Messina
& Associates LTD.
Understanding What Counts

2017 Year End Personal Tax Alert

Just as the daylight hours are getting shorter, so is the time for fine tuning any last-minute strategies to lower your 2017 tax bill. Often, the correct steps to take will depend on whether you see your income going up or down next year. **You can find a recap of the most recent tax proposals on the Tax Reform Updates tab of our website www.messina-cpa.com.**

If you've been following the news out of Washington, you probably know that for the first time in decades, tax reform is a real possibility. Given that Republicans control Congress and the White House, and that taxes have become their number one legislative priority, it's likely that reform of some kind will pass. However, what that reform will be, who it will benefit, and when it will be effective is still up in the air. So, in analyzing how we may reduce your 2017 tax burden, we should start with what we do know and how it may affect you, and avoid putting too much weight on proposed changes.

For 2017, current law provides seven tax rates depending on your income. The top tax rate of 39.6 percent applies to incomes over $418,400 (single), $470,700 (married filing jointly and surviving spouse), $235,350 (married filing separately), and $444,550 (heads of households). However, high-income taxpayers are also subject to the 3.8 percent net investment income tax and/or the .9 percent Medicare surtax.

Much of tax planning for the current year depends on what you expect to happen next year. Will there be any major life changes next year, such as a marriage, additional dependents, a change in jobs, or retirement? The year-end tax strategies will also depend on whether you expect your income to go up or down next year or, correspondingly, whether you expect a significant changes in your deductions. The following are some of the items we should review when discussing year-end tax planning options that may be relevant to your situation.

Life Events

Life events can significantly impact your taxes. For example, if you will be getting married next year and you and your spouse have significant income, you may want to consider accelerating income into the current year or deferring deductions into 2018. This is because combined incomes can lead to higher tax brackets. For example, in 2017, a single taxpayer is not subject to the 28 percent tax rate until his or her taxable income exceeds $91,900. However, for a married couple, the 28 percent rate kicks in when the couple's taxable income exceeds $153,100, much less than twice the single taxable income level.

Similarly, if you are using head of household or surviving spouse filing status for 2017, but will change to a filing tax status of single for 2018, your tax rate will go up. Thus, accelerating income into 2017 and pushing deductions into 2018 may also yield tax savings.

Retirement Plans Considerations

Fully funding your company 401(k) with pre-tax dollars will reduce current year taxes, as well as increase your retirement nest egg. For 2017, the maximum 401(k) contribution you can make with pre-tax earnings is $18,000. For taxpayers 50 or older, that amount increases to $24,000.

If you have a SIMPLE 401(k), the maximum pre-tax contribution for 2017 is $12,500. That amount increases to $15,500 for taxpayers age 50 or older.

If certain requirements are met, contributions to an individual retirement account (IRA) may be deductible. For taxpayers under 50, the maximum contribution amount for 2017 is $5,500. For taxpayers 50 or older but less than age 70 1/2, the maximum contribution amount is $6,500. Contributions exceeding the maximum amount are subject to a 6 percent excise tax. Even if you are not eligible to deduct contributions, contributing after-tax money to an IRA may be advantageous because it will allow you to later convert that traditional IRA to a Roth IRA. Qualified withdrawals from a Roth IRA, including earnings, are free of tax, while earnings on a traditional IRA are taxable when withdrawn.

If you already have a traditional IRA, we should evaluate whether it is appropriate to convert it to a Roth IRA this year. You'll have to pay tax on the amount converted as ordinary income, but subsequent earnings will be free of tax. And if you have a traditional 401(k), 403(b), or 457 plan that includes after-tax contributions, you can generally rollover these after-tax amounts to a Roth IRA with no tax consequences. A rollover of a SIMPLE 401(k) into a Roth IRA may also be available. As with all tax rules, there are qualifications that apply to these rollovers that we should discuss before you take any actions.

Capital Gains and Losses

While most of the stock market has been soaring to new heights in 2017, there are some stocks, such as those invested in brick and mortar businesses, which have lost value during the year. If your stock portfolio includes such stocks and you've decided you want to divest yourself of them, we should evaluate whether you might benefit from selling off appreciated stocks, particularly those that would generate a short-term capital gain, and using the resulting gain to limit your exposure to a long-term capital loss, the deduction of which is limited. And any net capital gain you may reap, will be taxed at the substantially reduced capital gain tax rate.

The tax rate for net capital gain is generally no higher than 15 percent for most taxpayers. Some or all of your net capital gain may be taxed at 0 percent if you're in the 10 percent or 15 percent ordinary income tax brackets. However, a 20 percent tax rate on net capital gain does apply to the extent that your ordinary taxable income is taxed at the 39.6 percent tax rate. There are a few other exceptions where capital gains may be taxed at rates greater than 15 percent: (1) the taxable part of a gain from selling certain qualified small business stock is taxed at a maximum 28 percent rate; (2) net capital gains from selling collectibles (such as coins or art) are taxed at a maximum 28 percent rate; and (3) the portion of certain unrecaptured gain from selling real property is taxed at a maximum 25 percent rate. If you have been involved in any such transactions during the year, we should review your options for reducing the tax on those transactions.

Penalty for Failing to Carry Health Insurance

Despite numerous attempts by Congress to repeal Obamacare, the law is still with us and so is the penalty for not having health insurance coverage. You may be liable for this penalty if you or any of your dependents didn't have health insurance for any month in 2017. The penalty is 2.5 percent of your 2017 household income exceeding the filing threshold or $695 per adult, whichever is higher, and $347.50 per uninsured dependent under 18, up to $2,085 total per family. However, you may be eligible for an exemption from the penalty if certain conditions apply.

Reporting Healthcare Coverage

According to the IRS, if your tax return does not indicate whether or not you and your family had healthcare coverage during the year, your return will not be processed. This is the first year that the IRS is refusing to process returns if this information is omitted from the return.

Alternative Minimum Tax

A growing number of taxpayers are subject to the alternative minimum tax (AMT). If it looks like you may be subject to the AMT this year, there are certain strategies we should review to see if they may reduce or eliminate the impact of the AMT in your situation. All taxpayers are eligible for an exemption from the AMT, the amount of which depends on your filing status. For 2017, the exemption amounts for individuals, other than those subject to the kiddie tax, are (1) $84,500 in the case of a joint return or a surviving spouse; (2) $54,300 in the case of an individual who is unmarried and not a surviving spouse; and (3) $42,250 in the case of a married individual filing a separate return. However, these exemptions are phased out by an amount equal to 25 percent of the amount by which your alternative minimum taxable income (AMTI) exceeds: (1) $160,900 in the case of married individuals filing a joint return and surviving spouses; (2) $120,700 in the case of other unmarried individuals; and (3) $80,450 in the case of married individuals filing separate returns.

Certain adjustments to your taxable income for regular tax purposes are not allowed for AMT purposes and will increase your AMTI, thus potentially subjecting you to the AMT. Typical items which may reduce regular income but are not allowed for AMTI purposes include personal exemptions, the standard deduction, miscellaneous itemized deductions, state and local income taxes, property taxes, interest on a second mortgage where the proceeds from that second mortgage were not used for a qualified purpose (i.e., such as home improvements), and various tax credits. Thus, if you have a substantial increase in any of these items for 2017, but have not previously been subject to the AMT, there is more of a likelihood that you will be subject to the AMT for 2017. If you work from home, one strategy for avoiding the AMT is to allocate part of your mortgage interest or property taxes to your Schedule C business. To the extent you can claim items on your Schedule C, they will not be added back in calculating AMTI.

Charitable Donations from an IRA

Taxpayers 70 1/2 years old and older who own an IRA are required to take minimum distributions from that account each year and include those amounts in taxable income. If you are in this category, a special rule allows you to make a charitable contribution directly from your IRA to a charity. This has several benefits. First, since charitable contributions deductions are usually only available to individuals who itemize, individuals who take the standard deduction instead can benefit from this rule. Second, making the contribution directly to a charity counts towards your required minimum distribution but that amount is not included in income. This reduces taxable income as well as your adjusted gross income (AGI). A lower AGI is advantageous because it increases your ability to take deductions that you might not otherwise be able to take. For example, medical expenses are only deductible to the extent those expenses exceed 10 percent of your AGI, miscellaneous itemized deductions are limited to the excess of 2 percent of AGI, personal exemptions are phased out once AGI exceeds a certain threshold, and, as AGI increases, more of your social security income is subject to tax. Finally, the 3.8 percent net investment income tax, as discussed below, applies to the extent your AGI exceeds a certain level.

Gifting Appreciated Stock

You can reap a large tax benefit by donating appreciated assets, such as stock, to a charity. Generally, the higher the appreciated value of an asset, the bigger the potential value of the tax benefit. Donating appreciated assets not only entitles you to a charitable contribution deduction but you also avoid the capital gains tax that would otherwise be due if you sold the stock. For example, if you own stock with a fair market value of $1,000 that was purchased for $250 and the capital gains tax rate is 20%, the capital gains tax would be $150 ($750 gain x 20%). If you donate that stock instead of selling it, and are in the 28% tax bracket, you get an ordinary income deduction of $280 ($1,000 FMV x 28%). You also save $150 in capital gains tax that you would otherwise pay if you sold the stock. Thus, the after-tax cost of the gift of appreciated stock is $570 ($1,000 - $280 - $150) compared to the after tax cost of a donation of $1,000 cash which would be $720 ($1,000 - $280). However, it should be noted that a tax deduction for appreciated property is limited to 30 percent of your adjusted gross income.

Additionally, if you have children, particularly college age kids, we should consider if there is any income that can be shifted to them so that the tax on the income is paid at the child's tax rate. One strategy is gifting appreciated stock to the child. Where a child has earned income and is taxed at the bottom two income brackets, capital gains generated on the stock sale are taxed at 0 percent, instead of the 15 percent or more that the parent would pay. However, if the child has little or no earned income, the kiddie tax could be a factor. In this case, you will want to limit the child's unearned income to $2,100 or less for 2017 in order to avoid having your top tax rate apply to the child's income.

Vacation Home Rentals

If you rent out a vacation home that you also use for personal purposes, we should review the number of days it was used for business versus pleasure to see if there are ways to maximize tax savings with respect to that property.

Accelerating Income into 2017

Depending on your projected income for 2018, it may make sense to accelerate income into 2017 if you expect 2018 income to be significantly higher because of increased income or substantially decreased deductions. Options for accelerating income include: (1) harvesting gains from your investment portfolio, keeping in mind the 3.8 percent NIIT; (2) converting a retirement account into a Roth IRA and recognizing the conversion income this year; (3) taking IRA distributions this year rather than next year; (4) if you are self-employed and have clients with receivables on hand, try to get them to pay before year end; and (5) settling any outstanding lawsuits or insurance claims that will generate income this year.

Deferring Income into 2018 (RECOMMENDED IF PENDING TAX LEGISLATION BECOMES LAW)

If it looks like you may have a significant decrease in income next year, either from a reduction in income or an increase in deductions, it may make sense to defer income into 2018 or later years. Some options for deferring income include: (1) if you are due a year-end bonus, having your employer pay the bonus in January 2018; (2) if you are considering selling assets that will generate a gain, postponing the sale until 2018; (3) if you are considering exercising stock options, delaying the exercise of those options; (4) if you are planning on selling appreciated property, consider an installment sale with larger payments being received in 2018; and (5) consider parking investments in deferred annuities.

Deferring Deductions into 2018

If you anticipate a substantial increase in taxable income next year, it may be advantageous to push deductions into 2018 by: (1) postponing year-end charitable contributions, property tax payments, and medical and dental expense payments, to the extent deductions are available for such payments, until next year; and (2) postponing the sale of any loss-generating property.

Accelerating Deductions into 2017 (RECOMMENDED IF PENDING TAX LEGISLATION BECOMES LAW)

If you expect a decrease in income next year, accelerating deductions into the current year can offset the higher income this year. Some options include: (1) prepaying property taxes in December; (2) making January mortgage payment in December; (3) if you owe state income taxes, making up any shortfall in December rather than waiting until your state income tax return is due; (4) since medical expenses are deductible only to the extent they exceed 10 percent of adjusted gross income, bunching large medical bills not covered by insurance into 2017 to help overcome this threshold; (5) making any large charitable contributions in 2017, rather than 2018; (6) selling some or all loss stocks; and (7) if you qualify for a health savings account, setting one up and making the maximum contribution allowable.

Reducing Exposure to the 3.8 Percent Net Investment Income Tax

A 3.8 percent tax applies to certain net investment income of individuals with income above a threshold amount. The threshold amounts are $250,000 (married filing jointly and qualifying widow(er) with dependent child), $200,000 (single and head of household), and $125,000 (married filing separately). In general, investment income includes, but is not limited to: interest, dividends, capital gains, rental and royalty income, non-qualified annuities, and income from businesses involved in trading of financial instruments or commodities. Thus, while the top tax rate for qualified dividend income is generally 20 percent, the top rate on such income increases to 23.8 percent for a taxpayer subject to the net investment income tax (NIIT).

If it appears you may be subject to the NIIT, the following actions may help avoid the tax and we should discuss whether any of these options make sense in light of your financial situation.

> (1) Donate or gift appreciated property. As discussed above, by donating appreciated property to a charity, you can avoid recognizing the appreciation for income tax purposes and for net investment income tax purposes. Or you may gift the property so that the donee can sell it and report the income. In this case, you'll want to gift the property to individuals that have income below the $200,000 (single) or $250,000 (couples) thresholds.
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> (2) Replace stocks with state and local bonds. Interest on tax-exempt state and local bonds are exempt from the NIIT. In addition, because such interest income is not included in adjusted gross income, it can help keep you below the threshold for which the NIIT applies.
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> (3) If you are in the real estate business, we should review the criteria for being classified as a real estate professional. If you meet these requirements, your rental income is considered non-passive and thus escapes the NIIT.
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> (4) If you intend to sell any appreciated assets, consider whether the sale can be structured as an installment sale so the gain recognition is spread over several years.
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> (5) Since capital losses can offset capital gains for NIIT purposes, consider whether it makes sense to sell any losing stocks, but keeping in mind the transaction costs associated with selling stocks.
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> (6) If you have appreciated real property to dispose of and are not considered a real estate professional, a like-kind exchange may be more advantageous. By deferring the gain recognition, you can avoid recognizing income subject to the NIIT.

Because the NIIT does not apply to a trade or business unless (1) the trade or business is a passive activity with respect to the taxpayer, or (2) the trade or business consists of trading financial instruments or commodities, we may want to look at ways in which a venture you are involved with could qualify as a trade or business. However, such classification could have Form 1099 reporting implications whereas personal payments are not reportable.

Liability for the .9 Percent Medicare Tax

An additional Medicare tax of 0.9 percent is imposed on wages, compensation, and self-employment income in excess of a threshold amount. The threshold amounts are $250,000 (joint return or surviving spouse), $125,000 (married individual filing a separate return), and $200,000 (all others). However, the threshold amount is reduced (but not below zero) by the amount of the taxpayer's wages. Thus, a single individual who has $145,000 in self-employment income and $130,000 of wages is subject to the .9 percent additional tax on $75,000 of self-employment income ($145,000 - $70,000 (the $200,000 threshold - $130,000 in wages)). No tax deduction is allowed for the additional Medicare tax.

For married couples, employers do not take a spouse's self-employment income or wages into account when calculating Medicare tax withholding for an employee. If you and your spouse will exceed the $250,000 threshold in 2017 and have not made enough tax payments to cover the additional .9 percent tax, you can file Form W-4 with the IRS before year end to have an additional amount deducted from your paycheck to cover the additional .9 percent tax. Otherwise, underpayment of tax penalties may apply.

Foreign Bank Account Reporting

The IRS has been actively pursuing individual who fail to report their holdings in foreign accounts. If you have an interest in a foreign bank account, it must be disclosed; failure to do so carries stiff penalties. You must file a Report of Foreign Bank and Financial Accounts (FBAR) if: (1) you are a U.S. resident or a person doing business in the United States; (2) you had one or more financial accounts that exceeded $10,000 during the calendar year; (3) the financial account was in a foreign country; and (4) you had a financial interest in the account or signatory or other authority over the foreign financial account. If you are unclear about the requirements or think they could possibly apply to you, please let me know.

The deadline for filing a FBAR is April 15. However, a six-month extension is available. If you are abroad, the due date is automatically extended until June 15, with an additional four-month extension available until October 15.

Flex Spending Accounts

Generally, you will lose any amounts remaining in a health flexible spending account at the end of the year unless your employer allows you to use the account until March 15, 2018, in which case you'll have until then. You should check with your employer to see if they give employees the optional grace period to March 15.

Health Savings Account (HSA) Funding

Taxpayers have until April 15, 2018 to make deductible HSA contributions for 2017. The maximum contribution limit for 2017 is $ 3,400 for single coverage, $ 6,750 for family coverage, and an additional $ 1,000 contribution for those employees 55 years of age and older. The employee, the employer, or both may contribute to the employee's HSA in the same year as long as the aggregate contributions are under the contribution limit.

Guard Your Identity

Each year, the IRS warns taxpayers about the dangers of identity theft and fraudulent returns. While the IRS reported nearly 275,000 fewer victims in 2016 than 2015, it is important to be vigilant and take every opportunity to protect your personal information. Contact the IRS immediately if you notice suspicious activity, such as receiving a call from someone asking you to pay back taxes with a credit card or receiving a letter about a refund when you didn't yet file your return.

Tax Reform

As mentioned before, the President and the Republican leadership in Congress have now elevated tax reform to be their highest legislative priority. Most of the proposals so far have dealt with lowering tax rates and reducing the number of tax brackets, doubling the standard deduction, and getting rid of the personal exemptions as well as almost all personal deductions except for the charitable contribution deduction and home mortgage interest deduction (which would stay on the books, but become unavailable to most taxpayers). There has also been talk of eliminating the AMT and estate taxes.

We are hesitant to speculate what the end result will be, and many of the proposed changes do not lend themselves to year-end planning opportunities. The one big exception is the potential repeal of most personal deductions, which does create a stronger than usual incentive to accelerate deductions into the current year. Whether that's a smart move depends on other factors, such as whether you'll be subject to AMT this year, and what direction you see your income heading in next year.

Go to the Tax Reform Updates tab on our website www.messina-cpa.com for a recap of the most recent tax proposals. Please give us a call before the end of the year if we can assist you in any steps necessary to reduce your tax burden as much as possible.

Sincerely,

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