2016

DMJ & Co., PLLC - Year-End Tax Planning Letter

DMJ & Co., PLLC
703 Green Valley Road, Suite 201, Greensboro, NC 27408 • PO Box 9258, Greensboro, NC 27429-0258
T 336-275-9886 • F 336-275-1129
dmj.com • Triad • Triangle • Sandhills

Dear Clients and Friends:

First of all, if we haven't thanked you recently for letting us work with your tax and accounting needs, then THANK YOU! Our growth is largely a result of the trust shown in us by our clients.

This growth in 2016 includes the addition of a Durham location, formerly the office of Hutchings and Hutchings, CPAs, PA. DMJ's new office in the Triangle area will add significant value with more resources to serve your needs, strong planning services, and the opportunity to attract professionals for continued growth in a new market area.

If you are a former Hutchings CPA client, please know that we look forward to diligently earning your trust, just as you had come to trust your Hutchings advisor. No personnel changes are planned as part of this transition, so your trusted advisor will not change under DMJ. In addition, should any questions arise, you should feel comfortable to contact the same staff member you have been accustomed to working with at the same phone number.

2016 Year-End Tax Planning Letter

General tax environment

So far, Congress has passed practically no tax legislation, which is not unexpected for an election year. Thankfully, we are not once again worried about the state of extenders at year end since the PATH Act enacted in last December provided permanent or multi-year extension of popular tax rules. No further major tax legislation affecting 2016 is on the horizon at this time.

As of this writing, President-Elect Trump has not commented further on tax legislative priorities. During the campaign, he proposed several significant changes in various areas of tax law. With Republican control of both the House and Senate, the road appears clear to enact changes - provided that all of the Republicans are on the same page. Stay tuned, and we will keep you current as the story develops.

In August, the Treasury Department under the Obama Administration announced Proposed Regulations to limit the applicability of discounts for the valuation of transfers of property to family and related parties. Those planning gifts of property interests for estate or other purposes are encouraged to consider accelerating those plans into 2016. Talk to us if this issue may apply to you or if significant property gifts are contemplated.

The IRS continues to send out computer-generated notices, usually from computer-based document-matching processes. Since IRS notices generated in this way are sometimes incorrect, you should consult your tax professional about the appropriate response. Never ignore an IRS notice – it will not go away. Deal with it promptly to reduce any penalties and interest that may accrue.

As in most years, tax law changes – or possible changes – make it worthwhile for you to stay informed so you can minimize taxes or at least avoid missteps that could complicate your life. Make sure that you receive our email blasts on tax updates. Sign up by sending an email to contact@dmj.com.

2015 Path Act

On December 18, 2015, President Obama signed the "Protecting Americans from Tax Hikes Act of 2015", which is commonly known as the PATH Act (the Act).

Individual tax provisions that were made permanent in the Act include: (1) the option to deduct state and local sales tax instead of income tax; (2) the American Opportunity tax credit for higher education; (3) the up to $250 teacher deduction; (4) the ability for those after age 70-1/2 to make charitable contributions of up to $100,000 directly from the IRA; and (5) the ability to exclude up to 100% of the gain on certain qualified small business stock. Temporary personal provisions include: (1) the deduction of qualified tuition; (2) the ability to exclude up to $2 million of cancelled mortgage debt on a principal residence from taxable income; and (3) the ability to deduct mortgage insurance premiums as mortgage interest.

Business tax provisions that became permanent include: (1) Section 179 expensing of up to $500,000, plus indexing this amount for inflation in the future; (2) the research tax credit; (3) a reduction in the "S" corporation built-in gains tax period to five years; and (4) a depreciable life of certain qualifying leaseholds and similar business real estate of 15 years. Temporary business extensions include: (1) Section 168(k) bonus depreciation of 50% through 2017, and at a lesser percentage through 2019; and (2) other extensions include certain energy and other business tax credits.

IRS adjusts tax provisions for inflation

Continued low interest rates result in small inflation indexes of key tax amounts. For 2016, the personal and dependency exemptions were increased to $4,050, from $4,000 in 2015. The standard deductions for all filing statuses received either no change or a small boost of $50 above the 2015 amounts.

Taxpayers who have a health savings account under a high-deductible health plan (HDHP) have a higher contribution limit this year of $6,750 for a family, an increase of $100 over 2015. The single contribution limit is unchanged at $3,350. The HDHPs' out-of-pocket maximums of $6,550 per individual and $13,100 for a family are up slightly from 2015, but minimum deductibles of $1,300 per individual and $2,600 for a family are unchanged from 2015.

In a major change of policy direction, the IRS announced in August of this year some significant relief for the 60-day rollover rule. The rule is that the taxpayer has 60 days to re-deposit an IRA withdrawal into that same or a new IRA account without facing tax, possibly including penalty. Traditionally, there has been no leniency in this strict interpretation of the 60-day rule. In recent years, the Service has allowed an extension of time, but only in extreme extenuating circumstances. But in August, the Service announced that taxpayers can re-deposit IRA withdrawals after 60 days if the failure to meet the deadline was due to certain specified reasons. This is the first opportunity to receive relief of the 60-day rule without applying for specific approval from the Service.

The future of the estate tax is unknown at this point. Currently, the estate tax exemption is $5.45 million. Together, a married couple can pass an estate valued at $10.90 million to their heirs without paying federal estate tax because of the portability provision. Republican legislative leadership and President-Elect Trump are in favor of repeal. But again, Congress will have a share in this discussion.

The annual gift tax exclusion remains at $14,000 per recipient in 2016 ($28,000 if married and using a gift-splitting election, or if each spouse uses separate funds). By making these gifts annually, taxpayers can transfer significant wealth out of their estate without using any of their lifetime estate exemption.

Retirement plan rules

A good tax strategy is to participate in your employer's 401(k) plan. You may elect to contribute up to $18,000 this year before taxes, and the additional catch-up contribution for employees who are age 50 and above is $6,000. Refer to your employer's plan to confirm that the catch-up contribution is permitted. These increased contribution limits also apply to 403(b) plans, most 457 plans, and the Thrift Savings Plan. These amounts are unchanged from 2015.

Some 401(k) plans allow you to make an after-tax Roth contribution, which will not reduce your current income. However, you generally will not owe tax when this contribution, plus any earnings, are withdrawn in retirement. Note that for those who fully maximize their 401(k) contributions, doing so as a Roth contribution is a way to make additional contributions, economically speaking, as you are not only contributing the maximum 401(k) contribution, but you are also contributing the tax on that contribution.

The IRA contribution limit was not raised in 2016. It is still $5,500, with an additional $1,000 catch-up contribution allowed for people 50 years of age or older. SIMPLE plan amounts also have not changed.

You and your spouse must have earned income to contribute to either a traditional or a Roth IRA. Only taxpayers with modified AGI below certain thresholds are permitted to contribute to a Roth IRA. If a workplace retirement plan covers you or your spouse, modified AGI also controls your ability to deduct your contribution to a traditional IRA.

There is no AGI limit on your or your spouse's deduction if you are not covered by an employer plan. If your modified AGI falls within the phase-out range, a partial contribution/deduction is still allowed.

If you would like to contribute to a Roth IRA, but your income exceeds the threshold, consider contributing to a traditional IRA for 2015, and convert the IRA to a Roth IRA in 2016. Be sure to inquire about the tax consequences of the conversion, <u>especially if you have funds in other traditional IRAs</u>.

Rules governing IRA rollovers have changed. As of 2015, you may make only one IRA-to-IRA rollover per year. This does not limit direct rollovers from trustee to trustee. Any attempted rollover after the first one will be treated as a withdrawal and taxed at regular rates – with potentially a 10 percent early withdrawal penalty. The attempted rollover will be subject to regular IRA contribution limits, meaning that, if the amount of funds in the account exceeds your contribution limit, it will be subject to a 6 percent excise tax.

As mentioned earlier, the provision that allowed an individual who is at least 70-1/2 years old to make a qualified charitable distribution of up to $100,000 from an IRA directly to a charity has been made permanent. This distribution to charity can satisfy all or part of your required minimum distribution requirement. This is generally a good idea for taxpayers who (1) are subject to the required minimum distribution rules, and (2) have charitable commitments to satisfy. It is arguably a better idea to first use long-term significantly appreciated stock for your charitable giving (discussed later in this letter), but a charitable IRA distribution is also a good idea.

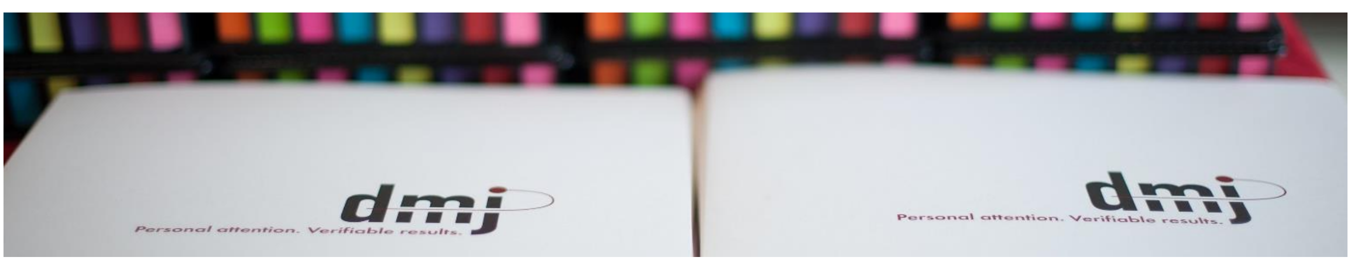
In addition to the SIMPLE IRA shown in the table below, self-employed individuals can have a Simplified Employee Pension (SEP) plan. They may contribute as much as 25 percent of their net earnings from self-employment, not including contributions to themselves. The contribution limit is $53,000 in 2016. The self-employed may set up a SEP plan as late as the due date, including extensions, of their 2016 income tax return.

An individual, or solo, 401(k) is another option for the self-employed. For 2016, a self-employed individual, as an employee, may defer up to $18,000 ($24,000 for age 50 or older) of annual compensation. Acting as the employer, the individual may contribute 25 percent of net profits, excluding the deferred $18,000, up to a maximum contribution of $53,000.

Inflation Adjustments for 2016 Tax Provisions	
Standard Deduction	
Single or married filing separately	$6,300
Married filing jointly or surviving spouse	$12,600
Head of household	$9,300
Exemption Amount	$4,050
Flexible Spending Account Limitation	$2,550
Health Savings Account Limitation	
Single	$3,350
Family	$6,750
401(k) Limitation	$18,000
Plus catch-up contribution for age 50 & over, if permitted by employer plan	$6,000
SIMPLE Plan Limitation	$12,500
Plus catch-up contribution for age 50 & over, if permitted by employer plan	$3,000
Estate Tax Exemption	$5,450,000
Foreign Earned Income Exclusion	$101,300

Make the most of long-term capital gains

- While avoiding or deferring tax may be your primary goal, to the extent there is income to report, the income of choice is long-term capital gain thanks to the favorable tax rate available. Short-term capital gain is taxed at your ordinary income tax rate.
- If you hold a capital asset for more than one year before selling it, your capital gain is long-term. For most taxpayers, long-term capital gain is taxed at rates no higher than 15 percent. But taxpayers in the 10 percent to 15 percent ordinary income tax bracket have a long-term capital gains tax rate of 0 percent.
- Taxpayers whose income exceeds the thresholds set for the 39.6 percent ordinary tax rate are subject to a 20 percent rate on capital gain. The thresholds are $415,050 for singles; $466,950 for married couples filing jointly or for surviving spouses; $441,000 for heads of household; and $233,475 for married couples filing separately.
- If the long-term capital gains rates of 0, 15, or 20 percent are not complicated enough, keep in mind that special rates of 25 percent can apply to certain real estate, and 28 percent to certain collectibles. Also, gains on the sale of certain C corporations held for more than five years can qualify for a 0 percent rate. Talk to your tax adviser before you assume which long-term capital gains rate would apply. In any event, the 3.8% tax on Net Investment Income could also apply in addition to these rates.
- Remember that you can use capital losses, including worthless securities and bad debts, to offset capital gains. If you lose more than you gain during the year, you can offset ordinary income by up to $3,000 of your losses. Then you can carry forward any excess losses into the next tax year.
- However, you should be careful not to violate the “wash sale” rule by buying an asset nearly identical to the one you sold at a loss within 30 days before or after the sale. Otherwise, the wash sale rule will prevent you from claiming the loss immediately. While wash sale losses are deferred, wash sale gains are fully taxable. It is important to discuss the meaning of “nearly” or “substantially” identical assets with your tax adviser.



Charitable deduction depends on qualified organization

As most taxpayers are aware, federal tax law allows a deduction for contributions made to qualified IRS tax-exempt organizations. Before making such contributions, however, you should become familiar with some of the laws and limitations on contributions so you can maximize the tax benefit of the deduction.

The contribution must be made to a qualified IRS tax-exempt organization. The IRS maintains an online tool (http://tinyurl.com/a72f74x) that simplifies the search for organizations that meet the criteria. It should be noted that churches are generally not on this list as they are automatically exempt. Also note that nonprofit status is granted by the state when the organization applies for its corporate charter as a nonprofit organization. Tax-exempt status is granted by the IRS upon application.

The donor cannot exercise undue control over the contribution. For example, you cannot make a contribution to a church, specifying that the funds be used to pay the medical bills of a good friend. A contribution may be made to the church benevolent fund with an expressed preference that the funds be used to help your friend, but the request may not be a condition of the gift.

The contribution must be made by December 31. A check mailed with a December 31 postmark is acceptable. A credit card charge is deductible when charged, not when the credit card bill is paid. The organization cannot "hold the books open" for a few days after the end of the year and credit those contributions to the year just ended.

There are limitations on the amount of charitable contributions that you may deduct. For individuals, the limit is 50 percent of adjusted gross income (AGI) or 30 percent of AGI if the donation is capital gain property. Any excess may be carried over to future years.

Corporations are limited to deducting 10 percent of the corporation's pretax net income. An S corporation carries the contribution to the individual shareholders' returns, so they are not subject to the 10 percent limitation.

Beyond the laws and limitations discussed above, some strategies may be employed to maximize the benefit of the deduction. If your itemized deductions are near the amount of the standard deduction, you may wish to bunch contributions in a year in which the standard deduction amount has been exceeded.

In addition, if your AGI exceeds a threshold amount, for example, $311,300 for married filing jointly, your charitable deduction amount will be phased out to not less than 80 percent of the contribution. If you have an unusually large income in a particular year, you may wish to defer your giving to another year to receive a greater benefit.

It is a good strategy to keep a running list of your charitable contributions so you can be prepared to speed up or delay any contributions to maximize your deductions. Along this same line, keeping tabs on your total income for the year, in case you will be subject to the phase-out provisions, will enable you to plan properly.

If you plan to contribute appreciated capital gain property, you will achieve the maximum benefit if the property is long-term – property held for more than 12 months. You can normally deduct the fair market value of the contribution rather than the cost basis. If held for 12 months or less, the deduction is limited to the basis in the property.

Before making such a contribution, you should ascertain that the property does qualify for deduction of the fair market value and is, in fact, appreciated property.

This overview provides some of the laws and strategies for deriving the maximum tax benefit from charitable contributions. Before making significant contributions, you would be wise to consult with us to assure that you are maximizing the benefit.

Timing income and expenses can be important tax reduction strategy

As you consider your tax plan, determine whether you are likely to be subject to the alternative minimum tax (AMT). The AMT's function is to level taxes when income – adjusted for certain preference items – exceeds certain exemptions, but the tax rate applied to that income falls below the AMT rate.

Before deciding to accelerate or defer income and prepay or delay deductible expenses, you need to gauge the possible effect of the AMT on these tax-planning strategies. Having a number of miscellaneous itemized deductions, personal exemptions, medical expenses, and state and local taxes can trigger AMT.

After analyzing your specific tax situation, if you anticipate that your income will be higher in 2017, you might benefit from accelerating income into 2016 and possibly postponing deductions, keeping the AMT threat in mind.

<table>
<tr><th colspan="5">2016 AMT Rates and Exemption Amounts</th></tr>
<tr><th colspan="2">AMT Income</th><th colspan="3">Rate</th></tr>
<tr><td colspan="2">$1-$186,300*</td><td colspan="3">26%</td></tr>
<tr><td colspan="2">Over $186,300*</td><td colspan="3">28%</td></tr>
<tr><th></th><th>Single</th><th>Head of Household</th><th>Married Filing Jointly and Surviving Spouses</th><th>Married Filing Separately</th></tr>
<tr><th>AMT Exemption Amount</th><td>$53,900</td><td>$53,900</td><td>$83,800</td><td>$41,900</td></tr>
<tr><th>Exemption Phase-out Begins</th><td>$119,700</td><td>$119,700</td><td>$159,700</td><td>$79,850</td></tr>
<tr><td colspan="5">*Note: Married taxpayers filing separate returns should substitute $93,150 for $186,300 in the rate table.</td></tr>
</table>

On the other hand, if you think you may be in a lower tax bracket in 2017, look for ways to defer some of your 2016 income. For example, you could delay into 2017:

- Collecting rents
- Receiving payments for services
- Accepting a year-end bonus
- Collecting business debts

And if you itemize deductions, consider prepaying some of your 2017 tax-deductible expenses in 2016.

Individuals usually account for taxes using the cash method. As a cash method taxpayer, you can deduct expenses when you pay them or charge them to your credit card. Expenses paid by credit card are considered paid in the year they are incurred.

In addition to charitable contributions discussed earlier, you should decide whether it would be beneficial for you to prepay the following expenses:

- **State and local income taxes** – You may prepay any state and local income taxes normally due on January 16, 2017, if you do not expect to be subject to the AMT in 2016. If you reside in a state with high income and property taxes, you are more likely to be subject to the AMT because state taxes are not deductible when computing AMT income.
- **Real estate taxes** – You can prepay in 2016 any real estate tax due early in 2017. But you should keep in mind how the AMT could affect both years when preparing to pay real estate taxes on your residence or other personal real estate. However, real estate tax on rental property is deductible and can be safely prepaid even if you are subject to the AMT.
- **Mortgage interest** – Your ability to deduct prepaid interest has limits. But, to the extent your January mortgage payment reflects interest accrued as of December 31, 2016, a payment before year end will secure the interest deduction in 2016. However, note that this technique really only works once. Deducting a 13th monthly payment in 2016 leaves you only 11 payments to deduct in 2017, thus you are forced to continue to prepay the January payment just to keep 12 months of deductions.
- **Margin interest** – If you bought securities on margin, any interest accrued as of December 31, 2016, will be deductible in 2016 only if you actually pay the interest by December 31 (subject to the investment interest limitation rules).
- **Miscellaneous itemized deductions** – You may deduct miscellaneous itemized deductions, like many deductions, only if you itemize your deductions and are not subject to the AMT. These deductions are different from other itemized deductions because the total amount of miscellaneous deductions must exceed 2 percent of your AGI to be deductible.
    - Taxpayers usually elect to itemize deductions only if total deductions exceed the standard deduction for the year. If itemized deductions are near the standard deduction amount, grouping these deductions in alternating years is often an effective tax-planning strategy.
    - Some expenses are deductible as itemized deductions only to the extent they exceed a specified percentage of your AGI.
    - Taxpayers with unreimbursed medical and dental expenses may deduct the amount in excess of 10 percent of AGI. For taxpayers age 65 or older, the percentage is 7.5 percent, but this exception is temporary, slated to expire at the end of this year.
    - Also deductible are unreimbursed employee business expenses, tax return preparation fees, investment expenses, and certain other miscellaneous itemized deductions that together are in excess of 2 percent of AGI.

- **Total deductions** – The amount of itemized deductions you can claim on your 2016 tax return is reduced by 3 percent of the amount by which your AGI exceeds the threshold amount:

2016 AGI Threshold	Filing Status
$259,400	Single taxpayers
$311,300	Married couples filing jointly
$285,350	Heads of household
$155,650	Married taxpayers filing separately

Taxpayers cannot lose more than 80 percent of the itemized deductions subject to the phase-out. Deductions for medical expenses, investment interest, casualty and theft losses, and gambling losses are not subject to the limitation.

Stay on top of your tax payments

If you expect to be subject to an underpayment penalty for failure to pay your 2016 tax liability on a timely basis, consider increasing your withholding between now and the end of the year to reduce or eliminate the penalty. Increasing your final estimated tax deposit due January 16, 2017, may reduce the amount of the penalty, but is unlikely to eliminate it entirely.

Withholding, even if done on the last day of the tax year, is deemed withheld ratably throughout the tax year. For federal taxes, underpayment penalties can be avoided when total withholdings and estimated tax payments exceed the 2015 tax liability, or in the case of higher-income taxpayers, 110 percent of 2015 tax. For NC tax, the rule is the same except you can replace "110 percent of 2015 tax"

Employer questions and responsibilities abound

If you are a business owner, make sure that you receive a copy of our year-end letter that focuses on business issues. If you do not receive a copy by December 10th or so, please contact us at contact@dmj.com.

If you classify some of your workers as independent contractors who are actually employees, please note that the government continues to pursue these issues. Your business could be required to pay unpaid payroll taxes, interest, and penalties. It could also be obligated to pay for employee benefits that your company did not previously provide, as well as federal penalties.

The basic guidance is an “economic realities test.” How much control does your company have over the way workers perform their jobs? For example:

- Do the workers in question determine how they accomplish their task, or do you closely supervise them?
- Do they have other clients, or do they work full-time for you?
- Do they receive payment for each job, or do you pay them on your schedule?
- Do they own their own equipment and facilities, or does your company provide equipment, supplies, and office space?

These and other considerations are important in determining a worker’s status. If you have any questions, consult with your CPA about the proper classification of your workers to avoid additional taxes and penalties.

Conclusion

The U.S. Tax Code is incredibly complex and can change rapidly, even though it may sometimes seem to be moving along at a snail’s pace. This complexity has given rise to more calls for simplification. For now, taxpayers must still live with the complexity and the changes, as simplification appears to be only a dream.

Although a majority of taxpayers have their taxes prepared by a professional, people are turning in larger numbers to self-prepared returns. Since the online program does the calculations, it seems to be an economical approach to preparing and filing taxes.

North Carolina Taxes

As most of our clients are NC residents, here are a few NC issues to consider.

Your NC personal income tax rate for 2016 will be 5.75%, unchanged from 2015 (however the rate is scheduled to drop to 5.499% for 2017). The basic mechanics of the computation of taxable income will be similar to 2015.

The most significant change for 2016 in NC taxation is in the sales tax area, with changes on both 3/1/2016 and 12/31/2016 in the taxation of repair, maintenance, and installation services. If you changed your sales tax assessment procedure for the March 1 change, be sure to check to see if the additional rule changes on December 31 require you to change how sales tax is charged a second time. If you are in a business that provides these services, make sure that you are aware of your sales tax collection responsibilities.

However, the program is no substitute for a qualified tax professional such as a CPA. Programs can calculate tax liability, but they cannot substitute for professional advice and guidance.

DMJ & Co., PLLC
PO Box 9258
Greensboro, NC 27429-0258

With such complexity in the tax code, a CPA is better able to keep abreast of the changes and can prepare taxes in a manner that determines a taxpayer's minimum legal tax liability. But minimizing tax liability started last week, last month, last year. Tax planning is a constant in today's complex world.

In closing, DMJ is committed to improving our connection with each client. We encourage you to stay in contact and learn more about our services and relevant news by following us at:

- twitter.com/dmjandco
- facebook.com/dmjandco
- contact@dmj.com - Receive monthly email updates and relevant tax-news by joining our mailing list.

Sincerely,

DMJ & Co., PLLC

Certified Public Accountants

The technical information in this newsletter is necessarily brief. No final conclusion on these topics should be drawn nor action taken without further review and consultation.