Year-end tax planning strategies

Getting clients ready for tax season

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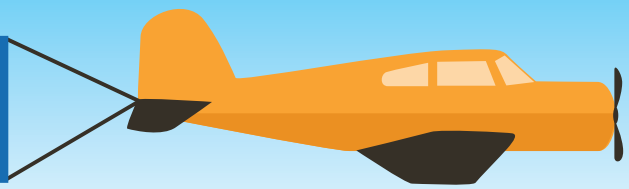

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While tax season won't begin in earnest until the W-2s and 1099s arrive, practitioners need to touch base with their clients well before then to discuss any year-end tax planning strategies that may be appropriate for reducing a client's taxes. In evaluating the most suitable approach, one of the first things to consider is whether tax rates will go up or down next year. Currently, no significant change in tax rates is expected in 2016. Thus, the marginal tax rates should remain the same, with the top tax rate being 39.6%.

For 2015, this top rate applies to incomes over $413,200 (single), $464,850 (married filing jointly and surviving spouses), $232,425 (married filing separately), and $439,000 (heads of households). However, as discussed below, a 3.8% net investment income tax may also apply to certain high-income taxpayers, and there are strategies to consider when dealing with this additional tax.

POSTPONING INCOME, ACCELERATING DEDUCTIONS

Typically, if a client is expected to be in a lower tax bracket in the future, it generally makes sense to defer income into later years and accelerate deductions into the current year. This strategy can help move the taxpayer into a lower tax bracket in the current year. It can also help the taxpayer avoid crossing the threshold at which he or she is subject to the net investment income tax or subject to losing all or part of certain deductions (e.g., the dependency exemption). In addition, lowering the taxpayer's income and accelerating expenses into the current year can make it easier to deduct expenses subject to the 2%-of-adjusted-gross-income threshold.

Some actions to consider in postponing income are:

- Pushing the sale of a gain-generating asset into the next year;
- Structuring the sale of a gain-generating asset as an installment sale;
- Deferring any year-end bonuses;
- Using the like-kind exchange provisions to defer recognizing gain on dispositions of business or investment property; and
- Delaying the collection of outstanding accounts receivables until the following year.

Some actions to consider in accelerating deductions are:

- Making fourth-quarter state estimated tax payments in the current year;
- Prepaying property taxes due the following year;
- Prepaying January's mortgage in December;
- Bunching medical and dental expenses into the current year if it's expected that those expenses for the current and following year will exceed the AGI floor limitation applicable to such expenses;
- Moving future charitable donations into the current year; and
- Harvesting losses from stocks or other assets by selling them before year end.

Note that, because short-term capital gains are taxed at ordinary income rates, if a client's income includes such gains, then harvesting short-term capital losses first to offset those gains is advisable.

ACCELERATING INCOME, POSTPONING DEDUCTIONS

Alternatively, if a client expects a substantial increase in income or anticipates using a less favorable tax filing status in the next year, accelerating income into the current year or deferring deductions to the following year may be an appropriate strategy to lessen the client's tax bill next year. Actions to consider for accelerating income are:

- Creating incentives for customers or clients to pay outstanding receivables in the current year;
- Advance billing of clients;
- Moving up planned retirement plan distributions to the current year rather than taking them in the next year (assuming the 10% penalty tax on early distributions to individuals under 59½ years old does not apply);
- If installment payments are being received, moving more installment income into the current year by either selling the installment note, having the debtor pay off the note, or using the note as collateral on a loan;
- Settling any legal disputes that might result in taxable income before next year;
- Selling gain-generating assets this year; and
- If government bonds on which interest income is being deferred are owned, making the election to recognize interest income currently, including interest deferred from prior years.

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Strategies to consider for deferring deductions include:

- Delaying the purchase of business property that will generate depreciation and Sec. 179 deductions;
- Bunching deductions (e.g., charitable contributions, expenses for medical and dental visits and surgery (to the extent they exceed the applicable limitation), property taxes, etc.) into the following year;
- Delaying the payment of state estimated tax payments to the following year, but taking into consideration any late-payment penalties;
- Delaying any actions that might establish the worthlessness of a debt until the following year when a bad debt deduction can be taken; and
- Postponing the sale of loss-generating property.

NET INVESTMENT INCOME TAX

Additionally, practitioners must consider the impact of the net investment income tax, which applies to individuals, estates, and trusts with income over a specified threshold. The tax is 3.8% on the lesser of net investment income or the amount by which the taxpayer's modified adjusted gross income (MAGI) exceeds a threshold amount. That threshold amount is $250,000 for married filing jointly and surviving spouses, $125,000 for married filing separately, and $200,000 for all others.

To lessen exposure to the net investment income tax, and if it otherwise makes good financial sense, taxpayers should consider moving income-producing investments to tax-exempt bonds, thereby lowering their MAGI and avoiding the net investment income tax. Because dividends are subject to the net investment income tax, pursuing growth stocks over dividend-paying stocks may be appropriate. The capital gains won't be subject to the net investment income tax until the stocks are sold, and capital gains, unlike dividends, can be offset by capital losses.

Additionally, because the net investment income tax applies to income from passive activities, it is worth seeing if anything can be done to reclassify a client's passive activity to a nonpassive activity. One of the biggest sources of passive activity income is rental income, which is *per se* passive income. However, such income is not automatically considered passive if the taxpayer qualifies as a real estate professional.

If a taxpayer meets the requirements to be a real estate professional, and the taxpayer materially participates in the activity, the income from the activity is not passive income. Material participation is determined for each rental activity separately, unless the taxpayer makes the election to treat all rental activities as a single activity. If the separate or grouped activities qualify as a trade or business, the income from them is excluded from the net investment income tax under the "ordinary course of a business" exception.

In addition, under a special safe harbor, a taxpayer that is a real estate professional as defined in the passive loss rules can exclude income from a rental activity from net investment income if he or she participates in the rental activity for more than 500 hours per year, or for more than 500 hours or more in any five tax years out of the past 10 tax years. If a real estate professional taxpayer makes an election to group all rental activities as a single rental activity under the passive loss rules, the election applies for net investment income tax purposes. Practitioners should ensure that clients eligible to group rental activities together do so because it will generally make it easier to qualify as a real estate professional and easier to offset nonpassive income with rental activity losses while avoiding the net investment income tax.

Practitioners should also review clients' participation levels in an activity and, if a client is near the cutoff between materially participating and not materially participating, recommend that the client put in additional hours to bring his or her participation level up to that of materially participating.

Where a client with passive activities is meeting the criteria for applying the net investment income tax rules for the first time, a review of the client's prior passive activity grouping elections may be appropriate to see if new groupings can reduce or avoid the net investment income tax. By grouping two activities into a larger activity, the taxpayer need only show material participation in the activity as a whole rather than in each activity. While regrouping after 2013 or 2014 is not generally allowed unless the prior grouping was clearly inappropriate or there is a material change in facts and circumstances, a special net investment income tax rule allows taxpayers to regroup activities in the first year in which they meet their applicable MAGI threshold and have net investment income.

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Because distributions from a qualified plan are not subject to the net investment income tax, practitioners may want to recommend that individual clients with their own businesses start a qualified plan.

CHARITABLE DONATION PLANNING

Practitioners who have clients with hefty stock portfolios may want to recommend to those wishing to make charitable contributions that they consider using appreciated corporate stock. Assuming a client itemizes deductions, not only is the cost of the stock deductible, but the appreciation on the stock is deductible as well. Otherwise, if the stock is sold, the appreciation may be subject to capital gains tax and the net investment income tax.

RETIREMENT PLANNING

A practitioner should not forget to impress upon clients the tax savings associated with maxing out their retirement plan contributions. For 2015, the limitations on 401(k), 403(b), and 457(b) plan contributions is $18,000. For a taxpayer in the 25% tax bracket, that equals a tax savings of $4,500. The catch-up contribution limitation for individuals age 50 and older is $6,000. That translates into another $1,500 of savings for an individual in the 25% tax bracket for a total tax savings of $6,000. If a client's employer provides a 401(k) match, it's especially important that the client contribute the maximum amount required to get the full match from the employer. Otherwise, the client is leaving free money on the table.

For individual retirement arrangements (IRAs), the maximum deductible contribution is $5,500, with a catch-up contribution of $1,000.

Additionally, for high-income individuals covered by an employer's retirement plan, there is always the option of investing in a nondeductible IRA. While this option is not right for most people, the tax deferral may still be worth something, depending on a client's situation and the type of assets funding the IRA. First, the downside. Putting money in a nondeductible IRA rather than a taxable account means the client can't reach the money until he or she turns 59½ without incurring a penalty.

Additionally, capital gains in a taxable account, as opposed to in an IRA, are taxed at the reduced capital gain rates, whereas money withdrawn from an IRA is taxed at the client's regular tax rate. However, if the IRA is funded with 30-year bonds instead, the net amount at the end of the 30 years will yield more income to the client even after paying taxes on the IRA withdrawal as a result of compounding the interest income and not having to currently pay taxes on that interest.

Finally, it may be advantageous for clients who haven't done so already, to convert their IRA to a Roth IRA. While the client will pay tax on the amount of deductible contributions that have been made to the IRA and all the appreciation that has taken place in it up to that point, the future appreciation in the account will be tax-free if certain requirements are met (i.e., a five-year waiting period has passed and the account owner is age 59½ or over, disabled, or deceased). Whether such a conversion is the right path for a particular client depends on several factors.

First, since the client will have to include the amounts converted, other than nondeductible contributions to the account, in income, converting an IRA during a year a client is in a lower tax bracket makes more sense than if the client is in a higher tax bracket. Second, the client should consider when he or she is going to need the money in the account. The benefits of a Roth IRA account increase the longer the money is in the account. So if a client's time horizon for keeping the money in the account is short, converting to a Roth IRA may not be in the client's best interest.

Finally, because there are no required minimum distributions from a Roth IRA as there are from a traditional IRA, if the client's tax rate will be the same or higher in years when an RMD is required, then converting to a Roth IRA may make sense. ■

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