YEAR-END TAX PLANNING

Dear Clients and Friends,

With the end of the year approaching, it is a good time to review your 2017 income tax situation and take steps to ensure that you are taking full advantage of the many tax planning strategies available. For 2017, the top federal income tax rate is 39.6%, but higher-income individuals can also be hit by the 0.9% additional Medicare tax on wages and self-employment income and the 3.8% Net Investment Income Tax (NIIT), which can both result in a higher-than-advertised marginal federal income tax rate.

Before we get to specific suggestions, here are three important considerations to keep in mind:

1. There are currently two tax reform bills moving through Congress, both of which would be effective in 2018. Although it is too early to tell if tax reform legislation will ultimately be enacted and what exactly it might contain, it will be important to monitor the progress of the tax reform legislation and consider its potential impact on year-end tax planning.
2. Effective tax planning requires considering both this year and next year, at a minimum. Without a multi-year outlook, you cannot be sure planning strategies intended to save taxes on your 2017 return will not backfire and cost additional money in the future.
3. Be on the alert for the Alternative Minimum Tax (AMT) in all of your planning. What may be a great planning strategy for regular tax purposes may create or increase an AMT problem. You will likely be hit with AMT if you deduct a significant amount of state and local taxes, claim multiple dependents, exercise incentive stock options, or recognize a large capital gain this year. The repeal of AMT is in both tax reform bills.

Here are a few tax-saving ideas for you to consider. As always, you can call on us to help you sort through the options and implement strategies that make sense for you.

YEAR-END INVESTMENT MOVES

Depending on your taxable income, the 2017 federal income tax rates on long-term capital gains and qualified dividends are 0%, 15%, and 20%. High-income individuals can also be hit by the 3.8% NIIT which can result in a marginal long-term capital gains/qualified dividend tax rate as high as 23.8%. Still, that is substantially lower than the top regular tax rate of 39.6% (43.4% if the NIIT applies). To minimize your taxes, consider the following:

HOLDING ON FOR FAVORABLE RATES. Whenever possible, try to hold appreciated securities for a minimum of one year and one day to qualify for the more favorable long-term capital gains rates.

SELECT THE RIGHT SHARES TO BE SOLD. Use specific identification or standing orders, instead of the default first-in, first-out method, to identify the stock or mutual fund shares to be sold. Selecting the highest basis shares, even if held one year or less, can minimize your capital gains taxes in certain situations.

SELL DEPRECIATED SECURITIES TO HARVEST CAPITAL LOSSES. As long the same or similar investments are not acquired within 30 days of the sale, the loss can be used to offset capital gains. If capital losses exceed capital gains, up to $3,000 of capital losses can be used to offset other income.

TAKE ADVANTAGE OF 0% FEDERAL RATE ON LONG-TERM CAPITAL GAINS. If your taxable income is not greater than $75,900 married filing joint, $37,950 single, or $50,800 head of household, sell appreciated securities held for more than one year. Until taxable income exceeds the thresholds above, long-term capital gains are taxed at a 0% federal rate.

SECURE A DEDUCTION FOR NEARLY WORTHLESS SECURITIES. If you own any securities that are nearly worthless with little chance of recovery, sell them to an unrelated party before year end so that you can deduct the loss in the current year.

MAXIMIZING NONBUSINESS DEDUCTIONS AND CREDITS

GIFT APPRECIATED STOCK. If you have appreciated stock that you have held for more than a year and you plan to make significant charitable contributions, keep your cash and donate the stock instead. You will avoid paying tax on the appreciation, but will still be able to deduct the full value of the donated property. If you want to maintain a position in the donated securities, you can immediately buy back a like number of shares. On the other hand, if the stock is now worth less than when you acquired it, sell the stock, take the loss, and then give the cash to the charity. Also, if you sell the stock at a loss, you cannot immediately buy it back as this will trigger the wash sale rules. This means your loss will not be deductible, but instead will be added to the basis in the new shares.

MAXIMIZE THE BENEFIT OF THE STANDARD DEDUCTION. For 2017, the standard deduction is $12,700 for married filing joint, $6,350 for single, and $9,350 for head of household. If your total itemized deductions are normally close to these amounts, you may be able to maximize the benefit of your deductions by bunching deductions in every other year. This allows you to time your itemized deductions so that they are high in one year and low in the next. You claim actual expenses in the year they are bunched and take the standard deduction in the intervening years. For instance, you might consider moving charitable donations you normally would make in 2018 to 2017. This strategy may become more important going forward, as both tax reform bills propose to almost double the standard deduction. You may also want to consider accelerating payments of your real estate taxes and state income taxes otherwise due in 2018. Both tax reform bills propose to eliminate the deduction for state and local taxes, as well as cap or eliminate the deduction for property taxes on personal use property.

CONTRIBUTE TO A 529 PLAN. For Indiana taxpayers, contributions to an Indiana 529 Plan can provide a 20% state tax credit (maximum credit of $1,000). Many other states offer deductions or credits for contributions to that state's 529 plan. Contributions must be received by the 529 Plan on or before December 31.

YEAR-END MOVES FOR SENIORS AGE 701/2 PLUS

MAKE CHARITABLE DONATIONS DIRECTLY FROM YOUR IRA. You can make cash donations totaling up to $100,000 per individual IRA owner per year to IRS-approved charities directly from your IRA ($200,000 per year maximum on a joint return if both spouses make Qualified Charitable Distributions [QCDs] of $100,000). QCDs are not treated as taxable distributions and you receive no itemized deduction for the contribution. QCDs have many potential tax benefits such as reducing your Adjusted Gross Income (which may decrease the phase-out of other tax benefits and reduce the amount of your Social Security benefits that are taxable), receiving a state tax benefit where you otherwise would not, and effectively allowing you to deduct charitable contributions and claim the standard deduction on the same return. If you decide to make a QCD, be sure to transfer the funds directly from your IRA to the charity.

TAKE YOUR REQUIRED MINIMUM DISTRIBUTIONS. Individuals with retirement accounts must generally take withdrawals based on the size of their account and their age every year after they reach age 701/2. Failure to take a required withdrawal can result in a penalty of 50% of the amount not withdrawn. QCDs discussed above count as payouts for purposes of the required distribution rules. This means you can donate all or part of your 2017 required distribution (up to the $100,000 per individual IRA owner limit on QCDs) and convert taxable required distributions into tax-free QCDs.

If you turned age 701/2 in 2017, you can delay your 2017 required distribution to 2018. However, waiting until 2018 will result in two distributions in 2018 (the amount required for 2017 plus the amount required for 2018). While deferring income is normally a sound tax strategy, here it results in bunching income into 2018, which might throw you into a higher tax bracket or have a detrimental impact on your tax deductions.

YEAR-END MOVES FOR YOUR BUSINESS

Take advantage of tax breaks for purchasing equipment, software, and certain real property acquired and placed in service during 2017.

- Under Section 179, an eligible business can claim a significant first-year depreciation deduction for the cost of new and used equipment, software additions, and qualified costs for restaurant buildings and improvements to interiors of retail and leased nonresidential buildings. For tax years beginning in 2017, the maximum Section 179 deduction is $510,000, but this amount is reduced to the extent qualified purchases exceed $2,030,000 for 2017. Lower limits apply to the amount that can be deducted for most vehicles. If your business has a tax loss for the year before considering any Section 179 deduction, you cannot claim a Section 179 deduction that would create or increase the overall business tax loss.
- In addition to the Section 179 deduction, your business can claim first-year bonus depreciation equal to 50% of the cost of most new (not used) equipment and software placed in service by December 31 of this year. For a new passenger auto or light truck subject to the luxury auto depreciation limitations, 50% bonus depreciation increases the maximum first-year depreciation deduction by $8,000 for vehicles placed in service during 2017. Unlike the Section 179 deduction, bonus depreciation deductions can create or increase a Net Operating Loss (NOL) for your business. You could then potentially carry back a 2017 NOL to 2015 and/or 2016 and collect a refund of taxes paid in those years.

REVIEW AND UPDATE ACCOUNTING POLICY FOR EXPENSING SMALL-DOLLAR EQUIPMENT AND FIXED ASSET PURCHASES. The IRS generally allows taxpayers to expense equipment and fixed assets up to $2,500 per item using the de minimis safe harbor. The de minimis safe harbor requires that an accounting policy be established at the beginning of the tax year that requires items costing less than a certain dollar amount or lasting less than 12 months be expensed for both book and tax purposes. The accounting policy does not have to be written. For taxpayers that have Applicable Financial Statements (generally, certified audited or provided to any federal or state agency other than IRS), the de minimis threshold increases to $5,000 per item. Additionally, the accounting policy for taxpayers with applicable financial statements must be written.

CHECK YOUR PARTNERSHIP AND S CORPORATION STOCK BASIS. If you own an interest in a partnership or S corporation, your ability to deduct any losses it passes through is limited to your basis. Although any unused loss can be carried forward indefinitely, the time value of money diminishes the usefulness of these suspended deductions. If you expect the partnership or S-corporation to generate a loss this year and you lack sufficient basis to claim a full deduction, you should consider making a capital contribution or loan additional funds to the business before year end.

EMPLOY YOUR CHILD. Employing your child provides tax benefits by shifting income from you to your child, who normally is in a lower tax bracket or may avoid tax entirely due to the standard deduction. There can also be payroll tax savings since wages paid by sole proprietors to their children age 17 and younger are exempt from both social security and unemployment taxes. Employing your children has the added benefit of providing them with earned income, which enables them to contribute to a traditional or Roth IRA. Remember a couple of things when employing your child. First, the wages paid must be reasonable given the child's age and work skills. Second, if the child is in college, or is entering soon, having too much earned income can have a detrimental impact on the student's need-based financial aid eligibility.

REVIEW YOUR HEALTH INSURANCE COSTS AND COVERAGE

MAKE SURE YOU HAVE ADEQUATE HEALTH INSURANCE COVERAGE. If you and your family do not have adequate medical coverage (referred to as minimum essential coverage), you may be subject to a penalty. Medical insurance provided by your employer or through an individual plan purchased through a state insurance marketplace generally qualifies as adequate coverage. The penalty amount varies based on the number of uninsured members of your household and your household income. If you have three or more uninsured household members, the penalty may be $2,085 or more for 2017, depending on your household income.

TAKE ADVANTAGE OF FLEXIBLE SPENDING ACCOUNTS (FSA). If your company has a healthcare and/or dependent care FSA, you must specify how much of your salary to convert into tax-free contributions to the plan. You can then take tax-free withdrawals next year to reimburse yourself for out-of-pocket medical and dental expenses and qualifying dependent care costs. Keep in mind, however, that FSAs are "use-it-or-lose-it" accounts. You do not want to set aside more than what you will likely have in qualifying expenses for the year. If you currently have a healthcare FSA, make sure you spend it by incurring eligible expenses before the deadline for your plan.

CONSIDER A HEALTH SAVINGS ACCOUNT (HSA). If you are enrolled in a high-deductible health plan and do not have any other coverage, you may be eligible to make tax deductible contributions to an HSA of up to $6,750 for family coverage or $3,400 for individual coverage, plus an extra $1,000 if you will be 55 or older by the end of 2017. Distributions from the HSA will be tax-free as long as the funds are used to pay unreimbursed qualified medical expenses. Furthermore, there is no time limit on when you can use your contributions to cover expenses. Unlike a healthcare FSA, amounts remaining in the HSA at the end of the year can be carried over indefinitely.

MANAGE YOUR ADJUSTED GROSS INCOME (AGI)

Many tax deductions and credits are only available to taxpayers with AGI below certain levels. Some common AGI-based tax breaks include the child tax credit (phase-out begins at $110,000 for married filing joint and $75,000 for single and head of household), the $25,000 rental real estate passive loss allowance (phase-out range of $100,000–$150,000 for most taxpayers), and the exclusion of social security benefits ($32,000 threshold for married filing joint; $25,000 for most other filers). Also for 2017, taxpayers with AGI over $313,800 for married filing joint, $261,500 for single, and $287,650 for head of household lose part of their personal exemptions and itemized deductions.

Accordingly, strategies that lower your income or increase certain deductions might not only reduce your taxable income, but also help increase some of your other tax deductions and credits. Managing your AGI can also help you avoid (or reduce the impact of) the 3.8% Net Investment Income Tax that potentially applies if your AGI exceeds $250,000 for joint returns, $200,000 for unmarried taxpayers.

Managing your AGI can be somewhat difficult, since it is not affected by many deductions you can control, such as deductions for charitable contributions and real estate and state income taxes. However, you can effectively reduce your AGI by increasing "above-the-line" deductions, such as those for retirement plan contributions. For sales of property, consider an installment sale that shifts part of the gain to later years when the installment payments are received or use a like-kind exchange that defers the gain until the exchanged property is sold. If you're age 70½ or older, consider making charitable contributions from your IRA, as discussed previously. If you own a cash-basis business, delay billings so payments are not received until 2018 or accelerate payment of certain expenses, such as office supplies and repairs and maintenance, to 2017. Of course, before deferring income, you must assess the risk of doing so.

ESTATE AND GIFT PLANNING

For 2017, the unified federal gift and estate tax exemption is $5.49 million, and the federal estate tax rate is 40%. As long as a decedent's taxable estate and lifetime taxable gifts are below the exemption amount, no estate tax will be due. If a married taxpayer dies, it may be beneficial to file an estate tax return to preserve any unused exemption for the surviving spouse even though no estate tax will be due. Both tax reform bills have proposed an increase in the exemption to $11 million per individual ($22 million for couples), with the House bill also completely repealing the estate tax in 2025.

Take advantage of the annual gift tax exclusion. For 2017, the annual gift tax exclusion is $14,000. Therefore, a taxpayer can give $14,000 per year to any number of recipients without owing any federal gift tax. Direct payments to providers for medical expenses and tuition do not count towards the annual exclusion.

CONCLUSION

The ideas discussed in this letter are a good way to get you started with year-end planning, but they are no substitute for personalized professional assistance. Please do not hesitate to call us with questions or for additional strategies on reducing your tax liability. We would be glad to set up a planning meeting or assist you in any other way that we can.

Very truly yours,

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