2016 Year-End Tax Planning for Individuals

Individual income taxes, whether paid through employer withholding or quarterly estimates, are probably one of your largest annual expenditures. So, just as you would shop around for the best price for food, clothing, or merchandise, you want to consider opportunities to reduce or defer your annual tax obligation. This *Tax Letter* is intended to assist you in that effort.

Your 2016 year-end tax planning begins with a projection of your estimated income, deductions, and tax liability for 2016 and 2017. You should review actual amounts from 2015 to assist you with these projections. To the extent you can control the timing of income and deductions between 2016 and 2017, you should make decisions that will result in the lowest overall tax for both years. If shifting income and deductions between 2016 and 2017 does not reduce your overall tax liability, you should try to defer as much tax liability as possible from 2016 to 2017.

Tax planning for individuals also requires consideration of the tax consequences to any businesses conducted directly or indirectly by the individual owners. This *Tax Letter* discusses planning for federal income taxes. However, state income taxes should also be considered. Your client service professional can be consulted regarding state tax matters.

November Election Results

Just as this newsletter was going to press, the results of the November elections became evident. Donald Trump became President-elect and the Republicans maintained control of the House with 239 seats and the Senate with 51 seats. Although compromise with Democrats will still be required in the Senate where 60 votes are often needed to bring legislation to the President for consideration, the likelihood is great that significant tax changes could result. Thus, as you read this newsletter please keep in mind that 2017 could be a remarkable year for tax law changes. Such changes could materially alter behavior concerning how businesses and individuals structure their financial affairs to maximize net worth and revenue after taxes. Because of the necessary give and take required to obtain a tax bill that passes both houses of Congress, the ability to predict with certainty the contents of broad based tax legislation is impossible. Nevertheless, President-elect Trump's tax plan may provide some insight as to the likely direction such tax legislation might take. Some of the aspects of his plan include:

- Repeal of estate, gift and generation skipping transfer taxes;
- Three ordinary income tax rates of 12%, 25% and 33%
- Three long term capital gains tax rates of 0%, 15% and 20%
- Repeal of the alternative minimum tax
- Repeal of the 3.8% net investment income tax
- Cap itemized deductions for married filing joint taxpayers to $200,000 and for single taxpayers to $100,000
- Carried interests will be taxed as ordinary income
- Business tax rates would be lowered from 35% to 15%
- Deemed repatriation of corporate profits held offshore at one-time rate of 10%

Considering these possibilities, you might want to consider:

- Accelerating deductions into 2016. Consider, for example making 2016 contributions to private foundations or donor advised funds and paying property taxes in 2016 instead of 2017.
- Deferring capital gains and the exercise of incentive stock options (ISOs). Weigh the potential market risk with the potential for tax rates in 2017.
- Restructuring holdings in 2017 to take advantage of the potentially lower business tax rates.
- Waiting on gift planning.

2016 Versus 2017 Marginal Tax Rates

Whether you should defer or accelerate income and deductions between 2016 and 2017 depends to a great extent on your projected marginal (highest) tax rate for each year. The highest marginal tax rate for 2016 and 2017 is nominally 39.6%, but certain provisions that reduce deductions as income increases may also increase the effective marginal tax rates slightly. Also, an additional 3.8% tax on unearned income of high-income taxpayers applies for taxable years beginning after December 31, 2012. The tax brackets for 2016 and 2017 are included in this *Tax Letter* (see page 3). Projections of your 2016 and 2017 income and deductions are necessary to estimate your marginal tax rate for each year.

Shifting Income and Deductions Into the Most Advantageous Year

You can shift taxable income between 2016 and 2017 by controlling the receipt of income and the payment of deductions. Generally, income should be received in the year with the lower marginal tax rate, while deductible expenses should be paid in the year with the higher marginal rate. If your top tax rate is the same in 2016 and 2017, deferring income into 2017 and accelerating deductions into 2016 will generally produce a tax deferral of up to one year. On the other hand, if you expect your tax rate to be higher in 2017, you may want to accelerate income into 2016 and defer deductions to 2017.

Interest on U.S. Series EE savings bonds

Other than not being taxable until the proceeds are received, interest on issued Series EE bonds may be exempt from tax if the proceeds of the bond are used to pay certain educational expenses for yourself or your dependents, and the requirements of "qualified United States savings bonds" are met.

IRA distributions

All distributions from a regular individual retirement account ("IRA") are subject to ordinary income taxes. This tax liability can be delayed until age 70½ at which time you are required to begin taking distributions from your IRA. The ten percent (10%) early withdrawal penalty prevents distributions before age 59½ in most cases. However, if you are over 59½ you can take a penalty-free voluntary distribution if accelerating ordinary taxable income into 2017 is desirable. Penalty-free access to the funds is available prior to age 59½ to the extent the distribution is used (1) to pay unreimbursed medical expenses in excess of 10% of your adjusted gross income ("AGI"), (2) to pay any health insurance premiums (provided you have received unemployment compensation for at least 12 weeks), or (3) for a limited number of other exceptions.

If you are planning to purchase a new home, you may withdraw up to $10,000 from your IRA to pay certain qualified acquisition expenses without having to pay the 10% early withdrawal penalty. The distribution is still subject to the regular income tax. The $10,000 withdrawal is a lifetime cap. If a taxpayer or spouse has owned a principal residence in the previous two years, this penalty-free provision is not available. An eligible homebuyer for this purpose can be the owner of the IRA, his or her spouse, child, grandchild, or any ancestor. Also, penalty-free distributions can be made from IRAs for higher education expenses of a taxpayer, spouse, child, or grandchild.

Charitable contributions (cash or property)

You must obtain written substantiation from the charitable organization, in addition to a canceled check, for all charitable donations in excess of $250.

Charities are required to inform you of the amount of your net contribution, where you receive goods or services in excess of $75 in exchange for your contribution.

If the value of contributed property exceeds $5,000, you must obtain a qualified written appraisal (prior to the due date of your tax return, including extensions), except for publicly-traded securities and non-publicly-traded stock of $10,000 or less.

> ***Planning Suggestion:*** If you are considering contributing marketable securities to a charity and the securities have declined in value, sell the securities first and then donate the sales proceeds. You will obtain both a capital loss and a charitable contribution deduction.

On the other hand, if the marketable securities or other long-term capital gain property have appreciated in value, you should contribute the property in kind to the charity. By contributing the property in kind, you will avoid taxes on the appreciation and receive a charitable contribution deduction for the property's full fair market value.

If you wish to make a significant gift of property to a charitable organization yet retain current income for yourself, a charitable remainder trust may fulfill your needs. A charitable remainder trust is a trust that generates a current charitable deduction for a future contribution to a charity. The trust pays you income annually on the principal in the trust for a specified term or for life. When the term of the trust ends, the trust's assets are distributed to the designated charity. You obtain a current tax deduction when the trust is funded based on the present value of the assets that will pass to the charity when the trust terminates. This accelerates your deduction into the year the trust is funded, while you retain the income from the assets. This method of making a charitable contribution can work very well with appreciated property.

If you volunteer time to a charity, you cannot deduct the value of your time, but you can deduct your out-of-pocket expenses. If you use your automobile in connection with performing charitable work, including driving to and from the organization, you can deduct 14 cents per mile. You must keep a record of the miles.

The allowable deduction for donating an automobile (also, a boat and airplane) is significantly reduced. The deduction for a contribution made to a charity, in which the claimed value exceeds $500, will be dependent on the charity's use of the vehicle. If the charity sells the donated property without having significantly used the vehicle in regularly conducted activities, the taxpayer's deduction will be limited to the amount of the proceeds from the charity's sale. In addition, greater substantiation requirements are also imposed on property contributions. For example, a deduction will be disallowed unless the taxpayer receives written acknowledgement from the charity containing detailed information regarding the vehicle donated, as well as specific information regarding a subsequent sale of the property.

Medical expenses

In addition to medical expenses for doctors, hospitals, prescription medications, and medical insurance premiums, you may be entitled to deduct certain related out-of-pocket expenses such as transportation, lodging (but not meals), and home healthcare expenses. If you use your car for trips to the doctor during 2016, you can deduct 19 cents per mile for travel during 2016. Payments for programs to help you stop smoking and prescription medications to alleviate nicotine withdrawal problems are deductible medical expenses. Uncompensated costs of weight-loss programs to treat diseases diagnosed by a physician, including obesity, are also deductible medical expenses.

The deduction is limited to the extent your medical expenses exceed 10% of your adjusted gross income if you are under age 65. The AGI floor remains at 7.5% for taxpayers over age 65. In the case of married taxpayers filing jointly, only one spouse needs to have attained the age of 65 before the end of the taxable year for the lower 7.5% AGI limit.

> ***Planning Suggestion:*** If you pay your medical expenses by credit card, the expense is deductible in the year the expense is charged, not when you pay the credit card company. It is important to remember that prepayments for medical services generally are not deductible until the year when the services are actually rendered. Because medical expenses are deductible only to the extent they exceed 7.5% or 10% of AGI as

discussed above, they should, where possible, be bunched in a year in which they would exceed this AGI limit.

Under certain conditions, if you provide more than half of an individual's support, such as a dependent parent, you can deduct the unreimbursed medical expenses you pay for that individual to the extent all medical expenses exceed the applicable AGI limit. Even if you cannot claim that individual as your dependent because his or her 2016 gross income is $4,050 or more, you are still entitled to the medical deduction. Please consult your client service professional for details.

Long-term care insurance and services

Premiums you pay on a qualified long-term care insurance policy are deductible as a medical expense. The maximum amount of your deduction is determined by your age. The following table sets forth the deductible limits for 2017:

AGE	40 or less	41 – 50	51 – 60	61 – 70	Over 70
DEDUCTION LIMITATION	$410	$770	$1,530	$4,090	$5,110

These limitations are per person, not per return. Thus, a married couple over 70 years old has a combined maximum deduction of $10,220, subject to the applicable AGI limit.

Mortgage interest and points

Interest as well as points paid on a loan to purchase or improve a principal residence is generally deductible in the year paid. The mortgage loan must be secured by your principal residence. Points paid in connection with refinancing an existing mortgage are not deductible currently, but rather must be amortized over the life of the new mortgage unless the loan proceeds are used to substantially improve the residence. However, if the mortgage is refinanced again, the unamortized points on the old mortgage can be deducted in full. See page 11 for additional information regarding mortgage and other interest payments.

Interest paid on qualified education loans

An "above-the-line" deduction (a deduction to arrive at AGI) is allowed for interest paid on qualified education loans. All student loan interest up to the $2,500 annual limit is deductible. However, in 2017 this deduction begins to phase out for single individuals with modified AGI of $65,000 and is completely phases out if AGI is $80,000 or more ($135,000 to $165,000 for joint returns).

Caution: Interest paid to a relative or to an entity (such as a corporation or trust) controlled by you or a relative does not qualify for the deduction.

Non-business bad debts

Non-business bad debts are treated as short-term capital losses when they become totally worthless. To establish worthlessness, you must demonstrate there is no reasonable prospect of recovering the debt. This might include documenting the efforts you made to collect the debt, including correspondence to the debtor to demand payment.

IRA deductions

The total allowable annual deduction for IRAs is $5,500, subject to certain AGI limitations if you are an “active participant” in a qualified retirement plan. A non-working spouse may also make an IRA contribution based upon the earned income of his or her spouse. A catch-up provision for individuals age 50 or older applies to increase the deductible limit by $1,000 for IRAs to a total deductible amount of $6,500 (these amounts are unchanged for 2017).

> ***Planning Suggestion:*** Consider making your full IRA contribution early in the year so that income earned on the contribution can accumulate tax-free for the entire year.

> ***Planning Suggestion:*** If money is tight, consider the use of credit cards to make tax deductible year-end payments. Note however, interest paid to a credit card company is not deductible because it is personal interest (see page 11).

Capital Gains and Losses

The tax rate for net long-term capital gains is 20% for taxpayers otherwise subject to the 39.6% marginal tax on ordinary income. The 15% tax rate continues to apply for taxpayers otherwise subject to the 25% to 35% ordinary marginal tax rate, and a 0% rate applies for taxpayers otherwise subject to the 10% to 15% ordinary tax rate.

Note: Capital gains may also be subject to the 3.8% net investment income tax discussed on page 2.

Caution: The tax law contains rules to prevent converting ordinary income into long-term capital gains. For instance, net long-term capital gains on investment property are excluded in computing the amount of investment interest expense that can be deducted (see page 12) unless the taxpayer elects to subject those gains to ordinary income tax rates. Additionally, if long-term real property is sold at a gain, the portion of the gain represented by prior depreciation is taxed at a maximum 25% rate.

Capital losses are offset against capital gains. For joint filers, net capital losses of up to $3,000 ($1,500 for single filers) can be deducted against ordinary income. Unused capital losses may be carried forward indefinitely and offset against capital gains and up to $3,000 ($1,500 for single filers) of ordinary income annually, in future years.

Sale of Principal Residence

For sales of a principal residence, up to $500,000 of gain on a joint return ($250,000 on a single or separate return) can be excluded. To be eligible for the exclusion, the residence must have been owned and occupied as your principal residence for at least two of the five years preceding the sale. The exclusion is available each time a principal residence is sold, but only once every two years. Special rules apply in the case of sales of a principal residence after a divorce and sales due to certain unforeseen circumstances. If a taxpayer satisfies only a portion of the two-year ownership and use requirement, the exclusion amount is reduced on a pro rata basis.

> ***Example:*** Husband and wife file a joint return. They own and use a principal residence for 15 months and then move because of a job transfer. They can exclude up to $312,500 of gain on the sale of the residence (5/8 of the $500,000 exclusion).

Legislation enacted in 2008 modified the provisions affecting the exclusion of the gain. For sales or exchanges after December 31, 2008, a portion of the gain attributable to a period when the residence is not used as a principal residence will not be eligible for the exclusion. Periods of ineligible use prior to January 1, 2009, will not be considered.

Planning Suggestions: If you want to sell your principal residence but are unable to do so because of unfavorable market conditions, you can rent it for up to three years after the date you move out and still qualify for the exclusion. However, any gain attributable to prior depreciation claimed during the rental period will be taxed at a maximum 25% rate.

If you own appreciated rental property that you wish to sell in the future, you should consider moving into the property to convert it to your principal residence. You will need to live in the property for at least two of the five years preceding the sale of the property. As long as you haven't sold another principal residence for the two years prior to the sale, a portion of the gain is excluded. Any gain attributable to prior depreciation claimed will be taxed at a maximum 25% rate.

The sale of a principal residence does not qualify for the exclusion if during the five-year period prior to the sale, the property was acquired in a tax-free like-kind exchange.

Retirement Plan Distributions

Retirement plans have many requirements regarding distributions, but taxpayers can exercise some authority over plan distributions that might facilitate income tax planning.

For instance, funds in a regular IRA can be accessed without additional early distribution penalties anytime after obtaining age 59½. Therefore, anyone meeting the age requirement in 2016 can take a distribution from regular IRAs if 2016 income is desired.

Once the IRA owner reaches age 70½, a minimum amount must be distributed from regular IRAs (Roth IRAs are not subject to any minimum distribution requirements) each year. The law allows, but does not require, a small delay of the first required minimum distribution until April 1 of the year after the attainment of age 70½. Therefore, if you reached age 70½ in 2016, you should evaluate the benefit of delayed tax liability on your first distribution compared with the spike in your 2017 taxable income that two distributions in 2017 could cause. Any failure to take the minimum required distributions ("MRDs") before the annual deadline causes the IRA owner to owe a 50% excise tax on the amount that should have been distributed. Example: Individual reached age 70½ in 2016 and is required to take a minimum required distribution for the 2016 calendar year. This distribution could be made during 2016 based on the December 31, 2015 IRA balance but the Individual waited until April 1, 2017, to take the required amount. Individual must also take a distribution by December 31, 2017, for the 2017 year based on the December 31, 2016, IRA balance, with certain adjustments. Therefore, individual is taxed on two distributions in 2017 which might result in an overall increase in income taxes.

Participants in qualified pension plans who are not 5% or more owners of the employer can delay taking distributions out of the plan beyond the minimum required distribution age of 70½ as long as they are still actively employed by the plan sponsor. If you are already receiving benefits, but have not yet retired, your plan may (but is not required to) allow you to stop receiving distributions until you retire.

If you received a taxable qualified retirement plan distribution that is not a part of a series of substantially equal payments over a specified period of ten years or more, over the life expectancy of the employee or over the joint life expectancies of the employee and the employee's beneficiary, or does not satisfy the minimum required distribution rules, you can generally avoid immediate taxation by "rolling" the money into a regular IRA or other qualified plan. The rollover rules are utilized most often to move retirement funds between IRAs inasmuch as qualified plans are required to allow participants to elect a direct trustee-to-trustee transfer of distributions and to withhold a 20% income tax on distributions made directly to participants. Participants who elect to receive a plan distribution net of the required withholding will have to restore the funds from other sources in order to complete a tax-free rollover of 100% of the distribution. If 100% of the distribution is indeed rolled over within the 60-day timeframe required by law, the distribution is nontaxable but any overpayment of income taxes will be refunded only as a result of filing a Form 1040 for the year.

Example: Employee E retires at age 54 on January 1, 2016 and is entitled to receive a $100,000 lump-sum distribution from his employer's profit-sharing plan. E does not elect a direct trustee-to-trustee transfer of his $100,000 to an IRA. At the time of the distribution, the employer must withhold $20,000 in federal income taxes from the distribution. E receives the remaining $80,000 on January 10, 2016, and transfers it to an IRA on January 11, 2016.
E will have $20,000 of gross income, unless he obtains $20,000 from another source and transfers it to the IRA by March 11, 2016 (within 60 days of receiving the distribution). The $20,000 will be refunded only after taking into account of all items reported on E's Form 1040 for 2016. In addition, if E fails to transfer the additional $20,000 to an IRA, E will be liable for the 10% early withdrawal penalty on the $20,000 because E was under age 55 (the minimum age for receiving penalty-free distributions upon a separation from service).

Roth IRAs and Education IRAS

Roth IRAS

Taxpayers with income under certain income limits are permitted to make contributions to a Roth IRA. Unlike regular IRAs, where contributions are deductible and later distributions are taxable, contributions to Roth IRAs are not deductible and later "qualified" distributions are not taxable. Qualified distributions are distributions made five or more years after the Roth IRA is established, provided the distribution is made after the account owner is at least age 59½, has died or become disabled, or uses the money for a first-time home purchase, subject to a $10,000 lifetime cap. If the distribution is not qualified, a portion of the distribution may be included in gross income and may be subject to the 10% early withdrawal penalty. The penalty applies on the amount of the distribution that exceeds the taxpayer's contributions to the Roth IRA. Roth IRAs are not subject to the MRD rules that apply to regular IRAs when the owner reaches age 70½.

For 2016 and 2017, taxpayers can contribute up to $5,500 to a Roth IRA (as long as you have compensation for the year at least equal to the contributed amount). Taxpayers age 50 or older can contribute an additional $1,000. Thus, the limit is $6,500 a year for people who will be age 50 (or older) in the applicable taxable year. However, the maximum contribution allowance must be reduced by any other contributions (deductible or nondeductible) the taxpayer makes to IRAs.

For single and head of household taxpayers, and for married taxpayers filing separately who did not live together at any time during the tax year, if 2017 modified adjusted gross income is between $118,000 and $133,000 ($117,000 and $132,000 for 2016), the $5,500 maximum contribution is phased out. Modified AGI in excess of $133,000 ($132,000 for 2016) prevents a contribution to a Roth IRA for these taxpayers. For married taxpayers filing jointly, no contribution can be made to a Roth IRA if AGI is $196,000 ($194,000 for 2016) or more, and the $5,500 maximum (per spouse) is phased out for AGIs between $186,000 and $196,000($184,000 and $194,000 for 2016). For married taxpayers filing separately who lived with their spouse at any time during the tax year, the allowable contribution is phased out for AGIs between $0 and $10,000.

As with regular IRAs, contributions to a Roth IRA may be made as late as the due date for filing your income tax return, excluding extensions. Thus, Roth IRA contributions may be made by most individuals for 2016 until April 18, 2017. Unlike regular IRAs, contributions to a Roth IRA may be made even if the taxpayer is over age

70½, and the taxpayer or spouse has earned income at least equal to the amount of the contribution.

The adjusted gross income limitation that prevented many taxpayers from converting traditional IRAs to Roth IRAs has been eliminated.

If a taxpayer converts a regular IRA or eligible employer plan into a Roth IRA, the amount that must be included in the distributee's gross income is the amount that would have been includible in gross income had the distribution not been part of a qualified rollover contribution. The entire taxable amount from a 2016 conversion must be recognized on the taxpayer's 2016 income tax return. The converted amount is not subject to the 10% early withdrawal penalty, provided no distributions are made from the account during the five-year period after the initial conversion.

Planning Suggestion: If you are not eligible to make a Roth IRA contribution due to an income limitation, consider making a nondeductible contribution to a traditional IRA and then converting the entire balance to a Roth IRA. The conversion would be a fully nontaxable event if the conversion takes place immediately because the taxpayer would have basis in the full amount of conversion.

Planning Suggestion: It may be beneficial to convert an existing IRA into a Roth IRA even though income will be accelerated and taxes will have to be paid. The advisability of converting depends on various factors, including the age of the taxpayer, current tax bracket, whether the taxpayer has funds from other sources to pay the income taxes on the accelerated income, and whether the taxpayer intends to withdraw funds from the account after age 59½, or after 70½. Two of the advantages of converting a regular IRA or eligible employer plan into a Roth IRA are avoiding the minimum distribution rules and avoiding income taxes on distributions after death to the beneficiary of the Roth IRA. Any decision to convert should also consider the estate tax effects.

Planning Suggestion: You may want to consider converting all or a portion of your traditional IRA to a Roth IRA if you have a net operating loss ("NOL"). You may be able to make a conversion without creating taxable income and make use of your NOL, especially if the NOL carryforward is due to expire soon.

Additional Planning: Regular IRAs can be converted to Roth IRAs. Roth IRA conversions for a year must be completed by December 31 of that year. You have until the extended due date of your return for the year of the conversion to recharacterize your Roth IRA back to a traditional IRA. You will treat the conversion as if it had never happened by recharacterizing it.

Caution: Assuming that you do not have an NOL or other tax attribute to completely offset the income on the conversion, you are going to need cash outside the IRA to pay tax on the conversion.

Example (1): Individual D makes a $5,000 contribution to a regular IRA in November 2016. D files his 2016 tax return on April 15, 2017. Immediately before filing the 2016 tax return, when the value of the IRA has increased to $5,500, D recharacterizes the account as a Roth IRA. D will be considered to have made a $5,000 contribution to a Roth IRA for 2016. The $500 of appreciation is not treated as a contribution to the Roth IRA.

Example (2): Individual E converts a regular IRA to a Roth IRA in August 2016, when the value of the account is $100,000. On December 18, 2016, the value of the account is $70,000. E may recharacterize the Roth IRA back to a regular IRA on December 18, 2016 (the election to recharacterize generally can be made as late as October 15, 2017) and it will be treated as if the original conversion in August had not occurred. E can then convert back to a Roth IRA by the later of the next taxable year or after 30 days. Thus, 31 days later, on January 18, 2017, E (assuming E otherwise qualifies) can convert the regular IRA to a Roth IRA based on the then values.

These rules are complicated, but may provide tax-planning opportunities if securities held in IRAs fluctuate significantly within short periods of time. Your client service professional can help you with your Roth IRA questions.

Coverdell Education Savings Accounts (Education IRAs)

Education IRAs may be established to help meet the cost of education for certain individuals. For 2016, annual, nondeductible contributions to an education IRA are limited to $2,000 per beneficiary and may not be made after the beneficiary reaches age 18. Contributions cannot be made prior to the child's birth. Contributions must be made by the due date of the return without extension. Only eligible donors within certain income limits can make contributions to education IRAs. Eligibility is phased out for single donors with AGI between $95,000 and $110,000, and married donors filing jointly with AGI between $190,000 and $220,000.

Distributions from an education IRA are not subject to tax to the extent the distributions do not exceed qualified education expenses. Qualified education expenses include elementary and secondary school expenses. In the year amounts are distributed from an education IRA, the beneficiary is also eligible for an American Opportunity Tax (Hope) Credit or Lifetime Learning Credit (see page 19) provided the same expenses are not used for each credit. Education IRAs can be rolled over, before the beneficiary reaches age 30, to benefit another person in the same family. If the beneficiary does not use the funds for qualified education expenses by age 30, the money must be withdrawn and will be subject to tax and penalty on the portion attributable to the earnings.

Moving Expenses

Deductible moving expenses are limited to the cost of moving household goods and personal effects, plus traveling (including lodging but not meals) from your old residence to your new residence. To be deductible, a taxpayer must satisfy a distance test, a length-of-employment test and a commencement-of-work test.

Moving expenses can be deducted "above-the-line" in computing AGI instead of as miscellaneous itemized deductions. Thus, these expenses are not subject to the various limitations applicable to itemized deductions and can be deducted in addition to itemized deductions or the standard deduction. Also, deductible moving expenses reduce AGI for purposes of calculating the various AGI-based limitations.

Interest Expense

Personal Interest

Interest is not deductible on tax deficiencies, car loans, personal credit card balances, student loans (except for taxpayers eligible for the above-the-line deduction for interest paid on qualified education loans), or other personal debts.

Home Mortgage Interest

A full regular tax deduction is allowed for:

- Interest on debt used to acquire, construct, or improve a principal or secondary residence to the extent this debt does not exceed $1 million.

- Other mortgage interest on a principal or secondary residence to the extent the mortgage does not exceed $100,000. The loan proceeds may be used for any purpose, except to purchase tax-exempt obligations.

These $1 million and $100,000 limits are cut in half for a married taxpayer filing a separate return.

Caution: These debts must be secured by the principal or secondary residence such that your home is at risk if the loan is not repaid.

A residence includes a house, condominium, mobile home, house trailer, or boat containing sleeping space, commode, and cooking facilities. If you own more than two residences, you can annually elect which one will be your secondary residence.

> ***Planning Suggestion:*** Since there is no deduction for personal interest, consider replacing personal debt with a home-equity loan of up to $100,000 to obtain a deduction for the interest.

These rules apply to interest on debt incurred after October 13, 1987. Interest on mortgages established prior to October 14, 1987, is generally subject to less restrictive rules.

Investment Interest Expense

If you want to add to your investment portfolio through borrowing, consider borrowing from your stockbroker through a margin loan. The interest paid is investment interest expense and will be deductible to the extent of your net investment income (dividends, interest, etc.). Investment interest expense in excess of investment income may be carried forward indefinitely.

> ***Planning Suggestion:*** Net long-term capital gain (long-term gains over short-term losses) and any qualified dividend income are not included as investment income for purposes of determining how much investment interest expense is deductible, unless you elect to subject the capital gain and dividend income to ordinary income rates.

You should consider switching your investments to those types of investments generating taxable investment income to absorb any excess investment interest expense.

Interest expense, to the extent that it is related to tax-exempt income, is not deductible. Interest expense relating to a passive activity, such as a limited partnership investment, is subject to the passive loss limitations on deductibility (see page 14).

Allocation Rules

Interest payments are generally allocated among the various categories –personal interest, home mortgage interest, investment interest, etc. – based on the ultimate use of the loan proceeds.

> ***Example:*** An individual borrows $25,000 on margin and uses the proceeds to purchase an automobile for personal use. The interest expense is treated as personal interest.

The Service has issued complex regulations for determining how these allocations are made, which may require maintaining separate bank accounts or other records. Your client service professional can help you maximize tax deductions for your interest payments.

Miscellaneous Deductions

Unreimbursed employee business expenses, investment expenses, personal tax advice and preparation fees, and most other miscellaneous itemized deductions, are deductible only if they exceed 2% of AGI.

> ***Planning Suggestion:*** Consider bunching miscellaneous itemized deductions into a year in which the 2% AGI limit will be exceeded. However, not all prepaid expenses, such as multi-year subscriptions to financial periodicals, are currently deductible.

Business Meals and Entertainment

Only 50% of an employee's unreimbursed cost of business meals and entertainment qualifies as a miscellaneous deduction. Club dues generally are not deductible; however, dues paid to the following types of organizations generally continue to be deductible as business expenses:

- Professional associations;
- Civic or public service organizations, such as Kiwanis, Lions, Rotary, or Civitan; and
- Business leagues, trade associations, chambers of commerce, boards of trade, and real estate boards.

Leased Automobiles

In prior years, the Service permitted salaried employees with unreimbursed business expenses as well as self-employed sole proprietors, partners, and S corporation shareholders to deduct only actual expenses incurred with respect to leased automobiles. Now, the Service allows taxpayers, beginning in the first year a leased automobile is placed in service, to use the standard mileage rate for business activity (54 cents per mile for travel during 2016).

> ***Planning Suggestion:*** Consider claiming the standard mileage rate for leased automobiles. There is less recordkeeping, and the standard mileage rate may result in a larger deduction.

Uniform Definition of "Child"

There is a uniform definition of qualifying child for the purposes of determining the dependency exemption, the child credit, the earned income credit, the dependent care credit, and head of household filing status for 2004 and later. A child is determined to be a qualifying child of a taxpayer if a residency test, a relationship test, and an age test are met. Pre-2004 law regarding support and gross income tests in determining qualification as a dependent generally does not apply if the child satisfies the uniform definition.

Passive Activities, Rental and Vacation Homes

Losses from passive activities (which, as discussed below, generally include the rental of real estate) are deductible only against passive income. Passive losses cannot be used to reduce non-passive income, such as compensation, dividends, or interest. Similarly, credits from passive activities can be used only to offset the regular tax liability allocable to passive activities. Unused passive losses are carried over to future years and can be used to offset future passive income. Any remaining loss is deductible when the activity, which gave rise to the passive loss, is disposed of in a transaction in which gain or loss is recognized.

A passive activity is one in which the taxpayer does not materially participate. Material participation is involvement in operations on a regular, continuous, and substantial basis. You are considered to materially participate in an activity if, for example:

- You participate in the activity for more than 500 hours in the taxable year.
- Your participation for the taxable year was substantially all of the participation in the activity.
- You participated for more than 100 hours during the taxable year, and you participated at least as much as any other individual for that year.

In determining material participation, a spouse's participation can be taken into account. Limited partners are conclusively presumed not to materially participate in the partnership's activity.

Rental activities are generally considered passive. However, there are two significant exceptions to this rule (see "Rental Real Estate" below).

A working interest in an oil or gas property is not treated as a passive activity, regardless of whether the owner materially participates, unless liability is limited (such as in the case of a limited partner or S corporation shareholder).

Planning Suggestion: Avoid investments producing passive losses unless there is an overriding economic reason to make the investment. If you already have such investments, consider acquiring an investment that generates passive income. If you own a corporation other than an S corporation or personal service corporation, consider transferring investments that generate passive losses to the corporation. The corporation can deduct passive losses against its active business income, but not against its dividends, interest, or other portfolio income.

Rental Real Estate

For real estate professionals, rental real estate activities are not subject to the passive loss rules if, during a taxable year:

- More than 50% of the taxpayer's personal services are performed in real property businesses, and
- More than 750 hours are spent in real property businesses.

For both of these tests, the taxpayer must materially participate in the real property businesses. If a joint return is filed, these two tests must be satisfied by the same spouse.

Services performed as an employee are ignored unless the employee owns more than 5% of the employer.

A closely-held C corporation that is generally subject to the passive loss rules will satisfy these tests if more than 50% of its gross receipts are derived from real property businesses in which the corporation materially participates. Real property businesses are those involving real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage.

For non-real estate professionals, another exception to the passive loss limitations exists for rental real estate activities in which the taxpayer "actively" participates. This requires the taxpayer to own at least a 10% interest in the activity. If the taxpayer actively participates in the activity, the taxpayer can offset up to $25,000 of losses and credits from the activity against non-passive income, subject to an AGI phaseout.

Active participation does not require regular, continuous, and substantial involvement in operations as long as the taxpayer participates in a significant and bona fide way by, for example:

- Arranging for others to provide services such as cleaning; or

- Making management decisions, which include approving new tenants, deciding rental terms, and approving repairs and capital expenditures.

The $25,000 allowance begins to phase out when the taxpayer's AGI exceeds $100,000 and is completely eliminated when AGI reaches $150,000. In that event, the regular passive loss rules determine the amount of any deductible loss. The $25,000 allowance and AGI thresholds are cut in half for a married taxpayer who files separately and does not live with his or her spouse. However, there is no $25,000 allowance if a married individual files separately and lives with his or her spouse at any time during the taxable year.

> ***Planning Suggestion:*** If your AGI is approaching $100,000, consider shifting income to 2017 to obtain a full $25,000 rental real estate loss for 2016. Consider filing a refund claim if rental real estate losses produce a net operating loss that may be carried back to prior taxable years.

If you think you may be affected by the passive loss rules, you should speak with your client service professional. In certain cases with proper planning, the adverse effect of these rules may be minimized.

Vacation Homes

Expenses of a rental property are deductible, even if they exceed gross rents and produce a loss. However, the current deduction of such a loss may be restricted due to the passive activity rules discussed above. A vacation home is treated as rental property if personal use during the year does not exceed the greater of:

- 14 days, or
- 10% of the number of days the home is rented at a fair rental value.

If personal use exceeds these limits, the property is considered to be a residence. In that event, the deductibility of expenses is limited, although property taxes, mortgage interest, and casualty losses can generally be deducted currently.

> ***Planning Suggestion:*** If you rent your home for less than 15 days during the year, the total rental income you receive is not subject to income tax.

Children's Taxes

Unearned income of a child under age 18, exceeding $2,100 for 2016 and 2017, is taxed at the parents' top rate rather than at the child's rate ("kiddie tax"). Earned (compensation) income received by a child under age 18 is taxed at the child's rate.

The kiddie tax applies to full-time students who have not attained the age of 24 by the end of the taxable year and non-full-time students who have not attained the age of 19 by the end of the taxable year, but in either case, only if the child's earned income does not exceed one-half of the amount of the child's support.

A child with earned income may claim a standard deduction up to $6,300 for 2016 and may be eligible for the $5,500 deductible IRA contribution. Therefore, the child may earn $11,800 without paying federal income tax. The child should also consider a contribution to a nondeductible Roth IRA.

> ***Planning Suggestion:*** If you own a business, consider hiring and paying a salary to your child. This income will be taxed at the child's rates, and the payment will be deductible by your business. This technique can be used to fund a college education. Of course, the child must perform services to earn the compensation, and the compensation must be reasonable for the services provided.

If the child is 18 or over, this compensation will be subject to social security tax. It will also be subject to federal unemployment insurance tax if the child is 21 or older. The child's compensation could also be subject to state and local income and payroll taxes.

For 2016, a child under age 18 is not required to file a tax return if the child only has interest and dividend income up to $1,050, has not made estimated payments, has total gross income less than $10,500, and is not subject to backup withholding. However, the parents must include the child's income exceeding $2,100 on his/her tax return.

Caution: A child under 18 who has capital gains or earned income must file his or her own tax return. Estimated taxes may have to be paid during the year if withholding taxes are not sufficient to cover the child's tax liability.

Reminder: Your income tax return must report social security numbers for all children whom you claim as dependents. A social security number can be obtained by filing an application on Form SS-5 with your local Social Security Administration office.

If you claim a dependent care credit, you must report the service provider's social security or employer identification number on your tax return. You should use IRS Form W-10 to obtain this number from the provider.

Adoption Expenses

Up to $13,460 for 2016 ($13,570 for 2017) of eligible adoption expenses are allowed to be claimed as a nonrefundable credit. The credit limitation is the same for special-needs children (children that cannot or should not be returned to the home of the birth parents because of specific factors, or who could not otherwise be adopted because of certain conditions). The credit is per adoption, not per year. Thus, if a person adopts two children in 2016 and incurs $30,000 of qualified expenses, the credit limitation is $26,920. The adoption credit is phased out for higher income individuals with modified AGI between $201,920 and $241,920 (for 2017 between $203,540 and $243,540). Unused adoption credit can be carried forward for up to five years.

Extender Provisions

Most of the temporary tax provisions generally referred to as "extenders" (because they are routinely extended by Congress on a one or two year basis) have either been again temporarily extended or made permanent as part of the 2015 PATH Act.

The extended provisions include:

- The above-the-line deduction for qualified tuition and related expenses (extended through 2016);
- The deduction for mortgage insurance premiums treated as qualified interest (extended through 2016);
- The exclusion of up to $2 million ($1 million if married filing separately) of discharged principal residence indebtedness from gross income (extended through 2016);
- The credit for construction of energy efficient houses (extended through 2016);
- Work opportunity tax credit (Sec. 51) (extended through 2010);
- Bonus depreciation (50% depreciation deduction under Sec. 168(k)) (extended through 2019);
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The following extenders have now been made permanent by the Protecting Americans from Tax Hikes Act of 2015 (PATH Act):

- The earned income threshold of $3,000 used to determine the refundable portion of the child tax credit (Sec. 24);
- The Hope Scholarship Credit (the American Opportunity Tax Credit) (Sec. 25A);

- The deduction for state and local sales taxes;
- The $250 above-the-line deduction for certain expenses of teachers;
- The exclusion for employer-provided mass transit and parking;
- Research and experimentation credit (Sec. 41);
- Increase in expensing to $500,000 and in expanded definition of property (Sec. 179);
- Exceptions under Subpart F for active financing income (Sec. 953(e)(10));
- The special 100% gain exclusion for qualified small business stock (Sec. 1202);
- The reduction in S corporation recognition period for built-in gains tax from 10 years to 5 years (Sec. 1374(d));
- The 15-year straight line cost recovery for qualified leasehold property, qualified restaurant property, and qualified retail improvements (Sec. 168(e)(3)(E)).
- The enhanced charitable deduction for contributions of food inventory;
- Tax-free distributions for charitable purposes from individual retirement account (IRA) accounts of taxpayers age 70½;
- The basis adjustment to stock of S corporations making charitable contributions of property; and