your retirement dreams come true. This means building tax savings into your planning. For example, starting contributions early can make a big difference because of tax-deferred compounding. Choosing the right retirement plan for your situation is also important — is one that offers tax-*deferred* or tax-*free* savings better for you? Or perhaps you should contribute to both types of plans. Last, but certainly not least, avoiding early withdrawals and being tax-smart with required minimum distributions can be key to living your desired retirement lifestyle.

### 401(k)s and other employer plans

Contributing to a traditional employer-sponsored defined contribution plan is usually a good first step:

- Contributions are typically pretax, reducing your taxable income.
- Plan assets can grow tax-deferred — meaning you pay no income tax until you take distributions.
- Your employer may match some or all of your contributions.

Chart 4 shows the 2016 employee contribution limits. Because of tax-deferred compounding, increasing your contributions sooner rather than later can have a significant impact on the size of your nest egg at retirement. Employees age 50 or older can also make “catch-up” contributions, however. So if you didn’t contribute much when you were younger, this may allow you to partially make up for lost time.

If your employer offers a match, at *minimum* contribute the amount necessary to get the maximum match so you don’t miss out on that “free” money.

### More tax-deferred options

In certain situations, other tax-deferred saving options may be available:

**You’re a business owner or self-employed.** You may be able to set up a plan that allows you to make much larger contributions than you could make to an employer-sponsored plan as an employee. You



might not have to make 2016 contributions, or even set up the plan, before year end. SEP plans, for example, generally may be set up as late as the due date (including extensions) of your business's income tax return for that year.

**Your employer doesn't offer a retirement plan.** Consider a traditional IRA. You can likely deduct your contributions, though your deduction may be limited if your spouse participates in an employer-sponsored plan. You can make 2016 contributions until the April 2017 income-tax-return-filing deadline for individuals. Your annual contribution limit (see Chart 4) is reduced by any Roth IRA contributions you make for the year.

## Roth alternatives

A potential downside of tax-deferred saving is that you'll have to pay taxes when you make withdrawals at retirement. Roth plans, however, allow tax-free distributions; the tradeoff is that contributions to these plans don't reduce your current-year taxable income:

**Roth IRAs.** An income-based phaseout may reduce or eliminate your ability to contribute. But estate planning advantages are an added benefit: Unlike other retirement plans, Roth IRAs don't require you to take distributions during your lifetime, so you can let the entire balance grow tax-free over your lifetime for the benefit of your heirs.

**Roth conversions.** If you have a traditional IRA, consider whether you might benefit from converting some or all of it to a Roth IRA. A conversion can allow you to turn tax-*deferred* future growth into tax-*free* growth and take advantage of a Roth IRA's estate planning benefits. There's no income-based limit on who can convert to a Roth IRA. But the converted amount is taxable in the year of the conversion.

Whether a conversion makes sense depends on factors such as:

- Your age,
- Whether the conversion would push you into a higher income tax bracket or trigger the 3.8% NIIT (see page 13),

CHART 4

### Retirement plan contribution limits for 2016

	Regular contribution	Catch-up contribution <sup>1</sup>
Traditional and Roth IRAs	\$ 5,500	\$ 1,000
401(k)s, 403(b)s, 457s and SARSEPs <sup>2</sup>	\$ 18,000	\$ 6,000
SIMPLEs	\$ 12,500	\$ 3,000

<sup>1</sup> For taxpayers age 50 or older by the end of the tax year.

<sup>2</sup> Includes Roth versions where applicable.

**Note:** Other factors may further limit your maximum contribution.



- Whether you can afford to pay the tax on the conversion,
- Your tax bracket now and expected tax bracket in retirement, and
- Whether you'll need the IRA funds in retirement.

**“Back door” Roth IRAs.** If the income-based phaseout prevents you from making Roth IRA contributions and you *don't* have a traditional IRA, consider setting up a traditional account and making a nondeductible contribution to it. You can then immediately convert the traditional account to a Roth account with minimal tax impact.

**Roth 401(k), Roth 403(b), and Roth 457 plans.** Employers may offer one of these in addition to the traditional, tax-deferred version. You may make some or all of your contributions to the Roth plan, but any employer match will be made to the traditional plan. No income-based phaseout applies, so even high-income taxpayers can contribute.

### Early withdrawals

Early withdrawals from retirement plans should be a last resort. With a few exceptions, distributions before age 59½ are subject to a 10% penalty on top of any income tax that ordinarily would be due on a withdrawal. Additionally, you'll lose the potential tax-deferred future growth on the withdrawn amount.

If you must make an early withdrawal and you have a Roth account, consider withdrawing from that. You can withdraw up to your contribution amount without incurring taxes or penalties. Another option: If your employer-sponsored plan allows it, take a plan loan. You'll have to pay it back with interest and make regular principal payments, but you won't be subject to current taxes or penalties.

Early distribution rules also become important if you change jobs or retire and receive a lump-sum retirement plan distribution. You should request a direct rollover from your old plan to your new plan or IRA. Otherwise, you'll need to make an indirect rollover within 60 days to avoid tax and potential penalties.

**Warning:** If you don't do a direct rollover, the check you receive from your old plan may be net of 20% federal income tax withholding. If you don't roll over the gross amount (making up for the withheld amount with other funds), you'll be subject to income tax — and potentially the 10% penalty — on the difference.

## Required minimum distributions

In the year in which you reach age 70½, you must begin to take annual required minimum distributions (RMDs) from your IRAs (except Roth IRAs) and, generally, from your defined contribution plans. If you don't comply, you can owe a penalty equal to 50% of the amount you should have withdrawn but didn't. (An RMD deferral is allowed for the initial year, but you'll have to take two RMDs the next year.) You can avoid the RMD rule for a non-IRA Roth plan by rolling the funds into a Roth IRA.

Waiting to take distributions until age 70½ generally is advantageous because of tax-deferred compounding. But a distribution (or larger distribution) in a year your tax bracket is low may save tax. Be sure, however, to consider the lost future tax-deferred growth and, if applicable, whether the distribution could: 1) cause Social Security payments to become taxable, 2) increase income-based Medicare premiums and prescription drug charges, or 3) affect tax breaks with income-based limits.

If you've inherited a retirement plan, consult your tax advisor about the distribution rules that apply to you. ❖

### WHAT'S NEW!

#### Taxpayers age 70½ and up can donate up to \$100,000 from their IRA to charities

The PATH Act makes permanent the provision that allows taxpayers who are age 70½ or older to make direct contributions from their IRA to qualified charitable organizations up to \$100,000 per tax year. The taxpayers can't claim a charitable or other deduction on the contributions. But the amounts aren't deemed taxable income and can be used to satisfy an IRA owner's required minimum distribution.

To take advantage of the exclusion from income for IRA contributions to charities on your 2016 tax return, you'll need to arrange a direct transfer by the IRA trustee to an eligible charity by Dec. 31, 2016. Donor-advised funds and supporting organizations aren't eligible recipients.



## Estate planning can secure your legacy

As difficult as it is, accumulating wealth is only the first step to providing a financially secure future for your family. You also need to develop a comprehensive estate plan. The earlier you begin, the more options you'll have to grow and transfer your wealth in a way that minimizes taxes and leaves the legacy you desire.

### Estate tax

The estate tax rate is currently 40%, and it's scheduled to remain at that level. The estate tax exemption increased to \$5.45 million for 2016 (see Chart 5), and it will continue to be adjusted annually for inflation.

To avoid unintended consequences, review your estate plan in light of the changing exemption. A review will allow you to make the most of available exemptions and ensure your assets will be distributed according to your wishes.

### Gift tax

The gift tax continues to follow the estate tax exemption and rates. (See Chart 5.) Any gift tax exemption used during life reduces the estate tax exemption available at death. Using up some of your exemption during life can be tax-smart, depending on your situation and goals.

CHART 5

### Transfer tax exemptions and rates

Year	Estate <sup>1</sup> and gift tax exemptions	GST tax exemption	Estate, gift and GST tax rate
2015	\$ 5.43 million	\$ 5.43 million	40%
2016	\$ 5.45 million	\$ 5.45 million	40%
Future years	Indexed for inflation	Indexed for inflation	40%

<sup>1</sup> Less any gift tax exemption already used during life.

You also can exclude certain gifts of up to \$14,000 per recipient each year (\$28,000 per recipient if your spouse elects to split the gift with you or you're giving community property) without depleting any of your gift and estate tax exemption. This is the same as the 2015 amount. (The exclusion is adjusted for inflation annually, but it increases only in \$1,000 increments, so it typically goes up only every few years. It might go up again for 2017.)

**Warning:** You need to use your 2016 exclusion by Dec. 31. The exclusion doesn't carry over from year to year. For example, if you don't make an annual exclusion gift to your granddaughter this year, you can't add \$14,000 to your 2017 exclusion to make a \$28,000 tax-free gift to her next year.

## **GST tax**

The GST tax generally applies to transfers (both during your lifetime and at death) made to people more than one generation below you, such as your grandchildren. This is in addition to any gift or estate tax due. The GST tax continues to follow the estate tax exemption and rate. (See Chart 5.)

The GST tax exemption can be a valuable tax-saving tool for taxpayers with large estates whose children also have — or may eventually have — large estates. With proper planning, they can use the exemption to make transfers to grandchildren and avoid any tax at their children's generation.

## **State taxes**

A federal estate tax deduction is available for state estate taxes paid. Keep in mind that some states impose estate tax at a lower threshold than the federal government does.

To avoid unexpected tax liability or other unintended consequences, it's critical to consider state law. Consult a tax advisor with expertise regarding your particular state.

## **Exemption portability**

If one spouse dies and part (or all) of his or her estate tax exemption is unused at his or her death, the estate can elect to permit the surviving spouse to use the deceased spouse's remaining estate tax exemption.

**Warning:** Portability is available only for the most recently deceased spouse. It doesn't apply to the GST tax exemption and isn't recognized by many states. And it must be elected on an estate tax return for the deceased spouse — even if no tax is due.

The portability election will provide flexibility if proper planning hasn't been done before the first spouse's death. But portability doesn't protect future growth on assets from estate tax like applying the exemption to a credit shelter trust does. Trusts offer other benefits as well, such as creditor protection, remarriage protection, GST tax planning and state estate tax benefits.

## WHAT'S NEW!

### Large estates must report fair market values

Under the 2015 highway funding law, executors of large estates (those subject to estate tax) must provide the IRS and each of the estate's heirs with statements identifying the fair market value of the inherited property as reported on the estate tax return.

Any underpayment of tax resulting from an overstatement of basis under this provision will be subject to a 20% accuracy-related penalty.

These requirements are intended to ensure consistent reporting for estate and income tax purposes. The changes apply to any estate tax returns filed after July 31, 2015.

So married couples should still consider marital and credit shelter trusts — and transferring assets to each other to the extent necessary to fully fund them at the first death. Transfers to a spouse (during life or at death) are tax-free under the marital deduction, assuming he or she is a U.S. citizen.

### Tax-smart giving

Giving away assets now will help reduce the size of your taxable estate. Here are some strategies for tax-smart giving:

**Choose gifts wisely.** Consider both estate and income tax consequences and the economic aspects of any gifts you'd like to make:

- To minimize *estate tax*, gift property with the greatest future appreciation potential.
- To minimize *your beneficiary's income tax*, gift property that hasn't appreciated significantly while you've owned it.
- To minimize *your own income tax*, don't gift property that's declined in value. Instead, consider selling the property so you can take the tax loss and then gifting the sale proceeds.

**Plan gifts to grandchildren carefully.** Annual exclusion gifts are generally exempt from the GST tax, so they also help you preserve your GST tax exemption for other transfers. For gifts to a grandchild that don't qualify for the exclusion to be tax-free, you generally must apply both your GST tax exemption and your gift tax exemption.

**Gift interests in your business.** If you own a business, you can leverage your gift tax exclusions and exemption by gifting ownership interests, which may be eligible for valuation discounts. So, for example, if the discounts total 30%, in 2016 you can gift an ownership interest equal to as much as \$20,000 tax-free because the discounted value doesn't exceed the \$14,000 annual exclusion.

**Warning:** The IRS may challenge the calculation; a professional, independent valuation is recommended.

**Gift FLP interests.** Another way to potentially benefit from valuation discounts is to set up a family limited partnership. You fund the FLP and then gift limited partnership interests. **Warning:** The IRS scrutinizes FLPs, so be sure to properly set up and operate yours.

**Pay tuition and medical expenses.** You may pay these expenses without the payment being treated as a taxable gift to the student or patient, as long as the payment is made directly to the provider.

**Make gifts to charity.** Donations to qualified charities aren't subject to gift tax and may provide an income tax deduction. (See page 3.)

## Trusts

Trusts can provide significant tax savings while preserving some control over what happens to the transferred assets. You may want to consider these:

- A *credit shelter (or bypass) trust* helps married couples minimize estate tax and provides additional benefits.
- A *qualified terminable interest property (QTIP) trust* can benefit first a surviving spouse and then children from a prior marriage.
- A *qualified personal residence trust (QPRT)* allows you to give your home to your children today — removing it from your taxable estate at a reduced gift tax cost (provided you survive the trust's term) — while you retain the right to live in it for a certain period.
- A *grantor-retained annuity trust (GRAT)* works on the same principle as a QPRT but allows you to transfer other assets; you receive payments back from the trust for a certain period.



Finally, a GST — or “dynasty” — trust can help you leverage both your gift and GST tax exemptions, and it can be an excellent way to potentially lock in the currently high exemptions while removing future appreciation from your estate.

## Insurance

Along with protecting your family's financial future, life insurance can be used to pay

estate taxes, equalize assets passing to children who aren't involved in a family business, or pass leveraged funds to heirs free of estate tax. Proceeds are generally income-tax-free to the beneficiary. And with proper planning, you can ensure proceeds are excluded from your taxable estate. ❖



## Tax brackets for businesses and individuals in 2016

Whether a taxpayer is subject to corporate or individual tax rates, the marginal tax bracket can have a significant impact on tax liability. The marginal rate is the rate you'll pay on the next dollar of income, so in your planning it's important to know what your marginal rate likely will be.

### Pay attention to thresholds

The taxable income thresholds at which the top rates apply are much different for corporations vs. individuals — as you can see in Charts 6 and 7. Remember, when businesses are structured as flow-through entities, income is taxed at the owners' individual rates.

And for individuals (see Chart 7), the thresholds also vary significantly based on filing status. Also keep in mind that a marriage “penalty” kicks in at the thresholds for the 28% bracket. In other words, the threshold for married taxpayers filing jointly is significantly less than twice that of the threshold for individuals. There are also AMT rates to consider. (See page 2 for information on when the AMT might apply.)

CHART 6

### 2016 corporate income tax rate schedule

Tax rate	Tax brackets
15%	\$ 0 – \$ 50,000
25%	\$ 50,001 – \$ 75,000
34%	\$ 75,001 – \$ 100,000
39%	\$ 100,001 – \$ 335,000
34%	\$ 335,001 – \$10,000,000
35%	\$10,000,001 – \$15,000,000
38%	\$15,000,001 – \$18,333,333
35%	Over \$18,333,333

**Note:** Personal service corporations are taxed at a flat 35% rate.



CHART 7

## 2016 individual income tax rate schedules

Tax rate	Regular tax brackets	
	Single	Head of household
10%	\$ 0 – \$ 9,275	\$ 0 – \$ 13,250
15%	\$ 9,276 – \$ 37,650	\$ 13,251 – \$ 50,400
25%	\$ 37,651 – \$ 91,150	\$ 50,401 – \$ 130,150
28%	\$ 91,151 – \$ 190,150	\$ 130,151 – \$ 210,800
33%	\$ 190,151 – \$ 413,350	\$ 210,801 – \$ 413,350
35%	\$ 413,351 – \$ 415,050	\$ 413,351 – \$ 441,000
39.6%	Over \$ 415,050	Over \$ 441,000
	Married filing jointly or surviving spouse	Married filing separately
10%	\$ 0 – \$ 18,550	\$ 0 – \$ 9,275
15%	\$ 18,551 – \$ 75,300	\$ 9,276 – \$ 37,650
25%	\$ 75,301 – \$ 151,900	\$ 37,651 – \$ 75,950
28%	\$ 151,901 – \$ 231,450	\$ 75,951 – \$ 115,725
33%	\$ 231,451 – \$ 413,350	\$ 115,726 – \$ 206,675
35%	\$ 413,351 – \$ 466,950	\$ 206,676 – \$ 233,475
39.6%	Over \$ 466,950	Over \$ 233,475
Tax rate	AMT brackets	
	Single	Head of household
26%	\$ 0 – \$ 186,300	\$ 0 – \$ 186,300
28%	Over \$ 186,300	Over \$ 186,300
Exemption	\$ 53,900	\$ 53,900
Phaseout <sup>1</sup>	\$ 119,700 – \$ 335,300	\$ 119,700 – \$ 335,300
	Married filing jointly or surviving spouse	Married filing separately
26%	\$ 0 – \$ 186,300	\$ 0 – \$ 93,150
28%	Over \$ 186,300	Over \$ 93,150
Exemption	\$ 83,800	\$ 41,900
Phaseout <sup>1</sup>	\$ 159,700 – \$ 494,900	\$ 79,850 – \$ 247,450

**Note:** Consult your tax advisor for AMT rates and exemptions for children subject to the “kiddie tax.”

<sup>1</sup> The AMT income ranges over which the exemption phases out and only a partial exemption is available. The exemption is completely phased out if AMT income exceeds the top of the applicable range.



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Cyclorama Building | 369 Franklin Street | Buffalo, NY 14202  
p: 716.856.3300 | f: 716.856.2524 | [www.LumsdenCPA.com](http://www.LumsdenCPA.com)

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