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Certified Public Accountants & Advisors

Client Tax Letter

Tax Saving and Planning Strategies *from your* **Trusted Business Advisor**sm

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Uncertainty Hampers Year-End Tax Planning

As of this writing, year-end tax planning is clouded by questions about federal legislation. President Trump and many of the Republicans in Congress favor changes that would affect the tax code. Currently, the success they'll have in their efforts is difficult to predict.

One undecided issue is the future of the Affordable Care Act (known as Obamacare), which might be retained, replaced, or repealed. Although this act addresses health insurance, it includes several provisions relating to taxes. For instance, it includes a 3.8% surtax on net investment income reported by certain high-income taxpayers—this surtax could be abolished.

In addition, President Trump urged far-reaching changes to the Internal Revenue Code. Full details of this plan have yet to be revealed but could include lower tax rates for individuals and businesses. As an offset, some itemized deductions, including those for medical expenses, as well as state and local taxes, could be eliminated.

Be prepared

How can you plan for tax savings at year-end in this environment? One vital step is to arrange for a tax planning meeting in late 2017. By November or December, we may know more about changes to the tax code and the effective dates.

For now, a basic strategy might be to delay certain income-generating events until 2018 and to accelerate deductions into 2017, when practical.

Example: Marge Wilson is planning a sale of income-producing property, which she expects to produce a substantial long-term capital gain. Marge anticipates that

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Shrinking Share

Union membership in the United States peaked in 1954 at nearly 35% of all U.S. wage and salary workers, but that number is now around 11%.

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such a gain would be taxed at a 20% rate, as well as the 3.8% surtax on net investment income. Unless there is a pressing reason to close the deal by the end of 2017, Marge could wait until 2018 in the hope of avoiding the 3.8% surtax.

Regarding health insurance, business owners and employees and self-employed individuals should weigh the pros and cons of high deductible plans when choosing coverage for next year. High deductible policies may be linked with health savings accounts (HSAs), if certain requirements are met. HSAs, in turn, offer unique tax benefits: deductible contributions, untaxed investment income inside the account, and tax-free distributions for qualified health care. However, high deductible health plans may lead to greater expenses for medical care before the insurance takes effect.

Taxing issues

Deferring income may pay off if Trump's tax plan leads to lower rates. Self-employed individuals might consider delaying year-end billing for work done in hopes they'll owe tax at, say, 25% instead of 28% or 33%.

That said, the proposed demise of certain itemized deductions might be worrisome. In some circumstances, accelerating expenses for medical bills, state estimated tax, and property tax from 2018 to 2017 could provide deductions in 2017 that might no longer be available in 2018. At year-end tax planning meetings, our office can recommend moves that are suitable in your specific situation. ■

Year-End Planning for Investors

Regardless of future legislation, some tried and true strategies will help investors trim their tax bill in 2017. Year-end loss harvesting can be worthwhile.

Example 1: Nick Rogers tallies his investment trades so far in 2017 and discovers he has realized $30,000 worth of net capital gains: his trading profits versus his trading losses. If those gains are all long-term (the assets were held more than one year), Nick would owe $4,500 to the IRS at his 15% rate.

Therefore, Nick goes over his portfolio to see if he has securities that he can sell at a loss. Although recent stock prices were generally strong, Nick has some energy and telecom shares that have lost value. If Nick takes $15,000 worth of losses in 2017, he will drop his net capital gain from $30,000 to $15,000, cutting his 2017 tax bill from his trading in half.

Example 2: Suppose that Nick can take $35,000 worth of losses by year-end. That would convert his $30,000 net capital gain for 2017 to a $5,000 net capital loss, avoiding any tax owed on Nick's trades this year.

In addition, taxpayers generally can deduct up to $3,000 worth of net capital losses on their annual tax returns. Assuming Nick is in a 33% tax bracket, a $3,000 net capital loss would save him $990—much better than a tax bill of $4,500.

Don't forget funds

When you tally your year-end net gains or losses to date, don't neglect to check your mutual funds. Many funds make distributions to shareholders in December; estimates of upcoming distributions may be posted on the fund's website before the payout.

Whether you receive the money or automatically reinvest in more shares of the fund, distributions from funds held in a taxable account will be taxable. These payouts could be interest, dividends, or capital gains, and taxed accordingly. A distribution of short-term capital gains, for instance, may be taxed more heavily than a distribution of long-term capital gains.

Be careful of how you purchase funds near year-end. If you buy before the payout (technically, the "ex-dividend" date), you will receive the scheduled distribution and owe tax on that amount. (Reinvested distributions add to your basis, which would produce a better tax result when you sell the shares.) Conversely, if you wait until after the distribution, you'll avoid the resulting tax and possibly buy at a lower price, as fund shares typically drop after the payout.

Selling shares before the distribution will enable you to avoid the tax on a distribution you haven't received. You may sell at a higher price before the payout, which would increase your taxable gain or reduce your capital loss from the sale. The bottom line is that the timing of mutual fund trades can be a topic for discussion in year-end tax planning sessions.

Gaining from gains

In example 2, Nick has a net capital loss of $5,000 in 2017, of which he can deduct $3,000. What happens to the other

Did You Know?

Baby boomers are delaying retirement. In the first quarter of 2017, the 55 and older age group had 4.8% job growth, more than any other age group. Key implications are that many older boomers still need to work, and there is strong demand for these workers and their skills.

Source: Automatic Data Processing

$2,000? If he wishes, Nick can carry over that $2,000 loss to future years to offset future capital gains. There are no limits to the amount of losses Nick can carry over or the length of time he can do so.

Example 3: Yet another option is for Nick to sell enough assets to produce an additional $2,000 gain by December 31. This gain will be tax-free because Nick can use his excess $2,000 net capital loss as an offset. If Nick wants, he can immediately buy back the shares he sold.

Why would Nick do this? To increase his basis in the shares he sold and bought. As mentioned, a higher basis will yield a better tax result on a future sale. This maneuver might work best with a mutual fund that does not charge for such transactions.

Going forward

After selling assets at a *gain*, an immediate repurchase can produce a smaller taxable gain or a larger capital loss in the future. A similar repurchase after a sale for a *loss*, though, can trigger the wash sale rule; then, the capital loss won't count and no current tax benefit will be allowed. The amount of the disallowed loss will be added to your basis in the repurchased assets.

To avoid a wash sale after taking a capital loss, several tactics can be used. You can wait for at least 31 days and then buy back the security you sold, if you still want to hold it. If you don't want to be out of the market that long, you can immediately buy another security that's not substantially identical to the one you sold. Yet another possibility is to "double up."

Example 4: As part of his plan to take losses near year-end, Nick intends to sell $10,000 worth of an energy stock that has lost value. He believes this stock is now well valued, so he wants to maintain his position in this holding.

To do so, Nick first invests another $10,000 in this stock, then waits 31 days and takes a $10,000 loss by selling shares that he previously held. Nick will wind up in the same position but will be able to take the $10,000 loss on the original shares. Because of the timing, a doubling up strategy must be initiated before the end of November to provide a 2017 tax benefit. ■

Year-End Retirement Tax Planning

If your company sponsors a 401(k) plan, your employer may offer a match. Make certain that you're contributing at least enough in 2017 to get the full match, which is essentially free money. The same is true when you're setting up your 2018 contributions late this year.

Example 1: Jill Myers earns $100,000 a year working for a company that offers a 50% match on 6% of pay. For Jill, 6% of pay is $6,000, so Jill must be sure that she has contributed at least $6,000 to her 401(k) in 2017 to get a $3,000 match, and that she'll contribute at least that much in 2018. That's an assured 50% return on her money.

Many companies now offer both a traditional 401(k) and a Roth 401(k). With the traditional version, contributions reduce taxable income and the current tax bill, but future distributions will be taxable. Roth 401(k) contributions offer no current tax benefit, but distributions will all be tax-free after age 59½, if you have had the account for at least five years.

If both versions are available, which should you choose for 2018 contributions? Employees in relatively low tax brackets may prefer the Roth 401(k) because the current tax savings will be modest and the advantage of tax-free withdrawals in retirement may be significant.

Employees in higher brackets may opt for the traditional 401(k) for upfront tax reduction. That's especially true for those who expect to be in a lower tax bracket after retirement. On the other hand, even plan participants with high income might choose the Roth side if they wish to have a source of tax-free cash flow in retirement and they already have ample pretax funds in the traditional 401(k). Note that all matches to a Roth 401(k) contribution will go into the participant's traditional 401(k) account.

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Considering contributions

In 2017, the maximum you can contribute to a 401(k) as a plan participant is $18,000, or $24,000 if you will be at least age 50 at year-end. As of this writing, the 2018 limits haven't been released, but some estimates indicate they could be $18,500 and $25,000. When you're finalizing your 2017 contributions and setting the amounts of income you'll place in the plan in 2018, should you choose the maximum amounts? That could be a savvy selection, but you should consider the alternatives.

Instead of maxing your 401(k), you may prefer to pay down any credit card balances. Credit card interest is not tax deductible, so paying off a card with a 15% interest rate is the equivalent of earning 15%, after tax, with no investment risk. It's possible you'll earn that much or more with an unmatched 401(k) contribution, which offers tax deferral, but that's not a sure thing.

The choice between unmatched 401(k) contributions and paying down a home mortgage or student loans is a tougher call. Mortgage interest usually is tax deductible, and student loan interest might be, as well.

Example 2: Jill Myers has a mortgage with a 4% interest rate. In her 25% tax bracket, Jill's return on paying down the mortgage would be 3%, and after tax, 75% of 4%. Jill believes she could earn more than that in her 401(k), so she increases her 2017 contributions to her 401(k) at year-end and raises her contributions for 2018, rather than planning on sending extra amounts to reduce her mortgage balance.

If her company does not offer a Roth 401(k), Jill may have to make another choice. She could reduce the amount she'll specify for unmatched 401(k) contributions and plan to contribute to a Roth IRA instead. As is the case with a Roth 401(k), Roth IRAs are funded with after-tax dollars but may deliver untaxed cash flow in the future. Roth IRA contributions in 2017 can be up to $5,500, or $6,500 for those 50 or older.

Example 3: Suppose Jill is age 40, and she has been putting $500 per month into her 401(k), for an anticipated total of $6,000 in 2017. As the year-end approaches, Jill believes she can contribute a total of $15,000 to retirement funds for 2017. Besides the $6,000 to get a full employer match in example 1, Jill decides to put $5,500 into a Roth IRA and a total of $9,500 into her 401(k). Therefore, Jill has her employer increase her 2017 401(k) contribution by $3,500, and she also sets her 2018 contribution at $800 a month, or $9,600 a year. Jill has until April 17, 2018, to make her 2017 Roth IRA contribution.

IRA withdrawals

IRA owners also have some year-end tax planning opportunities. Money in a traditional IRA compounds, tax deferred, but required minimum distributions (RMDs) take effect after age 70½.

Example 4: Bert Palmer, age 75, has $1 million in his IRA. The IRS Uniform Lifetime Table puts his "distribution period" at 22.9 years, so Bert divides $1 million by 22.9 to get his RMD for this year: $43,668. If Bert withdraws less, he'll owe a 50% penalty on the shortfall. (If you're 70½ or older, you should withdraw at least the RMD amount.)

Although Bert does not need the money for living expenses, he must take the distribution to avoid the penalty. That $43,668 is added to Bert's other income, so the effective tax on that distribution can be steep.

Suppose that Bert dies with that $1 million IRA, which passes to his daughter, Carol. Carol must take RMDs each year, regardless of her age. If Carol is now a middle-aged, successful executive with a high income, those RMDs likely will be heavily taxed. Indeed, pretax money in a traditional IRA probably will be taxed when paid out, whether to the IRA owner or to a beneficiary.

Therefore, IRA owners may want to take distributions before age 70½. Careful planning can fine tune the amount withdrawn at year-end 2017, keeping taxable income within a relatively low tax bracket. Withdrawn funds may be spent, given to loved ones, reinvested elsewhere, or moved to a Roth IRA for potential tax-free treatment in the future. Our office can go over your specific situation to assess whether it makes sense to reduce your traditional IRA before age 70½ and, thus, decrease the amount of RMDs for you and for your beneficiaries. ■

Year-End Tax Planning for Charitable Donations

Some surveys indicate that more than 30% of all charitable giving occurs in December, and that over 10% of donations are made in the last three days of the year. The year-end holiday spirit may be a factor in the early winter philanthropy, but taxes probably play a role, as well. A check you write to your favorite charity in December gives you a tax deduction the following April, but if you wait until New Year's, you'll have to wait a full year for the tax benefit.

To do well while doing good, you might reconsider the typical practice of writing checks for gifts to charity. Instead, give appreciated securities. Going into the ninth year of a bull market, you probably have stocks or stock funds that have gained value and would be ideal for contributing to your favorite cause.

Example 1: Wendy Harris donates, by check, $5,000 every year to a cancer research charity. This year, Wendy looks

over her portfolio and sees that one of her stocks has appreciated substantially since its purchase in 2015, so she decides to reduce her exposure to that company.

Wendy paid $30 each for the shares, which now trade at $50. If she sells $5,000 worth of those shares, Wendy would have a $2,000 long-term capital gain and owe $300 to the IRS, at a 15% tax rate. Instead, she donates $5,000 worth of shares to her favorite charity.

With this tactic, Wendy would get the same $5,000 tax deduction that she would have received with a cash contribution. If the assets have been held longer than one year, donors can deduct the fair market value of the contribution. Yet, the donated shares would have been worth only $4,700 to Wendy if she had sold them and paid the tax on her gain.

Meanwhile, the recipient can sell the shares for $5,000 and owe no tax as a charitable organization. Therefore, Wendy gets a full tax break, the charity keeps the full amount, and the capital gain tax obligation is never paid.

Multiple choice

The strategy followed by Wendy can be effective if you wish to make one or two charitable gifts of appreciated securities. However, if you want to make many gifts to various charities, the process can get cumbersome. (See the **Trusted Advice** box.) In these situations, you might want to contribute via a donor-advised fund.

Example 2: Jack Franklin donates $5,000 a year to 10 different charities, at $500 each. Jack sends $5,000 of appreciated securities, bought years ago for $3,000, to a donor-advised fund. If he donates the securities by December 31, 2017, Jack can take a $5,000 deduction on his 2017 tax return. Once the money is in the donor-advised fund, Jack can request grants of $500 each to his 10 designated recipients. Even if he requests the grants after 2017, his tax break for this year won't be affected.

Many financial firms and community foundations offer donor-advised funds, and they might have different requirements for the initial contribution, subsequent contributions, and individual grants.

Senior strategies

Yet another charitable opportunity is available for IRA owners over age 70½. Instead of writing checks or donating appreciated assets, they can make qualified charitable distributions (QCDs) from their IRAs, up to $100,000 per donor per year.

Example 3: Phyllis Thompson, age 77, donates a total of $3,000 a year to 3 different charities. Phyllis takes the standard deduction, rather than itemizing, so she gets no tax benefit from these donations.

In 2017, Phyllis donates via QCDs: she sends the $3,000 directly from her IRA to the 3 charities. In this example, Phyllis has a required minimum distribution of $15,000 in 2017. The $3,000 QCD counts as part of her RMD, so Phyllis satisfies her full RMD with a $12,000 IRA withdrawal.

Here, Phyllis has fulfilled her philanthropic intentions and the charities have received their funds. Instead of paying tax on a $15,000 taxable RMD, Phyllis picks up $12,000 of taxable income, saving tax by using QCDs.

Note that people who itemize deductions can't deduct QCDs. Even so, there may be tax advantages from using QCDs because making RMDs to charity, rather than to IRA owners, will reduce adjusted gross income (AGI). A lower AGI, in turn, may deliver benefits elsewhere on the IRA owner's tax return. ■

Trusted Advice

Donating Appreciated Shares

- Check with the charitable recipient to determine its procedure.
- You may need to obtain the charity's brokerage account number, then inform your broker or mutual fund company, which can execute the share transfer.
- Some financial firms have their own forms to be signed by the donor and the charity's representatives. Other paperwork might be required.
- The earlier you begin the process, the greater the probability of completing the transfer by December 31, for a 2017 tax deduction.
- Rather than donate shares that trade at a loss, you can sell those shares, take the capital loss for tax advantages, and donate the cash proceeds.

Year-End Business Tax Planning

IRC Section 179 permits "expensing," or first-year tax deduction, of outlays for business equipment that otherwise would be recovered through depreciation over many years. For 2017, expensing the costs of up to $510,000 of equipment is allowed, with a phase-out beginning after $2.03 million of purchases.

Example 1: ABC Corp. spends $400,000 on equipment and off-the-shelf computer software equipment in 2017. The company can deduct $400,000 this year on those purchases. To qualify for this Section 179 tax treatment in 2017, the equipment or software must be purchased and placed into service by December 31.

Example 2: DEF Corp. spends $800,000 on qualified items in 2017. The first $510,000 can be deducted immediately, but the other $290,000 must be depreciated.

Example 3: GHI Corp. spends $2.4 million on equipment and software in 2017. Above $2.03 million, there is a dollar-for-dollar phaseout of IRC Section 179 tax benefits, so the $370,000 phaseout limits first year deductions to $140,000. The remaining $2.26 million must be depreciated.

Bountiful bonus

Beyond IRC Section 179, "bonus" depreciation is in effect in 2017. Companies can depreciate 50% of the cost of relevant equipment acquired and placed in service this year—that would be a $145,000 deduction in the case of DEF Corp. in example 2 (50% of $290,000), in addition to the $510,000 deduction under IRC Section 179. Bonus depreciation will drop from 50% to 40% in 2018 and to 30% in 2019; this tax break applies only to new equipment, whereas Section 179 expensing applies to used and new equipment.

Sooner or later

As explained previously, there is considerable uncertainty about whether tax legislation will pass this year and what such a law might include. Lower tax rates are a possibility. Consequently, you might plan to defer business income into 2018, when tax rates might drop, and accelerate company deductions into 2017 to offset highly taxed income.

In terms of deferring income, if your company uses the cash method of accounting, you could delay sending out invoices late in the year, so you'll receive the payments (and owe the tax) in 2018. Deferring income can be more challenging if your company uses the accrual method of accounting, but, in certain circumstances, you may be able to defer income, even where you have been paid in advance. Our office can let you know if this is a practical approach for your firm and help with the required paperwork.

Even if tax rates do not drop under a new law, deferring income—and the resulting tax—for a year may be helpful for your company's cash flow. Similarly, accelerating deductible expenses from early 2018 to late 2017 may be advisable. Necessary equipment repairs might be pushed forward, for example.

If your company pays substantial bonuses to employees, consider the timing as 2017 ends. Cash method businesses might pay those bonuses in December. Companies on the accrual method generally can deduct bonuses to unrelated employees in 2017, if their obligation to pay the bonuses is fixed and determinable at year-end and they make the bonus payments within 2½ months after year-end. ■

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