PETER SHANNON & CO.
CERTIFIED PUBLIC ACCOUNTANTS

2016 Tax Considerations

- Extender Provisions
- Individual Income Tax Provisions
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EXTENDER PROVISIONS

Certain temporary tax provisions are generally referred to as "extenders" because they are routinely extended by Congress on a one or two year basis. At the very end of 2015, late legislation – the Protecting Americans from Tax Hikes (PATH) Act and Consolidated Appropriations Act, 2016 – went well beyond what many had expected would be another short-term, blanket extension of these temporary "extender" tax provisions. Instead, some provisions were retroactively extended for two years, others for longer periods, some were modified (including making some subject to a gradual phaseout), and some were made permanent.

Still, a number of these extender provisions will expire at the end of 2016. It is uncertain at this time whether all these extender provisions will be extended by Congress, whether some of the provisions will be extended on a permanent basis, or whether if legislations is not prompt enough, the extension will be made retroactively.

While there is a general expectation that many, if perhaps not all, of these provisions will ultimately be retained, it is an essential part of tax planning to be aware of these extenders and when they expire.

The following were a part of the Protecting Americans from Tax Hikes Act of 2015 (The Act) signed into law by the president on December 18, 2015:

Enhanced Child Tax Credit Made Permanent
The Child Tax Credit (CTC) allows taxpayers to claim a $1,000 tax credit for each qualifying child under age 17 that the taxpayer can claim as a dependent. The Credit phases out when taxpayers' income exceeds certain thresholds. To the extent the Credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit equal to 15% of earned income in excess of a threshold dollar amount.

Under pre-Act law, through 2017, the threshold dollar amount was an unindexed $3,000, and was then scheduled to rise to $10,000 indexed for inflation.

The Act makes the enhanced Credit permanent by setting the threshold dollar amount for purposes of computing the refundable credit at an unindexed $3,000. This change is effective for tax years beginning after the date of enactment.

Enhanced Earned Income Tax Credit Made Permanent
Certain low and moderate income workers may be eligible for a refundable EITC. The amount of the credit depends on the taxpayer's earned income and the number of qualifying children, if any, and is calculated as a percentage of an inflation-adjusted earned income level.

Under pre-Act law, through 2017, the EITC amount was temporarily increased (to 45%) for those with three or more children, and the EITC marriage penalty was reduced by increasing the income phase-out range by $5,000 (indexed for inflation) for those who are married and filing jointly.

The Act makes these provisions permanent.

Above-the-Line Deduction for Educator Expenses Made Permanent
Under pre-Act law, eligible elementary and secondary school teachers could, for tax years beginning before January 1, 2015, claim an above-the-line deduction for up to $250 per year of expenses paid or incurred for books, certain supplies, computer and other equipment, and supplementary materials used in the classroom.

Under pre-Act law, this above-the-line deduction was unavailable for tax years beginning after December 31, 2014.

The Act permanently extends the educator expense deduction and, for tax years beginning after December 31, 2015, modifies the deduction by (1) indexing the $250 amount for inflation, and (2) treating professional development expenses as expenses eligible for the deduction.

Increase in Excluded Employer-Provided Mass Transit and Parking Benefits Made Permanent
For 2015, an employee could exclude from gross income up to: (1) $250 per month for qualified parking, and (2) $130 a month for transit passes and commuter transportation in a commuter highway vehicle (including van pools). However, notwithstanding the applicable statutory limits on the exclusion of qualified transportation fringes (as adjusted for inflation), for any month beginning before January 1, 2015, a parity provision required that the monthly dollar limitation for transit passes and transportation in a commuter highway vehicle had to be applied as if it were the same as the dollar limitation for that month for employer-provided parking ($250 for 2014).

For months after December 31, 2014, the Act permanently extends the maximum monthly exclusion amount for transit passes and van pool benefits so that these transportation benefits match the exclusion for qualified parking benefits. These fringe benefits are excluded from an employee's wages for payroll tax purposes and from gross income for income tax purposes.

State and Local Sales Tax Deduction Made Permanent
Taxpayers who itemize deductions could, for tax years beginning before January 1, 2015, elect to deduct state and local general sales and use taxes instead of state and local income taxes.

Under pre-Act law, this choice was unavailable for tax years beginning after December 31, 2014.

Effective for tax years beginning after 2014, the Act retroactively revives and makes permanent the option to claim an itemized deduction for State and local general sales taxes in lieu of an itemized deduction for State and local income taxes. The taxpayer may either deduct the actual amount of sales tax paid in the tax year, or alternatively, deduct an amount prescribed by the IRS.

Nontaxable IRA Transfers to Eligible Charities Made Permanent
Taxpayers who are age 70 ½ or older could, in tax years beginning before January 1, 2015, make tax-free distributions to a charity from an Individual Retirement Account (IRA) of up to $100,000 per year. These distributions were not subject to the charitable contribution percentage limits since they were neither included in gross income nor claimed as a deduction on the taxpayer's return.

Under pre-Act law, these rules did not apply to distributions made in tax years beginning after December 31, 2014.

Effective for distributions made in tax years beginning after December 31, 2014, the Act retroactively revives and permanently extends the ability of individuals at least 70 ½ years of age to exclude from gross income qualified charitable distributions from IRAs of up to $100,000 per year.

Exclusion for Discharged Home Mortgage Debt Retroactively Extended Through 2016
Discharge of indebtedness income from qualified principal residence debt, up to a $2 million limit ($1 million for married individuals filing separately), was, in tax years beginning before January 1, 2015, excluded from gross income.

Under pre-Act law, this exclusion did not apply to any debt discharged after December 31, 2014.

The Act extends this exclusion for two years so that it applies to home mortgage debt discharged before January 1, 2017. For discharges of debt after December 31, 2015, the exclusion also applies to home mortgage debt that is discharged subject to a written arrangement that is entered into before January 1, 2017. Thus, according to an official summary of the bill, the exclusion applies to qualified principal residence debt that is discharged in 2017, if the discharge is pursuant to a binding written agreement entered into in 2016.

Mortgage Insurance Premiums as Deductible Qualified Residence Interest Retroactively Extended Through 2016
Mortgage insurance premiums paid or accrued before January 1, 2015 by a taxpayer in connection with acquisition indebtedness with respect to the taxpayer's qualified residence were treated as deductible qualified residence interest, subject to a phase-out based on the taxpayer's AGI. The amount allowable as a deduction was phased out ratably by 10% for each $1,000 by which the taxpayer's adjusted gross income exceeded $100,000 ($500 and $50,000, respectively, in the case of a married individual filing a separate return). Thus, the deduction was not allowed if the taxpayer's AGI exceeded $110,000 ($55,000 in the case of married individual filing a separate return).

Under pre-Act law, this provision only applied to premiums paid or accrued before January 1, 2015 (and not properly allocable to any period after that date).

Effective for amounts paid or accrued after December 31, 2014, the Act retroactively extends this provision for two years so that a taxpayer can deduct, as qualified residence interest, mortgage insurance premiums paid or accrued before January 1, 2017 (and not properly allocable to any period after 2016).

Research Credit Permanently Extended and Made Creditable Against Other Taxes
The research credit equals the sum of: (1) 20% of the excess (if any) of the qualified research expenses for the tax year over a base amount (unless the taxpayer elected an alternative simplified research credit); (2) the university basic research credit (i.e., 20% of the basic research payments); (3) 20% of the taxpayer's expenditures on qualified energy research undertaken by an energy research consortium.

The base amount is a fixed-base percentage of the taxpayer's average annual gross receipts from a United States trade or business, net of returns and allowances, for the 4 tax years before the credit year, and cannot be less than 50% of the year's qualified research expenses. The fixed base percentage for a non-startup company is the percentage (not exceeding 16%) that taxpayer's total qualified research expenses are of total gross receipts for tax years beginning after '83 and before '89. A 3% fixed base percentage applies for each of the first 5 tax years in which a "startup company" (one with fewer than 3 tax years with both gross receipts and qualified research expenses) has qualified research expenses.

A taxpayer can elect an alternative simplified research credit equal to 14% of the excess of the qualified research expenses for the tax year over 50% of the average qualified research expenses for the three tax years preceding the tax year for which the credit is being determined. If a taxpayer has no qualified research expenses in any one of the three preceding tax years, the alternative simplified research credit is 6% of the qualified research expenses for the tax year for which the credit is being determined.

Under pre-Act law, the research credit did not apply for amounts paid or accrued after December 31, 2014.

The Act retroactively and permanently extends the research credit.

Lower Shareholder Basis Adjustment for Charitable Contributions by S Corporations Permanently Extended
Before the Pension Protection Act of 2006 (PPA), if an S Corporation contributed money or other property to a charity, each shareholder took into account his pro-rata share of the fair market value of the contributed property in determining his own income tax liability. The shareholder reduced his basis in his S stock by reason of a charitable contribution that flowed through to him. The PPA amended this rule to provide that the amount of a shareholder's basis reduction in S Stock by reason of a charitable contribution made by the corporation is equal to his pro-rata share of the adjusted basis of the contributed property.

Under pre-Act law, the PPA rule did not apply of contributions made in tax years beginning after December 31, 2014.

The Act retroactively and permanently extends the PPA rule.

Enhanced Deduction for Food Inventory Permanently Extended and Expanded
A taxpayer engaged in a trade or business is eligible to claim an enhanced deduction for donations of food inventory. A C Corporation's deduction equals the lesser of (1) basis plus half of the property's appreciation, or (2) twice the property's basis, for contributions of food inventory that was apparently wholesome food (i.e., meant for human consumption and meeting certain quality and labeling standards). For a taxpayer other than a C Corporation, the aggregate amount of contributions of apparently wholesome food that may be taken into account for the tax year cannot exceed 10% of the taxpayer's aggregate net income for that tax year from all trades or businesses from which those contributions were made for that tax year.

Under pre-Act law, this enhanced charitable deducation did not apply for contributions after December 31, 2014.

The Act retroactively and permanently extends the apparently wholesome food contribution rules.

In addition, for tax years beginning after December 31, 2015:

- The Act increases the limitation on deductible contributions of food inventory from 10% to 15% of the taxpayer's aggregate net taxable income from all trades or businesses from which such contributions were made (15% of taxable income in the case of a C Corporation) per year;
- The fair market value (FMV) of apparently wholesome food that cannot or will not be sold solely by reason of internal standards of the taxpayer, lack of market, or similar circumstances is determined without regard to such internal standards, etc.; FMV is determined by taking into account the price at which the same or substantially the same food items - as to both type and quality - are sold by the taxpayer at the time of the contribution; and
- Taxpayers who do not account for inventories using full absorption costing and who are not required to capitalize indirect costs under the Code Sec. 263A UNICAP rules may elect to treat the basis of any apparently wholesome food as being equal to 25% of the market value of the food, in determining the amount of the charitable contribution deduction.

Differential Wage Payment Credit for Employers Permanently Extended and Expanded
Eligible small business employers that pay differential wages-payments to employees for periods that they are called to active duty with the United States Uniformed Services (for more than 30 days) that represent all or part of the wages that they would have otherwise received from the employer-can claim a credit. This differential wage payment credit is equal to 20% of up to $20,000 of differential pay made to an employee during the tax year. An eligible small business employer is one that: (1) employed on average less than 50 employees on business days during the tax year; and (2) under a written plan, provides eligible differential wage payments to each of its qualified employees. A qualified employee is one who has been an employee for the 91-day period immediately preceding the period for which any differential wage payment is made.

Under pre-Act law, the credit was not available for differential wages paid after December 31, 2014.

The Act retroactively and permanently extends the credit.

And, for tax years beginning after December 31, 2015, the Act provides that the credit applies to employers of any size (i.e., the less than 50 employee average no longer applies).

Work Opportunity Tax Credit Extended Through 2019 and Expanded
The work opportunity tax credit (WOTC) allows employers who hire members of certain targeted groups to get a credit against income tax of a percentage of first-year wages up to $6,000 per employee ($3,000 for qualified summer youth employees). Where the employee is a long-term family assistance (LTFA) recipient, the WOTC is a percentage of first and second year wages, up to $10,000 per employee. Generally, the percentage of qualifying wages is 40% of first-year wages; it is 25% for employees who have completed at least 120 hours, but less than 400 hours of service for the employer. For LTFA recipients, it includes an additional 50% of qualified second-year wages.

The maximum WOTC for hiring a qualifying veteran generally is $6,000. However, it can be as high as $12,000, $14,000, or $24,000 depending on factors such as whether the veteran has a service-connected disability, the period of his or her unemployment before being hired, and when that period of unemployment occurred relative to the WOTC-eligible hiring date.

Under pre-Act law, wages for purposes of the WOTC did not include any amount paid or incurred to: veterans or non-veterans who began work after December 31, 2014.

The Act retroactively extends the WOTC so that it applies to eligible veterans and non-veterans who begin work for the employer before January 1, 2019.

With respect to individuals who begin work for an employer after December 31, 2015, the credit also applies to employers who hire qualified long-term unemployed individuals (i.e., those who have been unemployed for 27 weeks or more). The credit with respect to such long-term unemployed individuals is 40% of the first $6,000 of wages.

Nonbusiness Energy Property Credit Retroactively Extended and Modified
For qualified energy property placed in service before January 1, 2015, a taxpayer could claim a credit up to a $500 lifetime limit (with no more than $200 from windows and skylights) over the aggregate of the credits allowed to the taxpayer for all earlier tax years ending after December 31, 2005. The credit equalled the sum of: (1) 10% of the amount paid or incurred by the taxpayer for qualified energy efficiency improvements installed during the tax year, and (2) the amount of the residential energy property expenditures paid or incurred by the taxpayer during the tax year. The credit for residential energy property expenditures could not exceed: (1) $50 for an advanced main circulating fan; (2) $150 for any qualified natural gas, propane, or hot water boiler; and (3) $300 for any item of energy-efficient building property.

Qualified energy efficiency improvements were energy efficient building envelope components, such as (a) insulation materials or systems specifically and primarily designed to reduce heat loss/gain, that met criteria set by the International Energy Conservation Code (IECC); or (b) exterior windows, skylights or doors, or any metal roof with pigmented coating or asphalt roof with cooling granules specifically designed to reduce heat gain, installed on a dwelling unit that met certain Energy Star program requirements.

Under pre-Act law, the credit was not available for property placed in service after December 31, 2014.

The Act retroactively extends the nonbusiness energy property credit for two years, to apply to property placed in service after December 31, 2014, and before January 1, 2017. The Act allows a credit of 10% of the amount paid or incurred by the taxpayer for qualified energy improvements, subject to new requirements described in Act Sec. 181(b), up to $500.

New Energy Efficient Home Credit Extended
An eligible contractor could, for homes acquired before January 1, 2015, claim a credit of $2,000 or $1,000 (depending on the projected level of fuel consumption) for each qualified new energy efficient home constructed by the contractor and acquired by a person from the contractor for use as a residence during the tax year.

Under pre-Act law, the new energy efficient home credit did not apply to homes acquired after December 31, 2014.

The Act retroactively extends the credit for energy-efficient new homes for two years (i.e., to homes acquired before January 1, 2017).

Delayed Refunds Where Taxpayer Claims Earned Income or Additional Child Credit
The earned income tax credit (EITC) is a refundable credit available to low-income workers who satisfy certain requirements.

Subject to income limitations, an individual may claim a tax credit, the child tax credit, for each qualifying child under the age of 17. To the extent the child credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit).

Effective for credits or refunds made after December 31, 2016, no credit or refund for an overpayment for a tax year will be made to a taxpayer before the 15th day of the second month following the close of that tax year (generally February 15th of the following year), if the taxpayer claimed the EITC or additional child tax credit on the tax return.

Changes to 529 Plan Distribution Rules
Nondeductible cash contributions can be made to a qualified tuition program (QTP or 529 plan) on behalf of a designated beneficiary. The earnings on the contributions build up tax-free, and distributions from the QTP are excludable to the extent used to pay qualified higher education expenses.

For expenses paid or incurred in 2009 or 2010, qualified higher education expenses included certain expenses for the purchase of any computer technology or equipment or Internet access and related services.

Any distribution from a QTP that is not used for qualified higher education expenses is includible in the distributee's gross income under the Code Sec. 72 annuity rules, which result in a portion of the distribution being included in gross income and a portion being excluded as a return of the amount contributed. There is a requirement to aggregate all of a beneficiary's QTPs when determining the taxable part.

For tax years that begin after December 31, 2014, the Act expands the definition of qualified higher education expenses for which tax-preferred distributions from 529 accounts are eligible to include the 2009/2010 computer equipment and technology rule.

For distributions made after December 31, 2014, the Act modifies 529-account rules to treat any distribution form a 529 account as coming only from that account, even if the individual making the distribution operates more than one account.

And, the Act treats a refund of tuition paid with amounts distributed from a 529 account as a qualified expense if such amounts are re-contributed to a 529 account within 60 days. This provision is effective for refunds after 2014, or in the case of refunds after 2014 and before the date of enactment, for refunds re-contributed not later than 60 days after date of enactment.

Residency Requirement Eliminated for ABLE Programs
Under Code Sec. 529A (which was added by the Achieving a Better Life Experience Act of 2014 (ABLE Act), a part of the Tax Increase Prevention Act of 2014), for tax years beginning after December 31, 2014, states may establish qualified ABLE programs under which contributions may be made to an ABLE account that is established for the purpose of meeting the qualified disability expenses of the designated beneficiary of the account who is a resident of that state and who is disabled.

Under pre-Act law, such tax-preferred savings accounts could only be located only in the State of residence of the beneficiary.

For tax years beginning after December 31, 2014, the Act allows ABLE accounts to be established in any State. This will allow individuals setting up ABLE accounts to choose the State program that best fits their needs, such as with regard to investment options, fees, and account limits.

The provision applies to tax years beginning before, on, or after the date of enactment.

New Exclusion for Wrongfully Incarcerated Individuals
Code Sec. 104(a)(2) excludes from gross income any damages received on account of personal physical injuries or physical sickness, whether by suit or agreement and whether as a lump sum or as periodic payments. This exclusion does not apply to punitive damages.

Under current law, there are no provisions that provide an exclusion for damages related to wrongful incarceration.

The Act allows an individual to exclude from gross income civil damages, restitution, or other monetary awards that the taxpayer received as compensation for a wrongful incarceration. A "wrongfully incarcerated individual" is either: (1) an individual who was convicted of a criminal offense under Federal or state law, who served all or part of a sentence of imprisonment relating to such offense, and who was pardoned, granted clemency, or granted amnesty because of actual innocence of the offense; or (2) an individual for whom the conviction for such offense was reversed or vacated and for whom the indictment, information, or other accusatory instrument for such offense was dismissed or who was found not guilty at a new trial after the conviction was reversed or vacated.

Rollover Allowed From Retirement Plans to SIMPLE Accounts
Code Sec. 408(p)(1) provides that the only contributions allowed to a SIMPLE IRA (also called a SIMPLE retirement account) are contributions under a qualified salary reduction arrangement or rollovers or transfers from another SIMPLE IRA.

Early withdrawals from a SIMPLE retirement account are subject to the 10% early withdrawal tax that applies to early IRA withdrawals. However, under Code Sec. 72(t)(6), the early withdrawal tax rises to 25% for withdrawals of contributions made during the two-year period beginning on the date the employee first participates in any qualified salary reduction arrangement by the employee's employer.

For contributions after the date of enactment, the Act allows a taxpayer to roll over amounts from an employer-sponsored retirement plan (i.e., 401(k) plan) to a SIMPLE IRA, if the plan has existed for at least two years. Specifically, a rollover may be made from a traditional IRA under Code Sec. 408(d)(3), a qualified trust under Code Sec. 402(c), a qualified annuity under Code Sec. 403(a)(4), a 403(b) tax-sheltered annuity under Code Sec. 403(b)(8), or a governmental section 457 plan under Code Sec. 457(e)(16). But no rollover contribution is allowed to be made to the SIMPLE retirement account until after the two-year period described in Code sec. 72(t)(6) (the two-year period beginning on the date that the employee first participated in a qualified salary reduction arrangement maintained by the employee's employer).

Accelerated Due Dates for W-2, 1099, Etc. forms
For wages paid to employees, and taxes withheld from employee wages, payors must file a Form W-2 return with the Social Security Administration by February 28th of the year following the calendar year for which the return must be filed, using Form W-3, Transmittal of Wage and Tax Statements. The due date for these information returns that are filed electronically is March 31st.

And, present law requires persons to file an information return with IRS, concerning certain transactions involving the payment of non-employee compensation. Generally, these returns are on Forms in the 1099 series. Payors generally must file the information with IRS on or before the last day of February of the year following the calendar year for which the return must be filed. However, the due date for most information returns that are filed electronically is March 31st.

The Act requires forms W-2, W-3, and returns to report non-employee compensation (i.e., Form 1099-MISC), to be filed on or before January 31st of the year following the calendar year to which such returns relate. Those returns are no longer eligible for the extended filing date for electronically filed returns. This provision is effective for returns and statements relating to calendar years after the date of enactment (i.e., filed in 2017).

Alternative Tax for Small Insurance Companies Modified
Insurance companies other than life insurance companies (i.e., nonlife insurance companies) with net written premiums, or direct written premiums if greater, not in excess of $1.2 million in the tax year, have the right to elect to be taxed, at regular corporate rates, only on taxable investment income, instead of being taxed on both investment and underwriting income. Net written premiums generally means gross premiums, including deposits and assessments, written or received on insurance contracts during the tax year, less return premiums and premiums for reinsurance. Generally, direct written premiums are the gross amount of premiums received by a nonlife insurance company for directly issued (not reinsurance) insurance policies.

Effective for tax years beginning after December 31, 2016, the Act increases the maximum amount of annual premiums that small property and casualty insurance companies can receive and still elect to be exempt from tax on their underwriting income (and instead be taxed only on taxable investment income), from $1.2 million to $2.2 million (adjusted for inflation). The Act requires that no more than 20% of net written premiums (or if greater, direct written premiums) for a tax year be attributable to any one policyholder. Alternatively, a company is eligible for this exception if each owner of the insured business or assets has no greater an interest in the insurer than he has in the business or assets, and each owner holds no smaller an interest in the business than his interest in the insurer.

INDIVIDUAL INCOME TAX PROVISIONS

0% and 15% Capital Gain Rates are Made Permanent; 20% Rate is Added for High-Income Taxpayers After 2012

The 2012 Taxpayer Relief Act added a new 20% capital gain tax rate for high-income taxpayers. The 20% rate applies to the adjusted net capital gain (or, if less, taxable income) that exceeds the amount that is taxed at the 0% or 15% rates.

For tax years beginning after 2012, the 2012 Taxpayer Relief Act raises the top rate for capital gains and dividends to 20% (up from 15%) for taxpayers with incomes exceeding $400,000 ($450,000 for married taxpayers). After accounting for Code Sec. 1411's 3.8% surtax on investment-type income and gains for tax years beginning after 2012, the overall rate for higher-income taxpayers will be 23.8%. (Under the EGTRRA/JGTRRA sunset provisions, long-term capital gain was to be taxed at a maximum rate of 20%, with an 18% rate for assets held more than five years, and dividends paid to individuals were to be taxed at the same rates that apply to ordinary income.)

For taxpayers whose ordinary income is generally taxed at a rate below 25%, capital gains and dividends will permanently be subject to a 0% rate. (Under the EGTRRA/JGTRRA sunset provisions, long-term capital gain of lower-income taxpayers was to be taxed at a maximum rate of 10%, with an 8% rate for assets held more than five years, and dividends were to be subject to ordinary income rates.) Taxpayers who are subject to a 25%-or-greater rate on ordinary income, but whose income levels fall below the $400,000/$450,000 thresholds, will continue to be subject to a 15% rate on capital gains and dividends. The rate will be 18.8% for those subject to the 3.8% surtax (i.e. those with modified adjusted gross income (MAGI) over $250,000 for joint filers or surviving spouses, $125,000 for a married individual filing a separate return, and $200,000 in any other case).

Under the 2012 Taxpayer Relief Act, the 15% rate applies to the lesser of:

- the portion of the adjusted net capital gain (or, if less, taxable income) that exceeds the amount that is taxed at a 0% rate, or
- the excess of: (i) the amount of taxable income that would otherwise be taxed at a rate below 39.6%, over (ii) the sum of the amounts that are taxed at ordinary income rates or the 0% capital gain rate.

The 39.6% income tax rate applies to taxable income above $450,000 for joint filers and surviving spouses, $425,000 for heads of household, $400,000 for single filers, and $225,000 for married taxpayers filing separately, adjusted for inflation after 2013. Thus, the 20% capital gain rate applies to taxpayers whose income exceeds these thresholds.

Because the 3.8% net investment income tax (NIIT) applies to most capital gains starting in 2013 the overall capital gain rate for some high-income taxpayers will be 23.8% (20% + 3.8%). The NIIT applies to taxpayers whose modified adjusted gross income (MAGI) exceeds $250,000 for joint returns and surviving spouses, $125,000 for separate returns, and $200,000 in all other cases.

Taxpayers who are subject to a 25%-or-greater rate on ordinary income, but whose income is below the 39.6% rate threshold, will continue to be subject to a 15% capital gain rate. For taxpayers whose ordinary income is taxed at a rate below 25%, capital gains will permanently be subject to a 0% rate.

Qualified Dividends are Taxed at 0%, 15%, and 20% Rates after 2012

"Qualified dividend income" – generally, dividends received from domestic corporations and "qualified foreign corporations," subject to holding period requirements and specified exceptions – is effectively treated as, and is taxed at the same rates that apply to, adjusted net capital gain.

Holding Period
For dividends on stock to qualify as qualified dividend income, the taxpayer must hold the stock for at least 61 days during the 121-day period beginning 60 days before the ex-dividend date.

Unrecaptured Section 1250 Gain

The amount of a taxpayer's "unrecaptured section 1250 gain" – that portion of a noncorporate taxpayer's long-term capital gain that is attributable to real estate depreciation – that is eligible to be taxed at a maximum 25% rate is limited to the taxpayer's net capital gain determined without regard to the taxpayer's qualified dividend income.

The treatment of qualified dividend income as adjusted net capital gain, taxable at the same rates that apply to adjusted net capital gain, is made permanent.

Under the 2012 Taxpayer Relief Act, capital gain is taxed at 0%, 15%, and 20% rates after 2012. The 20% rate applies to taxpayers whose income exceeds $450,000 for joint filers and surviving spouses, $425,000 for heads of household, $400,000 for single filers, and $225,000 for married taxpayers filing separately. Qualified dividends will be taxed at the same 0%, 15%, and 20% rates that apply to capital gain.

Because the 3.8% net investment income tax (NIIT) applies to dividends starting in 2013, the overall tax rate on qualified dividends for some high-income taxpayers will be 23.8% (20% + 3.8%). The NIIT applies to taxpayers whose modified adjusted gross income (MAGI) exceeds $250,000 for joint returns and surviving spouses, $125,000 for separate returns, and $200,000 in all other cases.

Taxpayers who are subjected to a 25%-or-greater rate on ordinary income, but whose income is below the 39.6% rate thresholds, will continue to be subject to a 15% rate on qualified dividends. For taxpayers whose ordinary income is taxed at a rate below 25%, qualified dividends will permanently be subject to a 0% rate.

With the removal of the JGTRRA sunset, the following rules related to qualified dividends, discussed above, have also been made permanent:

- The holding period rule for determining when dividends on stock qualify as qualified dividend income.
- The exclusion of qualified dividend income from net capital gain for purposes of computing the limitation on the amount of unrecaptured section 1250 gain that is eligible to be taxed at a maximum 25% rate.

The effect of the provision is to remove the sunset that would have been effective for tax years beginning after December 31, 2012.

Election to Include Qualified Dividends in Investment Income for Purposes of Investment Interest Deduction is Made Permanent

A noncorporate taxpayer's deduction for investment interest expense is limited to the amount of the taxpayer's net investment income, i.e., the excess of investment income over investment expenses for the year. Any investment interest that is disallowed because it exceeds this limit is carried over to the next tax year and treated as investment interest paid or accrued in that year.

Qualified dividend income (dividends taxed at capital gain rates) is included in "investment income" for this purpose only to the extent the taxpayer elects to include it. Any amount that the taxpayer elects to treat as investment income is not treated as qualified dividend income and is not eligible to be taxed at capital gain rates.

A taxpayer whose investment interest deduction is limited because the interest exceeds the amount of his net investment income can increase the deduction by electing to include all or part of qualified dividend income in investment income. The cost of making the election is that the dividends will be taxed as ordinary income rather than capital gain.

Exclusion of 100% of Gain on Certain Small Business Stock Permanently Extended

A taxpayer may exclude all of the gain on the disposition of qualified small business stock acquired after September 27, 2010 and before January 1, 2015. None of the excluded gain is subject to the alternative minimum tax.

Under pre-Act law, the exclusion was to be limited to 50% of gain for stock acquired after December 31, 2014, and 7% of the excluded gain was to be an alternative minimum tax preference.

The Act retroactively and permanently extends the 100% exclusion and the exception from minimum tax preference treatment.

Reduction in Itemized Deductions and Phaseout of Personal Exemptions Apply to Some High-Income Individuals

High-income individuals should be aware that their itemized deductions may be reduced, and their personal exemptions phased out, under the following rules:

Itemized deductions (other than medical and investment interest expenses, non-business casualty and theft loses, and gambling losses) must be reduced by the lesser of 3% of adjusted gross income in excess of specified levels, or 80% of the amount of itemized deductions otherwise allowable. The following are the levels at which the reduction begins in 2016 and 2017:

- For returns of single taxpayers, the level is $259,400 in 2016, and $261,500 in 2017.
- For returns of heads of household, the level is $285,350 in 2016, and $287,650 in 2017.
- For filers of joint returns, the level is $311,300 in 2016, and $313,800 in 2017.
- For returns of married taxpayers filing separate returns, the level is $155,650 in 2016 and $156,900 in 2017.

Personal exemptions ($4,050 per exemption for 2016, $4,050 for 2017) are phased out for taxpayers at a rate of 2% for each $2,500 or fraction of $2,500 ($1,250 or fraction of $1,250 for married taxpayers filing separate returns) by which the taxpayer's AGI exceeds certain levels. The levels at which the phase-out begins are the same levels set out above at which the reduction in itemized deductions begins.

The Adoption Assistance Exclusion is Made Permanent

Employees can exclude from gross income the qualified adoption expenses paid or reimbursed by an employer under an employer-provided adoption assistance program. The exclusion is subject to both (i) a dollar limit (under which the total amount of excludible adoption expenses cannot exceed a maximum amount), and (ii) an income limit (under which the exclusion is ratably phased out over a certain income range, based on modified adjusted gross income (AGI)).

The 2012 Taxpayer Relief Act permanently extends the adoption assistance exclusion.

For Tax years beginning in 2013 (and years thereafter), it is anticipated that IRS will issue inflation-adjusted amounts for the maximum exclusion and the phaseout range.

For tax years beginning in 2017:

- the maximum exclusion is $13,570 (up from $13,460 for 2016), as adjusted for inflation; and
- the phaseout range is $203,540 to $243,540, as adjusted for inflation.

Additional 0.9% Medicare Tax Will be Imposed After 2012 on Wages and Self-Employment Income over Threshold Amounts

FICA Taxes

The Federal Insurance Contributions Act (FICA) imposes two taxes on employees on wages received with respect to employment. Similar taxes are imposed on wages paid by employers.

The Old Age, Survivors and Disability Insurance (OASDI) tax is imposed at a 6.2% rate, on wages up to an annually adjusted "wage base" ($127,200 for 2017).

Under pre-2010 Health Care Act law, the Medicare Hospital Insurance (HI) tax was imposed at a 1.45% rate on all wages, regardless of amount.

Employers must collect the employee FICA tax by withholding it from the employee's wages when paid.

The 2010 Health Care Act increases the employee portion of the HI tax after 2012 by an additional tax of 0.9% on wages received in excess of the applicable threshold amount (see below). Unlike the general 1.45% HI tax on wages, the additional tax on a joint return is on the combined wages of the employee and the employee's spouse.

The same additional HI tax applies to the HI portion of SECA tax on self-employment income. Thus, an additional tax of 0.9% is imposed on every self-employed individual on self-employment income in excess of the applicable threshold amount. The threshold amount is reduced (but not below zero) by the amount of wages taken into account in determining the taxpayer's FICA tax.

For tax years beginning after December 31, 2012, an additional 0.9% HI tax will be imposed on taxpayers (other than corporations, estates, or trusts) on wages received with respect to employment in excess of:

- $250,000 for joint returns (Code Sec. 3101(b)(2)(A)),
- $125,000 for married taxpayers filing a separate return, and
- $200,000 in all other cases.

These threshold amounts are not indexed for inflation. Thus, as time goes on, more taxpayers will become subject to these taxes.

This tax will be in addition to the regular HI rate of 1.45% of wages received by employees with respect to employment.

Thus, the HI tax rate will be:

- 1.45% on the first $200,000 of wages ($125,000 on a separate return, $250,000 of combined wages on a joint return); and
- 2.35% (1.45% + 0.9%) on wages in excess of $200,000 ($125,000 on a separate return, $250,000 of combined wages on a joint return).

This change does not affect the HI tax imposed on employers.

A single taxpayer earns wages of $500,000 for 2013. Taxpayer pays HI tax of $2,900 on the first $200,000 of wages ($200,000 x 1.45%) and $7,050 on the excess of his wages over $200,000 ($300,000 x 2.35%), for a total HI tax of $9,950.

For 2013, H and W file a joint return. H earns wages of $125,000 and W earns wages of $175,000. H and W pay HI tax of $3,625 ($250,000 x 1.45%) on their first $250,000 of wages and $1,175 on the excess of their combined wages over $250,000 ($50,000 x 2.35%), for a total HI tax of $4,800.

Employer's Obligation to Withhold

The employer is required to withhold the additional 0.9% HI tax on wages. The employer is liable for the tax that it fails to withhold from wages or to collect from the employee (where the employer fails to withhold).

However, an employer's obligation to withhold the additional 0.9% HI tax applies only to wages in excess of $200,000 that the employee receives from the employer. The employer may disregard the amount of wages received by the employee's spouse. The Committee Report adds that the employer must disregard the spouse's wages.

Thus, the employer is only required to withhold the additional 0.9% HI tax on wages in excess of $200,000 for the year, even though the tax may apply to a portion of the employee's wages at or below $200.000, if the employee's spouse also has wages for the year, they are filing a joint return, and their total combined wages for the year exceed $250,000.

For 2016, H has wages of $250,000, and W has wages of $100,000. H's employer must withhold the additional 0.9% HI tax on the $50,000 of H's wages in excess of $200,000. W's employer is not required to withhold any portion of the additional 0.9% HI tax, even though H and W's combined wages are over the $250,000 threshold.

Couples in this situation may have to make estimated tax payments to cover the additional 0.9% HI tax, because the amounts withheld by their employers will not be sufficient.

The employer will not be liable for any additional 0.9% HI tax that it fails to withhold and that the employee later pays, but will be liable for any penalties resulting from its failure to withhold.

The employee will be liable for the additional 0.9% HI tax to the extent it is not deducted by the employer. In contrast, employees generally have no direct liability for the employee portion of the general 1.45% HI tax.

The amount of the additional 0.9% HI tax not withheld by an employer must be taken into account in determining a taxpayer's estimated tax liability.

The above is effective for tax years beginning after December 31, 2012.

New 3.8% Medicare Contribution Tax Will be Imposed after 2012 on Net Investment Income of Individuals, Estates, and Trusts

The 2010 Reconciliation Act imposes an unearned income Medicare contribution tax on individuals, estates, and trusts.

The tax is generally levied on income from interest, dividends, annuities, royalties, rents, and capital gains.

For individuals, the tax is 3.8% of the lesser of (a) net investment income or (b) the excess of modified adjusted gross income (MAGI) over the applicable threshold amount.

Net investment income is investment income reduced by the deductions properly allocable to such income.

MAGI is adjusted gross income (AGI) increased by the amount excluded from income as foreign earned income, net of the deductions and exclusions disallowed with respect to the foreign earned income.

The threshold amount is $250,000 for joint returns or surviving spouses, $125,000 for separate returns, and $200,000 in other cases.

Only individuals with MAGI above the applicable threshold amount will be subject to the tax.

1) *For 2016, a single taxpayer has net investment income of $50,000 and MAGI of $180,000. The taxpayer will not be liable for the Medicare contribution tax, because his MAGI ($180,000) does not exceed his threshold amount ($200,000).*
2) *For 2016, a single taxpayer has net investment income of $100,000 and MAGI of $220,000. The taxpayer would pay a Medicare contribution tax only on the $20,000 amount by which his MAGI exceed his threshold amount of $200,000, because that is less than his net investment income of $100,000. Thus, taxpayer's Medicare contribution tax would be $760 ($20,000 x 3.8%).*

An individual will pay the 3.8% tax on the full amount of his net investment income if his MAGI exceeds his threshold amount by at least the amount of the net investment income.

3) *Assume that the taxpayer in illustration (2) had MAGI of $300,000. Because taxpayer's MAGI exceeds his threshold amount by $100,000, he would pay a Medicare contribution tax on his full $100,000 of net investment income. Thus, taxpayer's Medicare contribution tax would be $3,800 ($100,000 x 3.8%).*

The Medicare contribution tax is in addition to the 0.9% HI tax on wages and on self-employment income in excess of threshold amounts. Taxpayers who have both high wages or self-employment income and high investment income may be hit with both taxes.

4) *For 2016, a single taxpayer has net investment income of $100,000, Wages of $300,000, and MAGI of $375,000. In addition to paying a Medicare contribution tax of $3,800, as explained in illustration (3), the taxpayer would also pay an additional HI (Medicare) tax of $900 ($100,000 x 0.9%) on his wages in excess of $200,000.*

For estates and trusts, the tax is 3.8% of the lesser of (a) undistributed net investment income or (b) the excess of AGI over the dollar amount at which the highest estate and trust income tax bracket begins.

"Net Investment Income" Defined

For purposes of the Medicare contribution tax, "net investment income" means the excess, if any, of:

1) The sum of:

- gross income from interest, dividends, annuities, royalties, and rents, unless those items are derived in the ordinary course of a trade or business to which the Medicare contribution tax does not apply (see below),
- other gross income derived from a trade or business to which the Medicare contribution tax applies (see below),
- net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the Medicare contribution tax does not apply, over

2) The allowable deductions that are properly allocable to that gross income or net gain.

Gross income does not include items, such as tax-exempt bond interest, veterans' benefits, and excluded gain from the sale of a principal residence, that are excluded from gross income for income tax purposes.

Trades and Businesses to Which Tax Applies
The Medicare contribution tax applies to a trade or business if it is:

- a passive activity of the taxpayer, within the meaning of Code Sec. 469, or
- a trade or business of trading in financial instruments or commodities as defined in Code Sec.475(e)(2).

The Medicare contribution tax does not apply to other trades or businesses conducted by a sole proprietor, partnership, or S corporation.

Thus, for a taxpayer that does not engage in a passive activity or a financial instrument or commodities trading business, "net investment income" will include non-business income from interest, dividends, annuities, royalties, rents, and capital gains, minus the allocable deductions. Business income will not be included.

For a taxpayer that does engage in a passive activity or a financial instrument or commodities trading business, "net investment income" will include the above items, plus the gross income (minus allocable deductions) from the passive activity or trading business.

Income on Investment of Working Capital Subject to Tax
For purposes of the definition of "net investment income," a rule applies that is similar to the rule of Code Sec. 469(e)(1)(B), which treats income, gain, or loss attributable to an investment of working capital as not derived in the ordinary course of a trade or business.

Thus, income, gain, or loss on working capital is not treated as derived from a trade or business.

As a result, those items will be subject to the Medicare contribution tax.

Exception for Certain Active Interests in Partnerships and S Corporations
Gain from a disposition of an interest in a partnership or S corporation is taken into account as net investment income only to the extent of the net gain that the transferor would take into account if the partnership or S corporation had sold all its property for fair market value immediately before the disposition.

A similar rule applies to a loss from a disposition of an interest in a partnership or S corporation.

Thus, only net gain or loss attributable to property held by the entity that is not properly attributable to an active trade or business is taken into account. For this purpose, a business of trading financial instruments or commodities is not treated as an active trade or business.

Qualified Plan Distributions
Qualified retirement plan distributions are not included in investment income. Specifically, net investment income does not include any distribution from a plan or arrangement described in: (Code Sec. 1411 (c)(5))

- Code Sec. 401(a) (qualified pension, profit-sharing, and stock bonus plans);
- Code Sec. 403(a) (qualified annuity plans);
- Code Sec. 403(b) (annuities for employees of tax-exempt organizations or public schools);
- Code Sec. 408 (individual retirement accounts-IRAs);
- Code Sec. 408A (Roth IRAs);
- Code Sec. 457(b) (deferred compensation plans of state and local governments and tax exempt organizations).

Investment income does not include amounts subject to SECA taxes. Specifically, net investment income does not include any item taken into account in determining self-employment income for the tax year, if that item is subject to the HI portion of SECA taxes under Code Sec. 1401(b).

Estates and trusts are subject to a Medicare contribution tax for each tax year equal to 3.8% of the lesser of:

1) The estate's or trust's undistributed net investment income for the tax year, or
2) The excess (if any) of:

- the estate's or trust's AGI for the tax year, over
- the dollar amount at which the highest tax bracket in Code Sec. 1(e) begins for the tax year.

For 2016, the highest estate and trust income tax bracket begins at $12,400. These brackets are indexed for inflation.

The Medicare contribution tax does not apply to a trust all of the unexpired interests in which are devoted to one or more of the charitable purposes described in Code Sec. 170(c)(2)(B).

The tax also does not apply to a trust that is tax-exempt under Code Sec. 501 or a charitable remainder trust exempt from tax under Code Sec. 664.

In addition, the Medicare contribution tax probably will not apply to simple trusts and grantor trusts. A simple trust is a trust that makes no distribution other than of current income and whose terms require all of its income to be distributed currently and do not provide for charitable contributions. Thus, it would not have any undistributed net investment income that would be subject to the Medicare contribution tax.

Under the grantor trust rules, a grantor or other person, such as a beneficiary, may be treated as "owner" of all or part of the trust and taxed directly, to that extent, on the trust income. To the extent that the grantor trust rules apply, the regular rules for taxing trusts and their beneficiaries do not apply.

The Medicare contribution tax is subject to the individual estimated tax provisions. The Medicare contribution tax is treated as "tax" for purposes of computing the penalty for underpayment of estimated tax.

Tax Planning

Items of income that are excluded from income reduce both MAGI and net investment income. This provides higher-income taxpayers potentially subject to the UIMCT additional incentive to structure transactions that result in either tax-exempt or tax-deferred income. Higher-income taxpayers can minimize the UIMCT by including non-dividend paying growth stocks, which do not increase MAGI or create investment income until sold, in their investment portfolio. Tax-deferred annuities and related investments will also minimize liability for the UIMCT, and may become more popular.

Because tax-exempt income is not included in either MAGI or investment income, higher-income taxpayers will have increased incentive to invest in state and local obligations exempt from tax.

Investment income includes net gain (to the extent taken into account in computing taxable income) from the disposition of property. Tax planning strategies that reduce or defer capital gain income will also reduce or defer net investment income for purposes of the UIMCT. Using the installment method of accounting to report gain on the sale of property sold on an installment basis, for example, will minimize the impact of the UIMCT because it avoids a large increase in both MAGI and investment income in the year of sale. Taxpayers selling property on an installment basis in 2012, on the other hand, should consider electing out of the installment method and recognizing the entire amount of the gain before the 3.8% UIMCT goes into effect.

Because gain on the disposition of property is included in investment income only to the extent it is taken into account in computing taxable income, taxpayers should analyze their portfolios at the end of the year to determine whether they can reduce their MAGI and investment income. For example, selling stock that has decreased in value and using the loss to offset capital gain that would otherwise be included in income will reduce both MAGI and investment income.

Because distributions from qualified retirement plans are not included in net investment income, the UIMCT provides taxpayers with additional incentive to maximize retirement plan contributions.

Taxpayers should consider the UIMCT in planning for passive activities. Passive income is investment income for purposes of the UIMCT. Classifying income as passive is generally advantageous for taxpayers with sufficient passive losses to offset the passive income. For taxpayers with net passive income, however, the UIMCT increases the tax rate on passive income. The UIMCT gives taxpayers with passive activities, including passive rental activities, and additional factor to consider in passive activity planning.

The UIMCT provides higher-income taxpayers with another incentive to consider the use of family limited partnerships and related estate planning techniques. Investment income transferred from parents with significant MAGI and investment income to children with MAGI below the applicable threshold amount through the use of family limited partnerships will not be subject to the UIMCT on what otherwise would be the parent's investment income. Although investment income transferred to children through a family limited partnership may be taxed at their parent's rate under the "kiddie tax" rules, the children will be subject to the UIMCT only if their income (including income from a family limited partnership) exceeds the applicable threshold. Children subject to the kiddie tax are taxed at their parent's rate for purposes of the regular tax. Children will not be subject to the UIMCT merely because their parents are.

Estates and trusts with undistributed net investment income will be subject to the UIMCT whenever their adjusted gross income exceeds the dollar amount at which the top marginal tax rate begins. Because the top marginal rate for estates and trusts begins at a relatively small amount of income ($12,400 in 2016), the UIMCT is of particular concern to estates and trusts and should be considered in both distribution and investment decisions.

Estates and trusts are subject to the UIMCT only if they have undistributed net investment income. Estates and trusts can reduce undistributed net investment income and thereby minimize or eliminate the UIMCT by distributing income to beneficiaries. Any distribution will increase the beneficiary's net investment income and potential liability for the UIMCT. However, the threshold amount for individuals is much higher than that for estates and trusts, and the UIMCT can be eliminated if the beneficiary's MAGI remains below the threshold amount.

Estates and trusts should also consider the UIMCT in making investment decisions. Because estates and trusts are subject to the UIMCT at a relatively low level of adjusted gross income, the previously discussed strategies for reducing adjusted gross income and net investment income are particularly important for estates and trusts. The UIMCT increases the already existing incentives estates and trusts have to invest in tax-exempt and tax-deferred investments.

The new 0.9% tax on earned income and 3.8% tax on net investment income will increase the tax burden of higher-income taxpayers beginning in 2013. Taxpayers should begin planning now in order to minimize the impact of these taxes in 2013 and beyond.

Limits on Deductions for Investment and Personal Interest

The deductibility of investment and personal interest is limited.

Investment Interest
Investment interest, generally defined as interest used to buy or carry investment property, is deductible by noncorporate taxpayers only to the extent of net investment income. Investment income includes income such as dividends, interest and certain gain on the sale of investment property but, for purposes of the investment interest deduction, generally does not include net capital gain from disposing of investment property (including capital gain distributions from mutual funds) or qualified dividend income. Net capital gain is the excess of net long-term capital gain for the year over the net short-term capital loss for the year. Qualified dividend income is income from dividends that qualify to be taxed at the net capital gain tax rates. However, the taxpayer can choose to include part or all of net capital gain and qualified dividend income in investment income. (Investment interest not allowed as a deduction for a tax year because of the investment interest limit is treated as interest paid or accrued in the following year and may eventually become deductible, either in the following tax year or in some later year).

Election to Include Net Capital Gain and Qualified Dividend Income in Investment Income
A taxpayer may elect to include all or part of his net capital gain and qualified dividend income in investment income. However, any amount that the taxpayer elects to include in investment income does not qualify for the favorable maximum tax rates that apply to net capital gain and qualified dividend income. Net capital gain and qualified dividend income is reduced (but not below zero) by the amount the taxpayer elects to take into account as investment income to permit investment interest deductions. (In deciding whether to make the special election, taxpayers whose marginal rate is 25% or higher should compare the relative tax benefits of:

- postponing the interest deduction to a later year, or
- giving up the benefit of the maximum capital gain and qualified dividend income rate ceilings.

Their calculations should take into account the time value of money, the length of the deferral and the taxpayer's top tax brackets for 2010 and for the year that the investment interest is likely to be deducted).

Personal Interest
Personal interest is not deductible. This includes all interest except:

- interest connected with a trade or business (but not interest paid on a tax deficiency arising from an unincorporated business),
- investment interest,
- passive activity interest,
- qualified residence interest,
- interest on qualifying higher-education loans, and
- otherwise deductible interest on deferred estate tax payments.

Passive Activity Loss Rules
Interest may also be subject to passive activity loss rules. The passive activity loss and investment interest rules dovetail in such a way that any interest, other than personal interest, qualified residence interest, estate tax interest, or interest relating to a trade or business in which the taxpayer materially participates, is subject to one of the two rules. The application of the investment interest limitation is described above. Interest that relates to a passive activity is subject to the passive activity rules.

Qualified Residence Interest
One kind of interest that remains deductible is qualified residence interest. This term includes interest on debt secured by the taxpayer's principal residence and one other qualified residence (including a trailer or houseboat). If the taxpayer has a principal residence and two or more other residences, he can choose each year which of the other homes qualifies as his second residence.

Qualified residence interest includes acquisition debt and home equity debt with respect to a taxpayer's qualified residence. The maximum amount of acquisition debt is $1 million. Home equity debt cannot exceed $100,000 (or, if less, taxpayer's equity in the home). Under a grandfather provision, pre-October 14, 1987 mortgage debt (regardless of amount) is treated as acquisition debt.

Acquisition debt is debt that is incurred in acquiring, constructing or substantially improving the principal or second qualified residence of the taxpayer and which is secured by the residence. If the debt to acquire, construct or substantially improve a principal and second residence exceeds $1 million, then only the interest on a total principal amount of $1 million is deductible as interest on acquisition debt.

You cannot deduct the interest for acquisition debt greater than $1 million ($500,000 for married individuals filing separately). So, for example, if you were to buy a $2 million house with a $1.5 million mortgage, only the interest that you pay on the first $1 million in debt will be deductible. The rest will be considered personal interest and not deductible.

Note also that the $1 million ceiling on deductible home mortgage debt includes both your primary residence and your second home combined.

Acquisition indebtedness is defined by code section 163(h)(3) as any indebtedness which is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and is secured by such residence. In other words if you borrowed $500,000 from the bank and secured this loan with your primary residence and further used the $500,000 to acquire a vacation home in Wisconsin, a literal reading of the code would conclude that the interest expense on this $500,000 loan would be non-deductible personal interest and this is because the Wisconsin residence does not secure such debt. The interest on this same loan would be fully deductible simply by securing the loan by the Wisconsin residence.

We have seen many clients borrowing on their principal residence in order to acquire a second home in the last few years. In order to be able to deduct this interest expense you must make sure that the debt is secured by the second home. While this may seem unnecessary, we have reached our conclusions after receiving second opinions on this issue from a law firm as well as directly from the IRS.

A residence under construction may be treated as a qualified residence for a period of up to 24 months, but only if it becomes a qualified residence as of the time it is ready for occupancy. The 24-month period referred to above may begin on or after the date construction began.

X owns a residential lot. On April 20 of year 1, X obtains a mortgage loan ***secured by the lot and any property to be constructed on the lot****. He uses the proceeds of the loan to finance the construction of a vacation home on the lot. Construction commences on August 9 of year 1. The vacation home is ready for occupancy on November 9 of year 3, and qualified as X's second residence at that time. Under these circumstances, X may treat the vacation home as a second residence for any 24-month period during which it was under construction. This 24-month period may commence on or after the date construction began (August 9 of year 1). If X chooses to begin this 24-month on August 9 of year 1, the period ends on August 8 of year 3. Whether the vacation home is a qualified residence for the period August 9 – November 8 of year 3 is determined without regard to the "under construction" rules.*

If you are planning to refinance your mortgage, special rules apply. If the old mortgage that you are refinancing is home acquisition debt, your new mortgage will also be home acquisition debt, up to the principal balance of the old mortgage just before it was refinanced. The interest on this portion of the new mortgage will be deductible. Any debt in excess of this limit will not be home acquisition debt. In other words, a taxpayer who refinances cannot take down additional cash and have it count as acquisition indebtedness. Acquisition indebtedness may be refinanced to take advantage of lower rates or more favorable terms. As long as there is no additional amount of indebtedness the new debt is also treated as acquisition indebtedness. In general, points that you pay to refinance your home are not fully deductible in the year that you paid them. Instead, you can deduct a portion of these points each year over the life of the loan.

Home Equity Debt

Home equity debt is debt (other than acquisition debt) secured by the taxpayer's principal or second residence. Interest on home equity debt is deductible even if the proceeds are used for personal purposes.

Tracing of Interest

Temporary regs on allocating interest expense for purposes of the limitations on passive activity losses, investment and personal interest employ a system of tracing disbursements of debt proceeds to specific expenditures. This generally means that the allocation of interest depends on how the debt proceeds are used. An exception to this rule applies to qualified residence interest, the allocation of which is governed by the security (i.e., the residence) given for the debt. Taxpayers can take advantage of these rules by using loan proceeds for deductible purposes, or by using home equity debt as the source of personal expenditures.

Health Savings Accounts

The rising cost of health care coverage has caused many individuals and employers to switch from traditional health insurance coverage to high-deductible health plans. Individuals or employees who were covered by a high-deductible health plan at any time during 2012 have a savings opportunity. They can contribute an amount equal to all or a part of their annual deductible to a Health Savings Account (HSA). Contributions by an individual to an HSA are deductible above-the-line in computing Adjusted Gross Income (AGI).

Any "eligible individual" can set up an HSA. An eligible individual is a person who:

- is covered under a high-deductible health plan (HDHP) on the first day of the month,
- is not covered by any other health plan that is not a HDHP (with certain exceptions for plans providing limited types of coverage),
- is not entitled to Medicare benefits (generally, has not yet reached age 65), and
- may not be claimed as a dependent on another person's tax return.

For example, an individual may acquire high-deductible health coverage from an insurer and set up an HSA through the insurer or with a bank. Similarly, an employee who has qualifying high-deductible coverage through his employer can independently establish and fund an HSA.

For 2017, a high deductible health plan may be either an insured plan or an employer-sponsored self-insured medical reimbursement plan. In the case of individual self-only coverage, a plan must have an annual deductible of at least $1,300 and an annual cap on out-of-pocket expenses (counting deductibles, copayments, and other amounts, but not premiums) of no more than $6,550. For family coverage, the annual deductible must be at least $2,600 and the annual out-of-pocket expense cap cannot exceed $13,100. The plan must provide that no payments will be made until the family as a whole has incurred annual covered expenses in excess of the annual deductible.

The amount that can be contributed to an HSA depends on the type of coverage (i.e., self-only or family), the annual deductible, and the period of coverage during the year. The maximum annual contribution is the sum of limits determined separately for each month.

For 2016, the maximum monthly contribution for an individual with self-only coverage is 1/12 of the lesser of the annual deductible (minimum $1,300) or $3,350 ($3,400 for 2017). For family coverage, the maximum annual contribution is 1/12 of the lesser of the annual deductible (minimum $2,600) or $6,750 ($6,750 for 2017).

Individuals age 55 and older can make catch-up contributions in addition to their regular contributions for the year. For 2016, the catch-up contribution limit is $1,000. As with regular contributions, catch-up contributions are computed on a monthly basis.

Contributions, including catch-up contributions cannot be made to an individual's HSA after age 65.

Although the contribution limits are determined monthly, annual HSA contributions can be made in one or more payments at any time before the contribution deadline. The contribution deadline is the due date (without extensions) for filing the individual's return for the year of the contribution. Thus, for calendar year taxpayers, the deadline for making 2016 HSA contributions is April 15, 2017.

Distributions from an HSA are tax-free to the extent they are used to pay for qualified out-of-pocket medical expenses of the HSA account holder or the account holder's spouse or dependents. However, distributions qualify for tax-free treatment only if they are used to pay qualified medical expenses that were incurred after the HSA was established. Consequently, taxpayers who have not yet established an HSA will not be able to use their 2016 contributions to cover medical expenses incurred earlier in the year.

HSA funds that are not needed for medical expenses can serve as a tax-deferred savings for retirement. A distribution that is not used to pay qualified medical expenses is includible in the gross income of the account holder. In addition, such a distribution generally is subject to an additional 10% tax. However, the 10% penalty tax does not apply to distributions made on account of death or disability or after the account holder reaches age 65.

Reduced Home Sale Exclusion for Some Sellers

Most homeowners are aware of the home sale exclusion, a provision of the tax laws which provides that homeowners who sell their principal residence typically do not need to pay taxes on as much as $500,000 of their gain if they meet certain conditions. (The $500,000 exemption is the maximum exclusion for a married couple filing jointly; taxpayers filing individually get an exemption of up to $250,000.) To be eligible for the full exclusion, a taxpayer must have owned the home – and lived in it as his or her principal residence – for at least two of the five years prior to the sale. Because of the "principal residence" requirement, vacation or second homes normally do not qualify for the exclusion. However, in what some saw as a loophole, the law permitted taxpayers to convert their second home to their principal residence, live in it for two years, sell it, and take the full $250,000/$500,000 exclusion available for principal residences, even though portions of their gains were attributable to periods when the property was used as a vacation or second home, not a principal residence.

The new law closes that "loophole" by requiring homeowners to pay taxes on gains made from the sale of a second home to reflect the portion of time the home was not used as a principal residence (e.g., vacation or rental property). The amount taxed will be based on the portion of the time during which the taxpayer owned the home that the house was used as a vacation home or rented out. The rest of the gain remains eligible for the up-to-$500,000 exclusion, as long as the two-out-of-five year usage and ownership tests are met. The new law in effect reduces the exclusion based on the ratio of years of use as a principal residence to the total time of ownership. For example, if a taxpayer owned a vacation home for ten years, but lived in it as a principal residence only for the final two years prior to sale, the maximum available exclusion would be reduced by four-fifths. Accordingly, a $400,000 gain on the sale that would be eligible for the full exclusion under pre-Act law would be reduced by four-fifths, to $80,000.

The good news for current owners of second homes is that the new law is not retroactive. The tightening applies only to sales after 2008. Plus, any periods of personal or rental use before 2009 are ignored for purposes of the provision. Also, the new law does not change the rule that allows homeowners to take advantage of the home sale exclusion every two years. Taxpayers can still "home hop" with full tax exclusion if they only own one home at a time. Moreover, the taxpayer still qualifies for capital gain treatment on the amount of gain that cannot be excluded.

For purposes of the allocation of gain to periods of nonqualified use, a "period of nonqualified use" is any period (other than the portion of any period preceding January 1, 2009) during which the property is not used as the principal residence of the taxpayer or the taxpayer's spouse or former spouse.

Since the definition of a period of nonqualified use doesn't include any period preceding January 1, 2009, a taxpayer can avoid the application of Code Sec. 121 (b)(4) if he moves into his vacation home (or any other residence owned by the taxpayer) and makes it his principal residence before January 1, 2009.

<u>*Exceptions to the Definition of a Period of Nonqualified Use*</u>
A period of nonqualified use will *not* include any portion of the five-year testing period which is after the last date that the property is used as the principal residence of the taxpayer or the taxpayer's spouse. Thus, any period after the last date the property was used as the principal residence of the taxpayer or his spouse (regardless of use during that period) is not taken into account in determining periods of nonqualified use.

Z, an individual, buys a principal residence on January 1, Year 9 (a year beginning after December 31, 2008), for $400,000, and moves out on January 1, Year 19. On December 1, Year 21 (more than two years after it was last used as Z's principal residence), Z sells the property for $600,000. The entire $200,000 gain will be excluded from gross income, as under pre-2008 Housing Act law.

Since the period that Z did not use the residence as a principal residence occurred after the last date that Z had used the property as a principal residence during the five-year testing period, that period will not be considered to be a period of nonqualified use under the exception. Thus, even if Z had rented the residence (his former principal residence) during Years 19 and 20, that period will not be considered to be a period of nonqualified use.

Since the exception provided above will only apply to any portion of the five-year testing period which is after the last date that the property is used as the principal residence of the taxpayer or the taxpayer's spouse, the exception will not apply to periods of nonqualified use that occurred before the five-year testing period. If a taxpayer uses the property as his principal residence in more than one period of time during the ownership period, the exception will only apply to the period after the last date that the property was used a principal residence by the taxpayer or his spouse. Any other periods that he did not use the property as his principal residence presumably will be considered to be periods of nonqualified use. Unless one of the other exceptions (such as the temporary absence exception or the exception for taxpayers serving on qualified official extended duty, both described below) apply, those periods of nonqualified use will be included in the numerator of the ratio (used to determine the amount of gain allocated to nonqualified use as part of the aggregate periods of nonqualified use during the period the taxpayer owned the property.

C, an individual, buys a principal residence on January 1, Year 1 (a year beginning after December 31, 2008), for $400,000, and lives in it as his principal residence for five years (i.e., until December 31, Year 5). Due to a change in his employment, C moves away and does not use the property as his principal residence for the next five years (January 1, Year 6 to December 31, Year 10). On January 1, Year 11, C moves back in the house and uses it as his principal residence. On December 31, Year 20, C sells the property for $800,000 and realizes a gain of $400,000.

The five-year period from January 1, Year 6 to December 31, Year 10 will not qualify for the exception and thus, is a period of nonqualified use. That period of nonqualified use was not a portion of the five-year testing period which was after the last date that the property was used as a principal residence.

Thus, 25% of the gain [5 years (the aggregate period of nonqualified use during the taxpayer's ownership of the property) ÷ 20 years (the period of the taxpayer's ownership of the property)] will be gain allocated to periods of nonqualified use and the Code Sec. 121 exclusion will not apply to $100,000 (25% of $400,000). Of the remaining $300,000 of gain, the maximum amount of gain that qualifies for the Code Sec. 121 exclusion will be $250,000.

In Summary, C's taxable gain from the sale will include: $100,000 of gain allocated to periods of nonqualified use, and $50,000 of gain in excess of C's Code Sec. 121 exclusion ($300,000 - $250,000).

C's absence from the residence (January 1, Year 6 to December 31, Year 10) will not qualify for the temporary absence exception to the definition of a period of nonqualified use because the absence exceeded an aggregate period of two years.

Temporary Absence – Exception to the Definition of a Period of Nonqualified Use
A period of nonqualified use will not include any other period of temporary absence (not to exceed an aggregate period of two years) due to change of employment, health conditions, or any other unforeseen circumstances as may be specified by IRS.

Taxpayers Serving on Qualified Official Extended Duty – Exception to the Definition of a Period of Nonqualified Use
A period of nonqualified use will *not* include any period (not to exceed an aggregate period of ten years) during which the taxpayer or the taxpayer's spouse is serving on qualified official extended duty as a member of the uniformed services , a member of the Foreign Service, or an employee of the intelligence community.

The suspension election for members of the uniformed services, members of the Foreign Service, and employees of the intelligence community is the same as it was under pre-2008 Housing Act law.

If any gain was attributable to post May 6, 1997 depreciation, the exclusion will not apply to that amount of gain as under pre-2008 Housing Act law.

The above is effective for sales and exchanges after December 31, 2008.

Converting a Residence to Rental Property

A taxpayer may decide to permanently convert a personal residence to rental property. This decision is often made as a result of the taxpayer's inability to sell the property at a gain, or a desire to retain the property for future personal use.

The decision whether to convert a personal residence to rental property may be based on several non-tax factors. If selling a personal residence would result in a nondeductible loss, the taxpayer should consider converting the residence to rental property since any loss realized while the home is a personal residence is never deductible. While tax savings opportunities are generally limited for residential rental conversions primarily because of the passive activity loss rules, converting a personal residence into rental property may allow the taxpayer to eventually recognize a loss on the property's subsequent sale if it continues to decline in value.

When a principal residence is converted to business use (or for use in the production of income), its starting point for basis for depreciation is the lower of (1) the adjusted basis on the date of conversion, or (2) the property's fair market value at the time of conversion.

Taxpayer purchased a home in Chicago in 2004 for $250,000, of which $50,000 represented the cost of the land. Taxpayer lived in the home until 2008, when he moved to New York. Rather than sell the house, he converted it to a rental property. The property's FMV, excluding the land, on its conversion to rental property was $185,000. Taxpayer's basis for depreciation is $185,000, the FMV at the time of conversion, since it was less than the adjusted basis. (Adjusted basis is generally the cost of the property plus amounts paid for capital improvements less any depreciation claimed for tax purposes).

Property converted from residential to rental use must be depreciated using the method and recovery period in effect in the year of conversion.

If the taxpayer intends to incur major renovation or remodeling costs, the costs should be incurred after the property has been placed into service (offered for rent). This may allow for a higher depreciable basis of the property and turn repairs into deductions.

Taxpayers may need the equity in cash from their current residence for a down payment on a new residence. Yet, for non-economic reasons they may want to retain the old residence. In this situation, they should consider selling the home to a newly formed controlled entity (for example, a wholly owned S Corporation) at fair market value for a mortgage note. The residence can then be rented inside the S Corporation and depreciated at the stepped-up FMV basis. The residence is effectively retained with no current tax cost because the gain on the sale is excluded under Sec. 121 (provided the requirements of Sec. 121 are met).

The IRS has ruled that the sale of a residence to a taxpayer's wholly owned corporation qualified for the former Sec. 1034 Gain Deferral. In that ruling, the IRS stated that there was no prohibition in the Sec. 1034 rules against selling the residence to a related party and excluding the gain. Many tax practitioners believe this same rationale can apply to the Sec. 121 Gain Exclusion rules.

Taxpayers own a house that they have lived in for 20 years. The house has a tax basis of $75,000 and a FMV of $275,000. They have decided to relocate in order to live closer to their family. They need the value in cash from their old residence for a down payment on their new residence. However, because they hope to move back in a few years, they would prefer not to sell the old residence. They like the idea of renting the old house in order to retain it and still provide some tax benefits and possibly some cash flow.

Taxpayers can form a wholly owned S Corporation and have the S Corporation buy the residence for its value ($275,000) on a third-party mortgage note. Taxpayers would receive cash of $275,000, and the $200,000 gain ($275,000-$75,000) is excluded under Sec. 121. Therefore, this is accomplished at no current tax cost.

The S Corporation can begin to rent the house and take depreciation deductions on the portion of the $275,000 cost allocated to the building. The rental activity inside the S Corporation will generate either passive activity gains or losses.

If gain from the sale of the residence to the controlled entity exceeds the maximum Sec. 121 exclusion, the excess is taxable as ordinary income (rather than capital gain) because the controlled entity (related-party) purchaser will depreciate the property (Sec. 1239 (a)).

If the S Corporation ultimately sells the residence, any gain would be taxed at capital gains rates (currently 15%), subject to a 25% rate for unrecaptured Sec. 1250 gain (i.e. gain attributable to depreciation allowed on the residence for periods after May 6, 1997).

If a residence converted to rental property is later sold at a gain, the basis in the converted property is the original cost or other basis plus amounts paid for capital improvements, less any depreciation taken. If the sale results in a loss, however, the starting point for basis is the lower of the property's adjusted cost basis or FMV when it was converted from personal to rental property. This rule is designed to ensure that any decline in value occurring while the property was held as a personal residence does not later become deductible on the sale of the rental property.

Taxpayer converted their personal residence to income-producing property in 2000. The house had a $50,000 original cost, and the property's FMV was $45,000 when it was converted to rental use. Over the eight year rental period, a total of $8,000 in depreciation was taken. In 2008, taxpayer sold the property for $40,000.

1)	*Original Cost*	*$ 50,000*
2)	*Conversion Value*	*45,000*
3)	*Depreciation Taken*	*8,000*
4)	*Adjusted Basis for Determining Gain (1– 3)*	*42,000*
5)	*Adjusted Basis for Determining Loss Lesser of (1) or (2 – 3)*	*37,000*
6)	*Sales Price*	*40,000*
7)	*Recognize Gain (6 – 4) but not less than 0*	*- 0 -*
8)	*Recognize Loss(6 – 5) but not more than 0*	*- 0 -*

No reportable gain or loss occurs because (1) no gain results when the original cost is used in the gain computation, and (2) no loss results when using the lower of cost or market basis for determining loss.

The fact that a residence is rented at the time of a sale does not automatically preclude gain attributable to such use from being excluded under Sec. 121. The taxpayer must still meet the ownership and use and the one-sale-in-two-years tests of Sec. 121 and gain cannot be excluded to the extent of depreciation adjustments to periods after May 6, 1997.

Safe Harbor for Exchanges of Vacation Homes

Until recently, taxpayers who own vacation and second homes have been in a quandary as to whether Section 1031 (Like-Kind Exchange) could apply to exchanges of those types of properties. In order to qualify for nonrecognition treatment under Section 1031 both the property relinquished and the property received must be deemed held for use in the taxpayer's trade or business or for investment.

One consequence of the held for requirement is that homes used purely for personal use do not qualify for exchange treatment. Nevertheless, taxpayers often purchase and own second homes with the duel intention of personal use and future appreciation. These taxpayers have wondered whether this type of ownership could be considered as "held for investment" so as to qualify the property for exchange treatment on sale.

In 2007, the tax court for the first time considered the application of Section 1031 to vacation homes. In Moore, TCM 2007 – 134, the court denied Section 1031 treatment on an exchange of vacation properties, which it deemed were not held primarily for trade or business or for investment by the taxpayers. The facts in Moore illustrate a fairly common scenario associated with recreational vacation properties. In 1988 the Moore's purchased two contiguous parcels of lakefront real property, along with a mobile home located on one of those parcels (the Clark Hill property). The Moore's and their children used the Clark Hill property two or three weekends a month during the summers. They also made various improvements to the property. They never advertised the Clark Hill property for sale and never rented or attempted to rent the property to others. They did not claim deductions for investment interest or for maintenance and repair costs. Several years later, the Moore's moved their principal residence and decided to sell the Clark Hill property and purchase another piece of improved lakefront property closer to their new residence (the Lake Lanier property). In 1999 they bought a 75% interest in the Lake Lanier property and an escrow agent bought a 25% interest, which the Moore's later acquired after the sold the Clark Hill property, treating the 25% Investment in the Lake Lanier property as replacement property in a Section 1031 exchange for the Clark Hill property. They and their children used the Lake Lanier property similarly to the Clark Hill property. They never rented or attempted to rent the Lake Lanier property. The Moore's asserted that one of their principal reasons for holding both the Clark Hill property and the Lake Lanier property was the investment potential of these assets. The tax court dismissed this rationale, holding that in order to qualify for Section 1031 treatment on the exchange the Moore's had to prove that they held both properties primarily for investment. This conclusion is the critical holding in the case.

The court specifically held that it was not sufficient to show that expectation of appreciation in value was one of the motives for holding the property, but that investment must be the principal or primary intent. It further relied on a line of cases that rejected taxpayer attempts to convert primary residences to investment property be moving out prior to placing the property on the market for sale. The court concluded, based on the Moore's use of the homes, the lack of rental activity, and their failure to hold the homes primarily for sale at a profit, that they did not hold the homes primarily for investment. Accordingly, Section 1031 treatment was denied.

A government report stated that there is a lack of IRS guidance as to whether vacation and second homes qualify under Section 1031. The report urged the IRS to issue clear guidance in this area.

In March 2008, the IRS issued Rev. Proc. 2008-16. The procedure provides a safe harbor under which the service will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment under Section 1031. The safe harbor is effective for exchanges occurring after March 9, 2008.

Under Rev. Proc. 2008-16, a dwelling unit passes the held for test with respect to its personal use as relinquished property in a like-kind exchange if it is owned by the taxpayer for at least 24 months immediately before the exchange and in each of the two 12-month periods immediately preceding the start of the exchange:

- The taxpayer rents the property to another person at a fair rental for 14 days or more, and
- The taxpayer's personal property does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the property is rented at a fair rental.

Similarly, a dwelling unit passes the held for test with respect to its personal use as replacement property in an exchange if it is owned by the taxpayer for at least 24 months immediately after the exchange and in each of the two 12-month periods immediately after the exchange:

- The taxpayer rents the property to another person at a fair rental for 14 days or more, and
- The taxpayer's personal use of the property does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

Steve has a summer cottage in Fort Wayne that he purchased in 2006. Steve lives full time in Indianapolis. For the first several years of ownership, Steve used the cottage himself during the summer. Steve did not attempt to rent the cottage to third parties. In 2007 and 2008, Steve rented the cottage to a family at fair rental value for 175 days during the summer and fall. In each of those two years, Steve used the cottage himself for 16 days during the spring. In December 2008, Steve exchanges the cottage for a larger house in Pompano Beach, Florida. Steve rents that house to third-party tenants a total of 200 days during 2009 and just 14 days during 2010. Steve uses the home himself for 19 days during 2009 and for no days during 2010.

Steve meets the safe harbor described by Rev. Proc. 2008-16. As such, he may properly report his exchange of the Fort Wayne cottage for the Pompano Beach house as a valid Section 1031 exchange on his 2008 federal income tax return, provided that all other requirements of Section 1031 are met.

The post-exchange replacement property use requirements applicable to Steve extends well beyond the time he is required to file his tax return for the year of the exchange. What if planned rental usage does not materialize or a taxpayer's personal use of the property exceeds the allowable limits? Rev. Proc. 2008-16 provides for this by stating that if a taxpayer reports a transaction as an exchange on the taxpayer's federal return expecting that the replacement property will meet the Revenue Procedure's qualifying use standards but this does not occur, the taxpayer, if necessary, should file an amended return and not report the transaction as an exchange.

Accordingly, if Steve ends up using the Pompano House primarily for his own personal use and does not rent it out for the two 12-month periods following its exchange, he may be required to amend his 2008 return and report a taxable sale of the Fort Wayne cottage unless he can establish that the personal use was not his primary purpose for ownership of the cottage.

Rev. Proc. 2008-16 offers a fairly clear, albeit limited, set of parameters for determining whether vacation property held for personal use as well as future appreciation qualifies under Section 1031. It is important to remember, however, that as a safe harbor it neither establishes substantive law nor affects any requirement of Section 1031 other than the question of whether personal use of a residence prevents it from being deemed to be held primarily for use in a trade or business or for investment.

To qualify for the safe harbor for property being sold, a taxpayer must rent out the property for the two years prior to an exchange, and during that period engage in limited personal use. To avoid potential IRS challenge on the held for issue with respect to vacation property being acquired in an exchange, the taxpayer must rent out that property and also limit personal use for the two years following the exchange. There is clearly no requirement that both sides of an exchange satisfy these requirements; because all real estate is generally considered like-kind, a taxpayer can exchange a vacation property for an office, commercial, or other type of rental property or vice versa.

While it clearly does not resolve the issue of when vacation homes may be the subject of like-kind exchanges, Rev. Proc. 2008-16 provides welcome guidance to taxpayers seeking to exchange vacation properties and second homes. The safe harbor will allow taxpayers that buy and hold such properties with true investment intent to structure valid Section 1031 exchanges despite limited amounts of personal use. It also should reduce the time to audit and review such transactions. Nevertheless, Rev. Proc. 2008-16 is just a safe harbor. Taxpayers can and should be able to structure exchanges of homes that fall outside its guidance.

Restrictions on Passive Activity Losses and Credits

Losses generated by passive activities may only be used to offset passive activity income. They cannot be offset against actively-earned income such as professional fees or salary, or portfolio income such as dividends or interest. Passive activity credits may be used only to offset tax on income from passive activities, with a carryover of any unused credits.

Passive activities generally include any trade, business or investment activity in which the taxpayer does not materially participate. Losses and credits attributable to rental activities are generally treated as passive without regard to whether the owner materially participates. However, passive activities do not include rental realty activities in which real estate professionals materially participate. Limited partnership interests are treated as passive activities except as regs otherwise provide. But directly-owned oil and gas working interests and such interests owned through a general partnership interest are treated as nonpassive even if the owner does not materially participate in them. And a taxpayer can deduct up to $25,000 a year of losses from rental real estate activities if a more lenient "active participation" standard is met, and the "deduction equivalent" in credits also is available to eligible taxpayers.

Publicly Traded Partnerships

The passive activity limitations apply separately to each "publicly traded partnership." As a result, net income or loss from such an organization cannot be offset against income or loss from any other passive activity interest held by the taxpayer.

Step Up Level of Involvement to Satisfy Material Participation Standard Before End of Year
A taxpayer can satisfy the material participation test by:

- Participating in an activity more than 500 hours during the tax year.
- Participating more than 100 hours if no one else does more.
- Participating more than 500 hours in all his "significant participation activities." A "significant participation activity" is one in which the taxpayer participates for more than 100 hours and in which he does not materially participate under any other rule.

Consider Sale of Passive Activity
One way to deal with passive activity losses may be to sell the activity generating them. If a taxpayer disposes of his entire interest in such an activity in a fully-taxable transaction, then any loss from the activity for the tax year of disposition (including losses carried over from earlier years), over any net income or gain for the tax year from all other passive activities (including carryover losses from earlier years), is treated as a loss that is not from a passive activity. (However, suspended passive activity credits are not freed up when the activity that generated them is sold, but the taxpayer may elect to increase his basis by the amount of the unused credits.)

A taxpayer may, for the tax year in which there is a disposition of substantially all of an activity, treat the part disposed of as a separate activity, but only if the taxpayer can establish with reasonable certainty (1) the amount of deductions and credits allocable to the part of the activity for the tax year with respect to carryover of disallowed deductions and credits, and (2) the amount of gross income and of any other deductions and credits allocable to that part of the activity for the tax year.

Real Estate Professionals Can Deduct Some Rental Realty Losses
An "eligible" taxpayer's losses and credits from rental real estate activities in which he materially participates will not be treated as passive and may be used to offset nonpassive activity income.

An individual taxpayer is "eligible" if (1) more than half of the personal services that he performs are performed in real property trades or businesses in which he materially participates, and (2) he performs more than 750 hours of services during the tax year in real property trades or businesses in which he materially participates. A closely held C corporation is eligible if more than 50% of its gross receipts for the tax year are derived from real property trades or businesses in which it materially participates.

New Tax-Advantaged Achieving a Better Life Experience (ABLE) Accounts

For tax years beginning after December 31, 2014, Tax Increase Prevention Act of 2014 allows states to establish tax-exempt "Achieving a Better Life Experience" (ABLE) accounts to assist persons with disabilities in building an account to pay for qualified disability expenses. A tax exemption would be allowed for an ABLE program; amounts in an ABLE account would accumulate on a tax-exempt (or, in some cases, tax-deferred) basis.

A qualified ABLE account is generally exempt from income tax but is subject to the tax imposed by Code Sec. 511 on the unrelated business income of tax-exempt organizations. A "qualified ABLE program" is subject to the excise tax on non-plan tax-exempt entities that are parties to prohibited tax shelter transactions and subsequently listed transactions. Any person may make contributions to an ABLE account. Contributions to an ABLE account are not deductible for income tax purposes.

A qualified ABLE program is a program established and maintained by a state or state agency or instrumentality that:

- provides that non-cash contributions and contributions that exceed the annual contribution limit will not be accepted. (Non-cash contributions will not violate this rule if they are returned before the return due date). Except in the case of a rollover contribution from another account, an ABLE program must limit the aggregate contributions from all contributors for a tax year to the amount of the annual Code Sec. 2503(b) gift tax exclusion for that tax year ($14,000 for 2015, adjusted annually for inflation). A 6% excise tax is imposed on excess contributions to an ABLE account;
- provides separate accounting for each designated beneficiary;
- limits the designated beneficiary's investment direction to no more than two times in a calendar year;
- prohibits the use of any interest or any portion of an interest in the program as security for a loan; and
- provides adequate safeguards to prevent excess aggregate contributions.

The program must limit a designated beneficiary to one ABLE account. If an ABLE account is established for a designated beneficiary, no account later established for that beneficiary is treated as an ABLE account.

The program must allow an ABLE account to be established only for a beneficiary who is a resident of either the state that maintains the program (a "program state") or of a contracting state that has not established an ABLE program but has entered into a contract with a program state to provide the contracting state's residents with access to the program state's ABLE program.

The designated beneficiary of an ABLE account is an eligible individual who established the account and is its owner. An individual is an eligible individual for a tax year if, during that tax year:

1) The individual is entitled to benefits based on blindness or disability under the Social Security disability insurance program (title II of the Social Security Act) or the SSI program (title XVI of the Social Security Act), and that blindness or disability occurred before the date on which the individual reached age 26, or

2) A disability certification for the individual has been filed with IRS for the tax year. A disability certification is one made by the eligible individual or his parent or guardian, that certifies that:

- The individual has a medically determinable physical or mental impairment, which results in marked and severe functional limitations, and that can be expected to result in death or that has lasted or can be expected to last for a continuous period of not less than 12 months, or is blind, and
- That blindness or disability occurred before the date on which the individual attained age 26.

The certification must include a copy of the individual's diagnosis relating to the individual's relevant impairment(s), signed by a licensed physician.

No amount of a distribution from an ABLE account is includible in gross income if distributions from the account do not exceed the designated beneficiary's qualified disability expenses. "Qualified disability expenses" are any expenses related to the eligible individual's blindness or disability that are made for the benefit of an eligible individual who is the designated beneficiary. They include:

- Education,
- Housing,
- Transportation,
- Employment training and support,
- Assistive technology and personal support services,
- Health, prevention, and wellness,
- Financial management and administrative services,
- Legal fees,
- Expenses for oversight and monitoring,
- Funeral and burial expenses, and
- Other expenses that are approved under IRS regs and consistent with Code Sec. 529A's purposes.

If the distributions exceed the qualified disability expenses, then the amount otherwise includible in gross income is reduced by an amount that bears the same ratio to the distributed amount as the qualified disability expenses bear to that amount.

Distributions from a qualified ABLE program are includible in the distributee's gross income under the Code Sec. 72 annuity rules to the extent not excluded from gross income under any other income tax provision.

A taxpayer who receives a distribution from a qualified ABLE program that is includible in gross income is subject to an additional 10% tax on the includible part. An exception to this rule applies to the distribution of certain contributions made during the tax year on the designated beneficiary's behalf.

A payment or distribution from an ABLE account is not taxable to the extent that the amount received is paid, no later than the 60th day after the date of the payment or distribution, into another ABLE account for the benefit of the designated beneficiary or an eligible individual who is a family member of the designated beneficiary.

A change in the designated beneficiary of an interest in a qualified ABLE program during a tax year is not treated as a taxable distribution if the new beneficiary is both an eligible individual for the tax year and a member of the family of the former beneficiary.

Upon the death of an eligible individual, any amounts remaining in the account (after Medicaid reimbursements) would go to the deceased's estate or to a designated beneficiary and would be subject to income tax on investment earnings, but not to the 10% penalty.

Amounts in an individual's qualified ABLE account (including earnings), contributions to the individual's account, and distributions to pay qualified disability expenses are disregarded for purposes of determining an individual's eligibility for, or the amount of any assistance or benefit authorized by any federal means-tested program. This rule overrides any other federal law that requires those amounts to be taken into account.

However, in the case of the SSI program, distributions from an ABLE account for housing expenses are considered income; and amounts (including earnings) in an ABLE account in excess of $100,000 are considered a resource of the designated beneficiary. The SSI benefits of an individual who has excess resources because the individual's ABLE account balance exceeds $100,000 are not terminated. Instead, the benefits are suspended until the individual's balance falls below $100,000. The suspension of SSI benefits does not apply for purposes of Medicaid eligibility.

For purposes of determining SSI eligibility, states must submit to the Commissioner of Social Security, in the manner specified by the Commissioner, monthly electronic statements on relevant distributions and account balances from all ABLE accounts. This requirement is effective for tax years beginning after December 31, 2014.

Property of a bankruptcy estate does not include funds placed in an ABLE account no later than 365 days before the filing date of the bankruptcy petition. But only if the designated beneficiary of the account was the debtor's child, stepchild, grandchild, or step-grandchild for the tax year for which funds were placed in the account.

EDUCATION

Enhanced American Opportunity Tax Credit Made Permanent

The Hope Scholarship Credit is a credit of $1,800 (indexed for inflation) for various tuition and related expenses for the first two years of post-secondary education. It phases out for AGI starting at $48,000 (if single) and $96,000 (if married filing jointly), with indexing for inflation.

Under pre-Act law, through 2017, the American Opportunity Tax Credit increased the above credit to $2,500 for four years of post-secondary education, and increased the beginning of the phase-out amounts to $80,000 (single) and $160,000 (married filing jointly).

The Act makes the American Opportunity Tax Credit permanent.

Lifetime Learning Credit

The lifetime learning credit helps parents and students pay for post-secondary education.

For the tax year, you may be able to claim a lifetime learning credit of up to $2,000 for qualified education expenses paid for all students enrolled in eligible educational institutions. There is no limit on the number of years the lifetime learning credit can be claimed for each student. However, a taxpayer cannot claim both the American opportunity credit and lifetime learning credits for the same student in one year. Thus, the lifetime learning credit may be particularly helpful to graduate students, students who are only taking one course and those who are not pursuing a degree.

Generally, you can claim the lifetime learning credit if all three of the following requirements are met:

- You pay qualified education expenses of higher education.
- You pay the education expenses for an eligible student.
- The eligible student is either yourself, your spouse or a dependent for whom you claim an exemption on your tax return.

If you're eligible to claim the lifetime learning credit and are also eligible to claim the American opportunity credit for the same student in the same year, you can choose to claim either credit, but not both.

If you pay qualified education expenses for more than one student in the same year, you can choose to take credits on a per-student, per-year basis. This means that, for example, you can claim the American opportunity credit for one student and the lifetime learning credit for another student in the same year. The 2016 income phaseout begins at $55,000 for a single person and at $111,000 for married filing jointly.

Above-the-Line Deduction for Higher Education Expenses Retroactively Extended Through 2016

Eligible individuals could, for tax years beginning before January 1, 2015, deduct higher education expenses (i.e., "qualified tuition and related expenses" of the taxpayer, his spouse, or dependents) as an adjustment to gross income to arrive at AGI. The maximum deduction was $4,000 for an individual whose AGI for the tax year does not exceed $65,000 ($130,000 in the case of a joint return), or $2,000 for individuals who do not meet the above AGI limit, but whose AGI does not exceed $80,000 ($160,000 in the case of a joint return). No deduction was allowed for an individual whose adjusted gross income exceeds the relevant adjusted gross income limitations, for a married individual who does not file a joint return, or for an individual for whom a personal exemption deduction may be claimed by another taxpayer for the tax year.

Under pre-Act law, this deduction was not available for tax years beginning after December 31, 2014.

Effective for tax years beginning after December 31, 2014, the Act retroactively extends through 2016 above-the-line deduction for qualified tuition and related expenses for higher education.

EGTRRA Changes to Student Loan Deduction Rules are Made Permanent

Individuals can deduct a maximum of $2,500 annually for interest paid on qualified higher education loans. The deduction is claimed as an adjustment to gross income to arrive at adjusted gross income (AGI). The deduction phases out ratably for taxpayers with modified AGI between $65,000 and $80,000 ($130,000 and $160,000 for joint returns). The phaseout amounts and ranges are indexed for inflation.

The Economic Growth and Tax Relief Reconciliation Act amended the rules for deducting interest on student loans, effective generally for tax years beginning after 2001, by:

- eliminating the 60-month limit on the deduction for interest paid on a qualified education loan, and
- increasing the pre-2001 EGTRRA AGI phaseout ranges ($65,000 to $80,000 for taxpayers other than joint filers; $130,000 to $160,000 for a married couple filing jointly) applicable to the student loan interest deduction. The phaseout ranges, as amended by 2001 EGTRRA, were indexed for inflation.

Increased $2,000 Contribution Limit and Other EGTRRA Enhancements to Coverdell ESAs are Made Permanent

An individual can make a nondeductible cash contribution to a Coverdell education savings account ("Coverdell ESA", or "CESA", formerly called an "education IRA") for qualified education expenses of a beneficiary under the age of 18. A specified aggregate amount can be contributed each year by all contributors for one beneficiary. The amount an individual contributor can contribute is phased out as the contributor's modified adjusted gross income (MAGI) exceeds specified levels. A 6% excise tax applies to excess contributions.

Earnings on the contributions made to a CESA are subject to tax when withdrawn. But distributions from a CESA are excludible from the distributee's (i.e., the student's) gross income to the extent the distributions do not exceed the qualified education expenses incurred by the beneficiary during the tax year the distributions are made. The earnings portion of a CESA distribution not used to pay qualified education expense is includible in a distributee's income, and that amount is subject to a 10% tax that applies in addition to the regular tax.

Tax-free (including free of the 10% tax described above) transfers or rollovers of CESA account balances from a CESA benefiting one beneficiary to a CESA benefitting another beneficiary (and redesignations of named beneficiaries) are permitted if the new beneficiary is a family member of the previous beneficiary and is under age 30. Generally, a balance remaining in a CESA is deemed to be distributed within 30 days after the beneficiary turns 30.

Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the CESA rules were modified to:

- increase the limit on CESA aggregate annual contributions (from $500) to $2,000 per beneficiary;
- permit corporations and other entities (in addition to individuals) to make contributions to a CESA, regardless of the corporation's or entity's income;
- increase the MAGI phaseout range for joint filers (from $150,000 - $160,000) to $190,000 - $220,000 to equal twice the range for single filers (i.e., $95,000 - $110,000), and so eliminate any "marriage penalty;"
- permit contributions to a CESA for a tax year to be made until April 15th of the following year;
- modify the definition of excess contribution to a CESA for purposes of the 6% excise tax on excess contributions to reflect various other EGTRRA changes;
- extend the time (to before June 1st of the following tax year) for taxpayers to withdraw excess contributions (and the earnings on them) to avoid imposition of the 6% excise tax;
- expand the definition of education expenses that can be paid by CESAs to include elementary and secondary school expenses (in addition to qualified higher education expenses);
- provide for coordination of the Hope and Lifetime Learning credits with the CESA rules to permit a Hope or Lifetime Learning credit to be taken in the same year as a tax-free distribution is taken from a CESA for a designated beneficiary (but for different expenses);
- provide rules coordinating distributions from both a qualified tuition program (QTP, or "529 plan") and a CESA for the same beneficiary for the same tax year (but for different expenses);
- eliminate the age limitations described above for acceptance of CESA contributions, deemed balance distributions, tax-free rollovers to other family-member-beneficiaries, and tax-free change of beneficiaries, for "special needs beneficiaries;"
- provide that the 10% additional tax on taxable distributions from a CESA does not apply to distributions of contributions to a CESA made by June 1st of the tax year following the tax year in which the contribution was made.

Specifically, as a result of the above extension, the following rules apply on a permanent basis:

- the limit on CESA aggregate annual contributions is $2,000 per beneficiary (and is not decreased to $500 per beneficiary);
- corporations and other entities (not just individuals) can make contributions to a CESA, and the corporations and other entities can do so regardless of their income;
- the MAGI phaseout range for joint filers is $190,000 - $220,000 (and does not decrease to $150,000 - $160,000);
- CESA contributions for a tax year can be made until April 15th of the following year;
- the definition of CESA excess contribution reflects the various other EGTRRA changes to the CESA rules;
- taxpayers have until June 1st of the following tax year to withdraw excess contributions (and the earnings on them) to avoid imposition of the 6% excise tax;
- education expenses that can be paid by CESAs include elementary and secondary school expenses and qualified higher education expenses (rather than only qualified higher education expenses);
- a Hope or Lifetime Learning credit can be taken in the same year as a tax-free distribution is taken from a CESA for a designated beneficiary (but for different expenses);
- the rule coordinating distributions being made from both a QTP and a CESA for the same beneficiary for the same tax year (but for different expenses) applies;
- special needs beneficiaries are exempted from the age limitations for a CESA's acceptance of contributions, deemed balance distributions, tax-free rollovers to other family-member-beneficiaries, and tax-free change of beneficiaries; and
- the 10% additional tax on taxable distributions from a CESA is inapplicable to distributions of contributions to a CESA made by June 1st of the tax year following the tax year in which the contribution was made.

<u>Exclusion for Employer-Provided Educational Assistance, and Restoration of the Exclusion for Graduate-Level Courses, Made Permanent</u>

Under Code Sec. 127, an employee's gross income does not include amounts paid or expenses incurred (up to $5,250 annually) by the employer in providing educational assistance to employees under an educational assistance program. An educational assistance program is a separate written plan of the employer for the exclusive benefit of its employees, having the purpose of providing the employees with educational assistance. The courses taken need not be related to the employee's job for the exclusion to apply. To be qualified, the program must not discriminate in favor of highly compensated employees, nor may more than 5% of the amounts paid or incurred by the employer for educational assistance during the year be provided for individuals (and their spouses and dependents) owning more than 5% of the employer. Further, the program cannot provide employees with a choice between educational assistance and other remuneration that would be includible in their gross income. Finally, reasonable notification of the program's availability and terms must be provided to employees.

Before the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA), Congress had periodically waited until the educational assistance exclusion was set to expire before renewing it, and had sometimes allowed it to expire, and then extended it retroactively. The exclusion was set to expire for courses beginning after December 31, 2001. Under EGTRRA, the exclusion was extended "permanently" subject to the EGTRRA sunset.

Also, EGTRRA restored the exclusion for graduate level courses, which had earlier been eliminated. This was also subject to the EGTRRA sunset.

<u>Income Exclusion for Awards Under the National Health Service Corps and Armed Forces Health Professions Programs Made Permanent</u>

Gross income does not include (i) any amount received as a "qualified scholarship" by an individual who is a candidate for a degree at a primary, secondary, or post-secondary educational institution, or (ii) qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of those educational institutions. But these exclusions do not apply to any amount that a student receives that represents payment for teaching, research, or other services provided by the student, required as a condition for receiving the scholarship or tuition reduction.

Thus, before enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, there was no exclusion from gross income for health profession scholarship programs which required scholarship recipients to provide medical services as a condition for their awards.

EGTRRA provided that education awards received under specified health scholarship programs may be tax-free qualified scholarships, without regard to any service obligation on the part of the recipient. Specifically, the rule that the exclusions for qualified scholarships and qualified tuition do not apply to amounts received which represent compensation does not apply to any amount received by an individual under the following programs:

- the National Health Service Corps Scholarship Program (the "NHSC Scholarship Program," under Sec. 338A(g)(1)(A) of the Public Health Services Act), and
- the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance program (the "Armed Forces Scholarship Program," under Subchapter 1 of Chapter 105 of Title 10 of the United States Code).

Interest Exclusion for Higher Education

The interest on U.S. Savings Bonds redeemed to pay qualified higher education expenses may be tax-free. The exclusion is phased out at certain income levels, which are adjusted annually for cost-of-living increases. The phaseout for 2016 will begin at modified adjusted gross income above $77,550 ($116,300 on a joint return). For 2017, the corresponding figures are $78,150 and $117,250.

Scholarships and Fellowships

A scholarship is generally an amount paid or allowed to, or for the benefit of, a student at an educational institution to aid in the pursuit of studies. The student may be either an undergraduate or a graduate. A fellowship is generally an amount paid for the benefit of an individual to aid in the pursuit of study or research. Generally, whether the amount is tax free or taxable depends on the expense paid with the amount and whether you are a degree candidate.

A scholarship or fellowship is tax free only if you meet the following conditions:

- You are a candidate for a degree at an eligible educational institution.
- You use the scholarship or fellowship to pay qualified education expenses.

Qualified Education Expenses

For purpose of tax-free scholarships and fellowships, these are expenses for:

- Tuition and fees required to enroll at or attend an eligible educational institution.
- Course-related expenses, such as fees, books, supplies, and equipment that are required for the courses at the eligible educational institution. These items must be required of all students in your course of instruction.

However, in order for these to be qualified education expenses, the terms of the scholarship or fellowship cannot require that it be used for other purposes, such as room and board, or specify that it cannot be used for tuition or course-related expenses.

Expenses that Don't Qualify

Qualified education expenses do not include the cost of:

- Room and board.
- Travel.
- Research.
- Clerical help.
- Equipment and other expenses that are not required for enrollment in or attendance at an eligible educational institution.

This is true even if the fee must be paid to the institution as a condition of enrollment or attendance. Scholarship or fellowship amounts used to pay these costs are taxable.

Illinois "Bright Start" College Savings Plan

The Illinois "Bright Start" college savings plan is being offered under provisions of Section 529 of the Internal Revenue code. Bright Start works by investing in mutual funds. Illinois has contracted with Oppenheimer Funds to manage the investment trust. Portfolios are managed by OFI Private Investments, Inc., a subsidiary of Oppenheimer Funds, Inc. and Illinois Investments managed by Oppenheimer Funds, Inc. and its affiliates, as well as the Vanguard Group and American Century Investments.

Illinois also has "College Illinois" which has been around for a few years. Prepaid tuition through the college Illinois plan is a less aggressive investment, a defined benefit plan that acts as a hedge against tuition inflation by allowing parents and grandparents to lock in current tuition rates for state schools.

Section 529 college savings plans offer contribution advantages over another option called Coverdell Education Savings Accounts with their low annual deposit limits of $2,000.

Contributions of up to $14,000 a year and $350,000 over the life of the account are permitted in Bright Start.

Provisions for lump sum contributions as large as $70,000 ($140,000 for married couples) without gift tax penalties are also included in the tax code, in case grandma and grandpa want some of their nest egg to go toward educating their grandchildren.

Private institutions may be sponsors of prepaid tuition programs. The definition of a "Qualified Tuition Program" will include certain prepaid tuition programs established and maintained by eligible educational institutions (including private institutions) that satisfy the requirements under code section 529.

Exclusion for qualifying payouts. Distributions will be excluded from gross income to the extent they are used to pay for qualified higher education expenses. The exclusion will apply to payouts from qualified state tuition programs, and to payouts from qualified tuition programs established and maintained by entities other than a state.

Qualified higher education expenses will include special needs services for special needs beneficiaries.

For the exclusion for distributions from qualified tuition plans to pay for qualified higher educational expenses, including room and board, the maximum room and board allowance will be the actual amount charged by the educational institution for room and board.

During the same tax year, taxpayers will be able to claim the American Opportunity Credit or Lifetime Learning Credit and exclude amounts distributed from a qualified tuition program for the same student as long as the distribution is not used for the same expenses as which a credit will be claimed.

The definition of a family member for purposes of beneficiary changes and rollovers will include first cousins of the original beneficiary.

Coverdell ESAs and Qualified Tuition Programs offer essentially the same income tax benefit, namely tax-free earnings if payouts are made for qualified educational purposes. However, each offers a unique combination of benefits and limitations. For example, a Coverdell ESA can be used for elementary and secondary school expenses or college costs, but annual contributions are limited $2,000 per beneficiary and an individual's contributions are subject to AGI phase outs. The qualified tuition program, on the other hand, does not restrict contributions, but must be used for higher education. The best savings vehicle ultimately will depend on the needs of the donor and the beneficiary who will receive the education.

Unlike custodial mutual funds in his name that become his property at age 18, college savings plans like Bright Start remain in the name of the adult who opened the account. The beneficiary may be changed to another family member, including adults who may want to pursue an advanced degree.

The account is also not included as part of the owner's taxable estate.

However, withdrawals for nonqualified education expenses incur a federally mandated 10% penalty on top of the income being taxed at the owner's higher rate.

Most Section 529 savings plans offered by other states are open to out-of-state residents.

Bright Start applications and other information are available at 877-43-BRIGHT or online at www.brightstartsavings.com.

TRUST, ESTATE AND DESCENDENT INCOME TAX

25%, 28%, and 33% Trust and Estate Income Tax Rates are Permanently Extended, Top Rate Increases to 39.6% Beginning in 2013

The 2012 Taxpayer Relief Act provides the following tax brackets beginning after 2012, for trusts' and estates' income tax at 15%, 25%, 28%, 33%, and 39.6% marginal tax rates.

2017 Rate Schedule for Trusts and Estates:

If taxable income is:	The tax would be:
Not over $2,550	15% of taxable income
Over $2,550 but not over $6,000	$383 plus 25% of the excess over $2,550
Over $6,000 but not over $9,150	$1,245 plus 28% of the excess over $6,000
Over $9,150 but not over $12,500	$2,127 plus 33% of the excess over $9,150
Over $12,500	$3,233 plus 39.6% of the excess over $12,500

2016 Rate Schedule for Trusts and Estates:

If taxable income is:	The tax would be:
Not over $2,550	15% of taxable income
Over $2,550 but not over $5,950	$383 plus 25% of the excess over $2,550
Over $5,950 but not over $9,050	$1,233 plus 28% of the excess over $5,950
Over $9,050 but not over $12,400	$2,101 plus 33% of the excess over $9,050
Over $12,400	$3,206 plus 39.6% of the excess over $12,400

ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAXES

Current Estate Tax Rules Made Permanent, but Top Rate Increases from 35% to 40%

Under the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA), the estate tax was scheduled to be repealed in 2010, and then to return in 2011 with an exemption of $1 million and graduated rates reaching a top rate of 55% on transfers over $3 million. The 2010 Tax Relief Act reinstated the estate tax retroactively to the beginning of 2010, except where the executor of the estate of a decedent dying in 2010 made an election to opt out of the estate tax and be subject to the modified carryover basis rules instead.

For estates of decedents dying after 2009, the 2010 Tax Relief Act provided an estate tax exemption of $5 million (indexed for inflation after 2011). The exemption amount was $5,120,000 for 2012, and based on inflation data, RIA has calculated the exemption amount to be $5,490,000 for 2017. Also, under the 2010 Tax Relief Act, the tax was imposed at a top rate of 35% on all transfers exceeding the exemption amount.

For estates of decedents dying after 2010, the 2010 Tax Relief Act made the estate tax exclusion (but not the GST exemption) portable between spouses, by allowing the estate of a surviving spouse to use any unused portion of the deceased spouse's exclusion, in addition to the surviving spouse's own exclusion.

Under pre-2010 Tax Relief Act law, the generation-skipping transfer (GST) tax was scheduled to be repealed in 2010. The 2010 Tax Relief Act reinstates the GST tax retroactively to the beginning of 2010. For transfers in 2010 only, the tax rate for GST tax purposes was zero. The amount of the GST exemption is the same as the estate tax exemption ($5 million in 2010 and 2011, indexed for inflation after 2011, see above). The GST exemption may have been allocated to a trust created or funded in 2010.

The gift tax was never scheduled to be repealed. For gifts made after 2010, the 2010 Tax Relief Act reunified the gift tax exemption with the estate tax exemption ($5 million, as indexed for inflation, see above). For gifts made after 2010, the 2010 Tax Relief Act reunified the gift and estate tax rate schedule, which imposed tax at a top rate of 35% on all transfers exceeding the exemption amount.

Thus, except for the changes to the estate and gift tax rates (see below), all of the estate, gift and GST tax rules applicable during the years 2010 to 2012 are made permanent starting in 2013. This includes the increased and indexed estate, gift and GST tax exemption of $5 million ($5,450,000 in 2016, as indexed for inflation), and the portability rules.

Top Tax Rate Increased to 40%

The Act also provides that the estate and gift tax rates for amounts over $500,000 are as follows:

- For amounts over $500,000 but not over $750,000, the tax is $155,800, plus 37% of the excess over $500,000;
- For amounts over $750,000 but not over $1 million, the tax is $248,300, plus 39% of the excess over $750,000; and
- For amounts over $1 million, the tax is $345,800, plus 40% of the excess over $1 million.

Thus, under the Act, the top estate and gift tax rate is increased from 35% to 40%.

For gifts made in 2017 the gift tax annual exclusion will be $14,000 (Same as gifts made in 2016).

Estate Tax Exclusion is Made Portable Between Spouses for Decedents Dying after 2010, but GST Exemption is not Portable

A credit (the "unified credit") is allowed against the estate tax imposed on U.S. citizens and residents. The credit is equal to the tentative tax on the "applicable exclusion amount," determined under the estate tax rate schedule.

Pre-2010 Tax Relief Act law did not allow for any unused portion of a decedent's applicable exclusion amount to be used by the estate of the decedent's surviving spouse.

Every individual is allowed an exemption from the generation-skipping transfer (GST) tax. Under pre-2010 Tax Relief Act law, the GST exemption amount was equal to the applicable exclusion amount for estate tax purposes.

Under the 2010 Tax Relief Act, any applicable exclusion amount that remains unused as of the death of a spouse who dies after December 31, 2010 (the "deceased spousal unused exclusion amount") generally is available for use by the surviving spouse, as an addition to the surviving spouse's applicable exclusion amount.

Specifically, the 2010 Tax Relief Act provides that the "applicable exclusion amount" is the sum of (1) the "basic exclusion amount" ($5 million, subject to an adjustment for inflation for estates of decedents dying after 2011), and (2) the "deceased spousal unused exclusion amount."

For the surviving spouse of a deceased spouse dying after December 31, 2010, the term "deceased spousal unused exclusion amount" means the lesser of:

- the basic exclusion amount ($5 million, subject to an adjustment for inflation for estates of decedents dying after 2011), or
- the excess of:
  - the basic exclusion amount of the **last** deceased spouse dying after December 31, 2010, of the surviving spouse, over
  - the amount of the tentative tax on the estate of the deceased spouse, determined under the estate tax rate schedule.

A surviving spouse may use the deceased spousal unused exclusion amount in addition to the surviving spouse's own $5 million exclusion for taxable transfers made during life or at death.

Assume that Husband 1 dies in 2014, having made taxable transfers of $3 million and having no taxable estate. An election (see below) is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1), which she may use for lifetime gifts or for transfers at death.

If a surviving spouse is predeceased by more than one spouse, the amount of unused exclusion that is available for use by the surviving spouse is limited to the lesser of $5 million or the unused exclusion of the last deceased spouse. This so-called "last deceased spouse" limitation applies whether or not the last deceased spouse has any unused exclusion, and whether or not his estate makes a timely election to allow the surviving spouse to use the deceased spousal unused exclusion amount.

Assume the same facts as above, except the Wife later marries Husband 2. Husband 2 also predeceases Wife (thus becoming the "last deceased spouse"), having made $4 million in taxable transfers and having no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's deceased spousal unused exclusion amount. Although the combined amount of unused exclusion of Husband 1 and Husband 2 is $3 million ($2 million for Husband 1 and $1 million for Husband 2), only Husband 2's $1 million unused exclusion is available for use by Wife, because the deceased spousal unused exclusion amount is limited to the lesser of the basic exclusion amount ($5 million) or the unused exclusion of the last deceased spouse (Husband 2) of the surviving spouse (Wife). Thus, Wife can only use Husband 2's $1 million unused exclusion. Thereafter, Wife's applicable exclusion amount is $6 million (her $5 million basic exclusion amount plus $1 million deceased spousal unused exclusion amount from Husband 2), which she may use for lifetime gifts or for transfers at death.

The Committee Report also provides the following example of how the deceased spousal unused exclusion amount works when the surviving spouse remarries, and then predeceases her second spouse.

Assume the same facts as above, except that Wife predeceases Husband 2. Following Husband 1's death, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1). Wife made no taxable transfers and has a taxable estate of $3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount, which is $4 million (Wife's $7 million applicable exclusion amount less her $3 million taxable estate). Under the provision, Husband 2's applicable exclusion amount is increased by $4 million, i.e., the amount of Wife's deceased spousal unused exclusion amount.

Election by deceased spouse's estate to allow surviving spouse's estate to use deceased spousal unused exclusion amount.

A deceased spousal unused exclusion amount may not be taken into account by a surviving spouse unless the executor of the estate of the deceased spouse files an estate tax return on which the amount is computed, and makes an election on the return that the amount may be taken into account by the surviving spouse. The election, once made, is irrevocable. No election may be made if the estate tax return of the deceased spouse is filed after the due date (including extensions) for filing the return.

The election must be made on an estate tax return of the deceased spouse, regardless of whether the estate of the deceased spouse is otherwise required to file an estate tax return.

GST Exemption is not Portable
The 2010 Tax Relief Act re-defines the amount of the generation-skipping transfer (GST) tax exemption from the "applicable exclusion amount" to the "basic exclusion amount" ($5 million, indexed for inflation after 2011). Thus, the 2010 Tax Relief Act provision allowing portability of the estate tax applicable exclusion amount does *not* allow a surviving spouse to use the unused GST exemption of a predeceased spouse.

Estate Tax Return Filing Threshold is Tied to Basic Exclusion Amount ($5 Million)
The Tax Relief Act provides that the estate of a U. S. citizen or resident must file an estate tax return if the gross estate exceeds the "basic exclusion amount" (i.e., $5 million, subject to an adjustment for inflation after 2011).

Thus, the estate of a U. S. citizen or resident dying after December 31, 2010, must file an estate tax return if the gross estate exceeds $5 million (as indexed for inflation after 2011), even if the decedent's applicable exclusion amount is greater than $5 million as a result of the deceased spousal unused exclusion amount.

Portability Rules
Portability permits the entire unused exemption of the first spouse to die to be preserved, even if that spouse's estate was too small to use the entire exemption. A first-deceased spouse's estate that is valued at zero may still leave to the surviving spouse a deceased spousal unused exclusion (DSUE) amount equal to the entire unused applicable exclusion amount, if a timely estate tax return is filed and an election is made.

Another advantage of portability is that the surviving spouse receives a second automatic basis adjustment when he or she dies with respect to the assets received from the first-deceased spouse which are then included in the surviving spouse's estate.

A third advantage of portability may be that it is available when the assets of the first-deceased spouse pass outside of the will or revocable trust, and are therefore unavailable to fund the nonmarital share. This could occur if much of the decedent's assets are held jointly with the surviving spouse with a right of survivorship, or are contractual benefits, such as life insurance. Portability is still available in such circumstances.

A fourth advantage of portability is that it may be an effective estate planning device where the first-deceased spouse's assets are largely items of income in respect of a decedent, such as retirement benefits (e.g., an IRA) and deferred annuities. Such assets are poor choices to fund nonmarital share, because they will be reduced by income taxes when they are received. Leaving $5.25 million of retirement benefits to a nonmarital deduction trust actually funds the trust with only about $3,412,500 (after, for example, combined federal and state income tax). Leaving the surviving spouse the DSUE amount passes a full $5.25 million exemption to the surviving spouse.

Portability, however, also has several limitations. First, the unused GST exemption of the spouse dying first is not portable and will be lost to the extent not used. A client who wants to leave assets in trust for the benefit of future generations more remote than the first generation below that of the client will want to use a trust to take full advantage of the GST exemption.

Second, assets passing outright to the surviving spouse likely will be subject to the claims of creditors of the survivor, including any subsequent spouse in a divorce. Property placed in trust usually is protected from such claims.

Third, a trust provides independent management of the assets, protecting them from the unwise decisions of the beneficiaries. Even clients who believe that their spouse and children are competent managers may want to consider this benefit, because it avoids the potential adverse influence of unwise friends and in-laws.

Fourth, as indicated above, to secure portability an estate tax return must be filed even if one otherwise would not be due, and that may increase the costs of administering the estate of the first deceased spouse. If an express credit-shelter trust is used, and the estate is below the indexed shelter at death, then no estate tax return would be due except to elect portability for any unused shelter.

Fifth, the DSUE amount is not indexed for inflation. Property that is placed into a credit-shelter trust may appreciate at a rate equal to or greater than inflation and that entire amount should pass free of estate tax when the surviving spouse dies.

Pension and IRA Provisions

Plan Benefit and Contribution Limits

Defined Benefit Plans
The maximum annual benefit payable at retirement under a defined benefit plan is generally the lesser of 100% of average compensation or a statutory amount, $215,000 for 2017.

Defined Contribution Plans
The qualification rules for defined contribution plans limits the annual additions for each plan participant to the lesser of 25% of compensation or a statutory amount ($54,000 for 2017 and $53,000 for 2016).

Compensation Limit
The annual compensation of each participant that can be taken into account for purposes of determining contributions and benefits under a plan is limited to a statutory amount, $270,000 for 2017.

Elective Deferral Limitations
The limit on the deductible amount of elective deferrals to 401(k) plans and 403(b) annuities may not exceed the "applicable dollar amount." The applicable dollar amount for these plans will be $18,000 for 2017 and $18,000 for 2016.

The deductible amount of elective deferrals to SIMPLE plans will be limited to another "applicable dollar amount." The applicable dollar amount for SIMPLE plans will be $12,500 for 2017 and $12,500 for 2016.

Section 457 Plans
The limit on the deductible amount of elective deferrals to a Section 457 plan is also an applicable dollar amount. The maximum annual deferral will be $18,000 for 2017 and $18,000 for 2016.

Under the special catch-up rule, the limit is twice the otherwise applicable dollar amount in the three years before retirement.

For Individuals Over Age 50, Additional Elective Deferrals in Excess of Otherwise Applicable Limits

The otherwise applicable dollar limit on elective deferrals under a Section 401(k) plan, Section 403(b) annuity, Simplified Employee Pension (SEP), or SIMPLE, or deferrals under a government Section 457 plan is increased for individuals who have attained age 50 by the end of the year. The additional amount of contributions that may be made is the lesser of (1) a specified dollar amount or (2) the participant's compensation for the year reduced by his or her other elective deferrals for the year. The dollar amount under a Section 401(k) plan, Section 403(b) annuity, SEP, or Section 457 plan is $6,000 for 2017 and $6,000 for 2016.

The dollar amount under a SIMPLE plan is $3,000 for 2017 and $3,000 for 2016.

Higher IRA Contribution Limits

An individual may make annual deductible contributions to a traditional IRA if neither the individual nor his spouse is an active participant in an employer-sponsored retirement plan. For a married couple, deductible IRA contributions can be made for each spouse (including, for example, a homemaker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount. If the individual is an active participant in an employer-sponsored retirement plan, the deduction limit is phased - out if Adjusted Gross Income exceeds certain levels for the tax year. For example, for 2017, the IRA deduction for single taxpayers phased out over $62,000 to $72,000 of Adjusted Gross Income ($99,000 to $119,000 for married taxpayers filing jointly). For a nonactive participant who had an active-participant spouse, the IRA deduction phaseout begins at $186,000 of Adjusted Gross Income.

Contributions to Roth IRAs are subject to income limits. The maximum yearly contribution that can be made to a Roth IRA is phased out for a single individual with an Adjusted Gross Income between $118,000 and $133,000 and for joint filers with Adjusted Gross Income between $186,000 and $196,000 in 2017.

The maximum annual dollar contribution limit for IRA contributions will increase to the following levels:

Tax Years Beginning in	Maximum Deductible IRA Amount
2013 through 2017	$5,500

Individuals who attain age 50 before the close of the tax year will be able to make additional catch-up IRA contributions. The otherwise allowable maximum contribution limit (before applying the Adjusted Gross Income phaseout limits) for these individuals will be $1,000 for 2006 and later years.

401(k) and 403(b) Plans May Treat Post-2005 Elective Deferrals as After-Tax Roth IRA Type Contributions

For tax years beginning after 2005, a 401(k) plan or 403(b) annuity will be allowed to include a "qualified Roth contribution program" that allows participants to elect to have all or part of their elective deferrals treated as Roth contributions. These deferrals will not be excludable from gross income. The annual dollar limit on a participant's Roth contribution will be the then-applicable Code Section 402(g) limitation on elective deferrals (e.g., $18,000 in 2017). This new option for elective deferrals will allow taxpayers to make larger annual Roth IRA contributions than they can make with regular Roth IRAs.

Tax Credit to Help Lower-Income Taxpayers Save for Retirement

Eligible lower-income taxpayers can claim a nonrefundable tax credit for contributions to certain qualified plans. **The maximum annual contribution eligible for the credit is $2,000.**

The credit will be in addition to any deduction or exclusion that would otherwise apply for a contribution. Only an individual who is 18 or over (other than a full-time student or an individual allowed as a dependent on another taxpayer's return) will be eligible for the credit.

The credit will be available for elective contributions to 401(k) plans, 403(b) annuities, Section 457 plans, SIMPLE or SEP plans, traditional or Roth IRAs, and voluntary after-tax employee contributions to a qualified retirement plan. The amount of any credit-eligible contribution will be reduced by taxable distributions received by the taxpayer.

The credit rate (50%, 20%, or 10%) depends on the taxpayer's filing status and modified Adjusted Gross Income. For 2017, the rates are as follows:

Modified Adjusted Gross Income						Applicable Percentage
Joint Return		*Head of Household*		*All Other Cases*		
Over	Not Over	Over	Not Over	Over	Not Over	
$ - 0 -	$37,000	$ - 0 -	$27,750	$ - 0 -	$18,500	50%
$37,000	$40,000	$27,750	$30,000	$18,500	$20,000	20%
$40,000	$62,000	$30,000	$46,500	$20,000	$31,000	10%
$62,000		$46,500		$31,000		0%

The maximum credit allowed to an individual will be $1,000 ($2,000 x 50%) on joint returns with modified Adjusted Gross Income not over $36,500.

Minimum Distribution Regulations

On April 16, 2002, the IRS released final minimum distribution regulations for profit sharing, stock bonus, 401(k), and other defined contribution plans and IRAs. The regulations are effective beginning January 1, 2003 but may be used in determining minimum distributions for 2002.

The required distribution beginning date has not changed. Minimum distributions are first required for the year the plan participant reaches age 70½ but may be deferred until April 1st of the following year. If the employee is not a 5% owner of a company that maintains a qualified plan, the first year a distribution from the qualified plan is required is the year in which the employee retires, if this is later than the year he or she reaches 70½.

The amount to be taken as a minimum distribution is the balance on December 31st of the prior year divided by a divisor, which generally appears in a uniform lifetime table. The table is based on the joint life expectancy of the IRA owner and a hypothetical person ten years younger.

The tables in the final regulations recognize improvements in mortality and allow distributions over a longer period of time than under tables previously used.

Distributions are required after an owner's death when an individual other than the spouse is beneficiary. When an individual who is not the owner's spouse is beneficiary, distributions must begin by December 31st of the year following the owner's death. If the owner dies before the required beginning date of his or her distributions, the amount to be distributed is determined by dividing the account balance at the beginning of the year following death by the beneficiary's remaining life expectancy. If the owner dies after the required beginning date of his or her distributions, the divisor is the longer of the owner's or beneficiary's remaining life expectancy.

Uniform Table for Lifetime Distributions					
Age	Applicable Divisor	Age	Applicable Divisor	Age	Applicable Divisor
70	27.4	*80*	18.7	*90*	11.4
71	26.5	*81*	17.9	*91*	10.8
72	25.6	*82*	17.1	*92*	10.2
73	24.7	*83*	16.3	*93*	9.6
74	23.8	*84*	15.5	*94*	9.1
75	22.9	*85*	14.8	*95*	8.6
76	22.0	*86*	14.1	*96*	8.1
77	21.2	*87*	13.4	*97*	7.6
78	20.3	*88*	12.7	*98*	7.1
79	19.5	*89*	12.0	*99*	6.7

Roth IRA Conversion

All taxpayers, regardless of their modified adjusted gross income (AGI), may convert amounts in a traditional IRA to amounts in a Roth IRA. Marrieds filing separately also are eligible. Before 2010, only taxpayers with modified AGI of $100,000 or less could make such conversion, and marrieds filing separately were not eligible regardless of modified AGI.

Amounts from a SEP-IRA or a SIMPLE IRA also may be converted to a Roth IRA, but a conversion from a SIMPLE IRA may be made only after the 2-year period beginning on the date on which the taxpayer first participated in any SIMPLE IRA maintained by the taxpayer's employer.

A conversion from a regular IRA to a Roth IRA generally is subject to tax as if it were distributed from the traditional IRA and not recontributed to another IRA, but isn't subject to the 10% premature distribution tax.

Roth IRAs have two major advantages over regular IRAs:

- Distributions from regular IRAs are taxed as ordinary income (except to the extent they represent nondeductible contributions). By contrast, Roth IRA distributions are tax-free if they are "qualified distributions," that is, if they are made after the 5-tax-year period that begins with the first tax year for which the taxpayer made a contribution to a Roth IRA, and when the account owner is 59 ½ years of age or older, or on account of death, disability, or the purchase of a home by a qualified first-time homebuyer (limited to $10,000).
- Regular IRAs are subject to the lifetime required minimum distribution (RMD) rules that generally require minimum annual distributions to be made commencing in the year following the year in which the IRA owner attains age 70 ½. By contrast, Roth IRAs aren't subject to the lifetime RMD rules that apply to regular IRAs (as well as individual account qualified plans).

The consensus view is that the conversion route should be considered by taxpayers who:

- Have a number of years to go before retirement (and are therefore able to recoup the dollars that are lost to taxes on account of the conversion),
- Anticipate being taxed in a higher bracket in the future than they are now, and
- Can pay the tax on the conversion from non-retirement-account assets (otherwise, there will be a smaller buildup of tax-free earnings in the depleted retirement account.

Roth IRA Contributions

Individuals may make nondeductible contributions to a Roth IRA, subject to the overall limit on IRA contributions. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with MAGI over certain levels for the tax year. For taxpayers filing joint returns, the otherwise allowable contributions to a Roth IRA will be phased out ratably in 2017 for MAGI between $186,000 and $196,000 (up from between $184,000 and $194,000 in 2016). For single taxpayers and heads of household it will be phased out ratably for MAGI between $118,000 and $133,000 (up from $117,000 and $132,000 for 2016). For married taxpayers filing separate returns, the otherwise allowable contribution will continue to be phased out ratably for MAGI between $0 and $10,000 (same as for 2016).

Distributions From Elective Deferral Plans May be Rolled Over to Designated Roth Accounts

The new law allows 401(k), 403(b), and governmental 457(b) plans to permit participants to roll over their pre-tax account balances into a designated Roth account. The amount of the rollover will be includible in taxable income except to the extent it is the return of after-tax contributions.

To be eligible for rollover to a designated Roth account, a distribution must be (i) an eligible rollover distribution, (ii) otherwise allowed under the plan, and (iii) allowable in the amount and form elected. For example, an amount in a 401(k) plan account that is subject to distribution restrictions (e.g., because the participant has not reached age 59 ½) cannot be rolled over to a designated Roth account under the new rollover rules. However, an employer may expand its distribution options beyond those currently allowed by the plan (e.g., by adding in-service distributions before normal retirement age) in order to allow employees to make rollover contributions to a designated Roth account through a direct rollover to the designated Roth account within that plan.

If a plan allows rollover contributions to a designated Roth account, the plan must be amended to reflect this plan feature.

Although there are many similarities between the treatment of Roth IRAs and designated Roth accounts, one difference is that, in determining the taxation of Roth IRA distributions that are not qualified distributions, after-tax contributions are considered recovered before income. This basis-first recovery rule for Roth IRAs does not apply to distributions from designated Roth accounts. Another difference is that a first-time homebuyer expense can be a qualified distribution from a Roth IRA (even without the occurrence of another event, such as the individual reaching age 59 ½), but cannot by itself be qualified distribution from a designated Roth account.

A taxpayer who can rollover an amount from an applicable employer plan to either a Roth IRA or a designated Roth account, might consider whether taking withdrawals from the Roth account or Roth IRA within the five-tax-year holding period for qualified distributions would result in additional tax on a distribution from a designated Roth account (because for the unavailability of the basis-first recovery rule). Also, a taxpayer who is contemplating a withdrawal from the Roth account or Roth IRA to purchase a home as a first-time homebuyer, but who has not yet reached age 59 ½, should consider that such a withdrawal can be qualified distribution from a Roth IRA, but not from a designated Roth account, if the taxpayer has not reached age 59 ½.

Under the 2010 Small Business Act, the tax-free treatment of rollovers that ordinarily applies (under Code Sec. 402(c) for qualified plans, under Code Sec. 403(b)(8) for 403(b) annuities and under Code Sec. 457(e)(16) for governmental section 457 plans) does not apply for distributions rolled over from an applicable retirement plan to a designated Roth account (as described above). Rather, the amount that an individual receives in a distribution from an applicable retirement plan that would be includible in gross income if it were not part of qualified rollover distribution, must be included in his gross income.

If a direct rollover is made by a transfer of property to a designated Roth account, then the amount of the distribution is the fair market value of the property on the date of the transfer.

Multiemployer Pension Reform

The consolidated and further appropriations Act of 2015 contains a significant 160 page amendment on multiemployer pension reform. This legislation is designed to give multiemployer pension plans the tools they need to remain viable. One of the new provisions allow trustees of severely underfunded plans to adjust vested benefits without violating the Code Sec. 411(d)(6) anti-cutback rule, which may enable deeply troubled plans to survive without a federal bailout.

Business Provisions

New Tax Legislation

On July 31, 2015, President Obama signed into law the "Surface Transportation and Veterans Health Care Choice Improvement Act of 2015" (the Transportation Act), which extended the Highway Trust Fund and included a number of important tax changes.

The most important tax changes in the Transportation Act are those that adjust tax-filing deadlines for partnerships and C corporations. Specifically, for tax years beginning after December 31, 2015:

- Partnerships and S corporations must file their returns by the 15th day of the third month after the end of the tax year. Thus, entities using a calendar year will have to file by March 15th of the following year. Thus the filing deadline for partnerships will be accelerated by one month but the filing deadline for S corporations will stay the same.
- C corporations must file by the 15th day of the fourth month after the end of the tax year. Thus, C corporations using a calendar year must file by April 15th of the following year. Thus, the filing deadline for C corporations will be deferred for one month. Under a special rule for C corporations with fiscal years ending on June 30th, the change will not apply until tax years beginning after December 31, 2025.

Due dates for extensions have been adjusted as well, effective generally for returns for tax years beginning after December 31, 2015. For example, the new law creates the following exceptions to the 6-month extension that generally applies to corporations:

- For any return for a tax year of a C corporation which ends on December 31st and begins before January 1, 2026, the automatic extension period is 5 months.
- For any tax year of a C corporation which ends on June 30th and begins before January 1, 2026, the automatic extension period is 7 months. And, the maximum extension for the returns of partnerships filing Form 1065 will be a 6-month period (ending on September 15th for calendar year taxpayers) (not 5 months).

The 6-year statute of limitations applies in cases where any overstatement of basis results in a substantial (25% or more) omission of income.

Effective for property with respect to which an estate tax return is filed after July 31, 2015, large estates (i.e., those required to file a federal estate tax return) are required to provide the IRS with the value of property included in the gross estate, to ensure consistent reporting for income and estate tax purposes.

Home Mortgage Interest Deduction Doubled for Unmarried Co-Owners

The Ninth Circuit Court of Appeals, reversing a Tax Court decision, concluded that the tax law's limits on the amount of debt eligible for the home mortgage interest deduction ($1 million of mortgage "acquisition" debt and $100,000 of home equity debt) are applied on a per-individual basis, and not a per-residence basis as the IRS has long maintained. Thus, for the unmarried co-owners in the case, their collective limit for the home mortgage interest deduction doubled from a maximum of $1.1 million to a maximum of $2.2 million acquisition and home equity debt.

Enhanced Expensing Made Permanent

Under Code Sec. 179, a taxpayer, other than an estate, a trust, or certain noncorporate lessors, may elect to deduct as an expense, rather than to depreciate, up to a specified amount of the cost of new or used tangible personal property placed in service during the tax year in the taxpayer's trade or business. The maximum annual expensing amount generally is reduced dollar-for-dollar by the amount of Code Sec. 179 property placed in service during the tax year in excess of a specified investment ceiling. Amounts ineligible for expensing due to excess investments in expensing-eligible property cannot be carried forward and expensed in a subsequent year. Rather, they can only be recovered through depreciation. The amount eligible to be expensed for a tax year cannot exceed the taxable income derived from the taxpayer's active conduct of a trade or business. And any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding tax years.

For tax years beginning in 2014: (1) the dollar limitation on the expensing deduction was $500,000; and (2) the investment-based reduction in the dollar limitation began to take effect when property placed in service in the tax year exceeds $2 million (the investment ceiling). Under the 2014 limits, the Code Sec. 179 deduction did not phase out completely until the cost of expensing-eligible property exceeded $2.5 million ($2 million (investment ceiling) + $500,000 (dollar limit)).

Under pre-Act law, for tax years beginning after 2014, the maximum expensing limit dropped to $25,000, and the investment ceiling dropped to $200,000. Thus, the Code Sec. 179 deduction phased out completely when the cost of expensing eligible property exceeded $225,000 ($200,000 (investment ceiling) + $25,000 (dollar limit)).

In general, under pre-Act law, property is eligible for Code Sec. 179 expensing if it is:

- Tangible property that is Code Sec. 1245 property (generally, machinery and equipment), depreciated under the MACRS rules of Code Sec. 168, regardless of its depreciation recovery period;
- For any tax year beginning in 2010 through 2014, up to $250,000 of qualified real property - qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property - (under a carryover limitation for qualifying real property no portion of the disallowed expensing could be carried to a tax year beginning after 2014); or
- Off-the-shelf computer software, but only if placed in service in a tax year beginning before 2015.

Under pre-Act law, for tax years beginning before 2015, an expensing election or specification of property to be expensed may be revoked without IRS's consent, but, if revoked, cannot be reelected. However, for tax years beginning after December 31, 2014, the expensing election, and any specification made in it, was to have been revocable only with IRS's consent.

The Act makes the following changes to the Code Sec. 179 expensing election:

- The $500,000 expensing limitation and $2 million phase-out amounts are retroactively extended and made permanent.
- For any tax year beginning after 2015, both the $500,000 and $2 million limits are indexed for inflation ($500,000 for 2016 and $510,000 for 2017).
- The rule that allows expensing for computer software is retroactively extended and made permanent.
- For tax years beginning after December 31, 2014, an expensing election or specification of property to be expensed may be revoked without IRS's consent. Thus, the ability to revoke a Code Sec. 179 election without IRS consent is made permanent.
- Qualified real property is eligible to be expensed for tax years beginning before 2016. No portion of disallowed expensing may be carried to a tax year beginning after 2015.
- For tax years beginning after December 31, 2015, expensing of qualified real property is made permanent without a carryover limitation and the $250,000 expensing limitation with respect to qualifying real property is eliminated.
- For tax years beginning after December 31, 2015, air conditioning and heating units are eligible for expensing.

Enhanced First-Year Depreciation Cap for Autos and Trucks Extended Through 2019

Under the luxury auto dollar limits of Code Sec. 280F, depreciation deductions (including Code Sec. 179 expensing) that can be claimed for passenger autos are subject to dollar limits that are annually adjusted for inflation. For passenger automobiles placed in service in 2015, the adjusted first-year limit is $3,160. For light trucks or vans, the adjusted first-year limit is $3,460. Light trucks or vans are passenger automobiles built on a truck chassis, including minivans and sport-utility vehicles (SUVs) built on a truck chassis that are subject to the Code Sec. 280F limits because they are rated at 6,000 points gross (loaded) vehicle weight or less.

The applicable first-year depreciation limit is increased by $8,000 (not indexed for inflation) for any passenger automobile that is "qualified property" under the bonus depreciation rules of Code Sec. 168(k) and which is not subject to a taxpayer election to decline bonus depreciation.

Under pre-Act law, qualified property did not include property placed in service after December 31, 2014 (except for certain aircraft and certain long-production-period property that had, instead, a December 31, 2015 placed-in-service deadline). Thus, under pre-Act law, the $8,000 boost in first-year depreciation allowances was not available for new cars and trucks purchased after 2014.

For property placed in service after December 31, 2015 and before January 1, 2018, the Act provides that the Code Sec. 280F limitation for a passenger auto or light truck or van that is qualified property is increased by $8,000. For an auto or light truck or van placed in service in 2018, the Code Sec. 280F limitation is increased by $6,400. For an auto or light truck or van placed in service in 2019, the Code Sec. 280F limitation is increased by $4,800.

Bonus First-Year Depreciation Extended Through 2019

Under pre-Act law, Code Sec. 168(k) generally allows an additional first-year depreciation deduction (also called bonus first-year depreciation) equal to 50% of the adjusted basis of qualified property acquired and placed in service after December 31, 2011, and before January 1, 2015 (before January 1, 2016 for certain longer-lived and transportation property). The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax (AMT) purposes, but is not allowed for purposes of computing earnings and profits. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. A taxpayer may elect out of additional first-year depreciation for any class of property for any tax year.

In general, an asset qualifies for the bonus depreciation allowance if:

- It falls into one of the following categories: property to which the modified accelerated cost recovery system (MACRS) rules apply with a recovery period of 20 years or less; computer software other than computer software covered by Code Sec. 197; qualified leasehold improvement property; or certain water utility property.
- It is placed in service before January 1, 2015. (Certain long-production-period property and certain transportation property may be placed in service before January 1, 2016).
- Its original use commences with the taxpayer. Original use is the first use to which the property is put, whether or not that use corresponds to the taxpayer's use of the property.

The Act extends bonus depreciation for qualified property acquired and placed in service in 2015 through 2019 (through 2020 for certain longer-lived and transportation property). Eligible taxpayers will be able to claim:

- A 50% bonus depreciation allowance for qualified property placed in service in 2015 through 2017;
- A 40% bonus depreciation allowance for qualified property placed in service in 2018; and
- A 30% bonus depreciation allowance for qualified property placed in service in 2019.

The percentages apply to certain longer-lived and transportation property placed in service one year later than shown in the list above.

The Act also provides that:

- After 2015, additional first-year depreciation is allowed for qualified improvement property without regard to whether the improvements are property subject to a lease, and there is no requirement that the improvement must be placed in service more than three years after the date the building was first placed in service.
- For plants planted or grafted after December 31, 2015 and before January 1, 2020, 50% bonus depreciation is allowed for certain trees, vines, and plants bearing fruit or nuts when planted or grafted, rather than when placed in service.
- The special rule for the allocation of bonus depreciation to a long-term contract is extended for five years to property placed in service before January 1, 2020 (January 1, 2021, in the case of certain longer-lived and transportation property).

Choice to Forego Bonus Depreciation and Claim Credits Instead Is Extended

Code Sec. 168(k)(4) generally permits a corporation to increase the alternative minimum tax (AMT) credit limitation by the bonus depreciation amount with respect to certain property placed in service after December 31, 2010 and before January 1, 2015 (January 1, 2016 in the case of certain longer-lived and transportation property) if it forgoes bonus depreciation on that property.

Under pre-Act law, the above provision did not apply to such property placed in service after December 31, 2014 (December 31, 2015 in the case of certain longer-lived and transportation property).

For property placed in service during 2015, the Act allows taxpayers to elect to accelerate the use of AMT credits in lieu of bonus depreciation under special rules. Beginning in 2016, the Act modifies the AMT rules by increasing the amount of unused AMT credits that may be claimed in lieu of bonus depreciation.

15-Year Writeoff for Qualified Leasehold and Retail Improvements and Restaurant Property Made Permanent

Qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property that was placed in service before January 1, 2015 was included in the 15-year MACRS class for depreciation purposes - that is, such property was depreciated over 15 years under MACRS.

Under pre-Act law, the 15-year writeoff did not apply to property placed in service after December 31, 2014.

Effective for property placed in service after December 31, 2014, the Act retroactively extends and makes permanent the inclusion of qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property in the 15-year MACRS class.

Reduction in S Corp Recognition Period for Built-In Gains Tax Permanently Extended

An S Corporation generally is not subject to tax, but instead passes through its income to its shareholders, who pay tax on their pro-rata shares of the S Corporation's income. Where a corporation that was formed as a C Corporation elects to become an S Corporation (or where an S Corporation receives property from a C Corporation in a nontaxable carryover basis transfer), the S Corporation is taxed at the highest corporate rate (currently 35%) on all gains that were built-in at the time of the election if the gain is recognized during a recognition period.

Under pre-Act law, for S Corporation tax years beginning in 2012 and 2013, the recognition period was five years (instead of the generally applicable 10-year period). Thus, the recognition period was the 5-year period beginning with the first day of the first tax year for which the corporation was an S Corporation (or beginning with the date of acquisition of assets if the rules applicable to assets acquired from a C Corporation applied). If an S Corporation disposed of such assets in a tax year beginning in 2012 or 2013 and the disposition occurred more than five years after the first day of the relevant recognition period, gain or loss on the disposition was not taken into account in determining the net recognized built-in gain.

The Act retroactively and permanently provides that, for determining the net recognized built-in gain, the recognition period is a 5-year period-the same rule that applied to tax years beginning in 2014.

Safe Harbor Provides Simplified Option for Claiming Home Office Deduction
Rev Proc 2013-13, 2013-6 IRB, IR 2013-5

In a revenue Procedure, IRS has provided an optional safe harbor method that individuals can use to determine the amount of their deductible home office expenses, effective for tax years beginning on or after January 1, 2013. The safe harbor - $5 x square feet of qualified use (up to three-hundred square feet) provides an alternative to the calculation, allocation, and substantiation of actual expenses required under Code Sec. 280A.

Background
The general rule under Code Sec. 280A(a) is that no deduction is allowed for the business use of a dwelling unit that is also used by the taxpayer as a residence during the tax year. But under exceptions, if strict requirements are met, deductions are allowed for direct expenses and the business-use part of the indirect expenses relating to business use of a residence:

- Home office expenses are deductible if part of the home is used regularly and exclusively as (i) a principal place of business, or (ii) as a place to meet or deal with customers or clients in the ordinary course of business. Taxpayers who are employees must meet an additional test – their use of the home office must be for the convenience of the employer. (Code Sec. 280A(c)(1))
- Expenses that are allocable to space within the dwelling unit used on a regular basis for the storage of inventory or product samples held for use in the taxpayer's trade or business of selling products at retail or wholesale are deductible if the dwelling unit is the sole fixed location of the trade or business. (Code Sec. 280A(c)(2))
- Expenses that are attributable to the rental of the dwelling unit or a part of the unit are deductible. (Code Sec. 280A(c)(3))
- Expenses that are allocable to the part of the dwelling unit used on a regular basis in the taxpayer's trade or business of providing day care for children, for individuals who have attained age sixty-five, or for individuals who are physically or mentally incapable of caring for themselves are deductible. (Code Sec. 280A(c)(4))

These deductions are limited to the activity's gross income reduced by all other deductible expenses that are allowable regardless of qualified use (e.g., mortgage interest, real estate taxes, and casualty losses) and by the business deductions that are not allocable to the use of the home itself (e.g., expenses of advertising, wages, and supplies). Expenses disallowed solely because they exceed business income can be carried forward, subject to the gross income limitation in the later year. (Code Sec. 280A(c)(5))

New Safe Harbor
To reduce the administrative, recordkeeping, and compliance burdens of determining the allowable deduction for the qualified business use of a residence under Code Sec. 280A, Rev Proc 2013-13 provides a safe harbor method under which an individual determines his allowable deduction for the qualified business use of a home by multiplying a prescribed rate ($5) by the square footage of the part of this residence that is used for business purposes, not to exceed three-hundred square feet. "Qualified business use" for this purpose is a business use that satisfies the requirements of Code Sec. 280A(c)(1) through Code Sec. 280A(c)(4) – that is, uses for which a deduction under Code Sec. 280A would otherwise be allowed. The $5 rate may be updated from time to time, as warranted. Adjustments are provided for determining the allowable square footage for a taxpayer with a qualified business use of a home for only a part of a year. (Rev Proc 2013-13, Sec. 3, Rev Proc 2013-13, Sec. 4)

Thus, the maximum deduction under the safe harbor is limited to $1,500 ($5 rate x three-hundred square feet).

For purposes of the safe harbor, "home" means a dwelling unit used by the taxpayer during the tax year as a residence (as defined in Code Sec. 280A(d) and Code Sec.(f)(1)), including a dwelling unit leased by a taxpayer. However, only a dwelling unit that is Code Sec. 1250 property (generally depreciable real property) and MACRS property (generally defined in Reg § 1.168(b)-1(a)(2) as tangible, depreciable property subject to Code Sec. 168 that is placed in service after Dec. 31, '86) qualifies as a home. (Rev Proc 2013-13, Sec. 3.03)

The safe harbor method does not apply to an employee with a home if he receives advances, allowances, or reimbursements for expenses related to the qualified business use of the employee's home under a reimbursement or other expense allowance arrangement with his employer. (Rev Proc 2013-13, Sec. 4.01(4))

The safe harbor is an alternative to deducting actual expenses. Accordingly, a taxpayer electing the safe harbor method for a tax year generally cannot deduct any actual expenses related to the qualified business use of that home for that tax year, with the following exceptions:

- *Otherwise Allowable Home-Related Deductions.*
  A taxpayer who itemizes deductions and uses the safe harbor may deduct any allowable expenses related to the home that are deductible without regard to whether there was a qualified business use of the home for that tax year (e.g., deductions for qualified residence interest, property taxes, and casualty losses). Taxpayers using the safe harbor method deduct these expenses as itemized deductions on Form 1040, Schedule A, and cannot deduct any part of these expenses from the gross income derived from the qualified business use of the home – either for purposes of determining the net income derived from the business or for purposes of determining the net income derived from the business or for purposes of determining the gross income limitation under Rev Proc 2013-13, Sec. 4.08(2) (which parallels the gross income limitation under Code Sec. 280A(c)(5)). Taxpayers with a qualified business use of a home who also have a rental use of the same home under Code Sec. 280A(c)(3) must allocate a portion of these expenses to the rental use to the extent required under Code Sec. 280A and its regs. (Rev Proc 2013-13, Sec. 4.04)

- *Business Deductions Unrelated to Qualified Home Use.*
  A taxpayer using the safe harbor method for a tax year may deduct any allowable trade or business expenses unrelated to the qualified business use of the home for that tax year (e.g., expenses for advertising, wages, and supplies). (Rev Proc 2013-13, Sec. 4.05)

  A taxpayer using the safe harbor for a tax year cannot deduct any depreciation (including first-year bonus depreciation) or Code Sec. 179 expensing for the part of his home that is used in qualified business use for that tax year. (Rev Proc 2013-13, Sec. 4.06) If he calculates and substantiates actual Code Sec. 280A expenses for a later year, he must calculate the depreciation deduction by using the appropriate optional depreciation table applicable for the property in the manner described in Rev Proc 2013-13, Sec. 4.07(2), regardless of whether he used an optional depreciation table for the property in its placed-in-service year. (Rev Proc 2013-13, Sec. 4.07)

A taxpayer using the safe harbor method for a tax year cannot deduct any disallowed amount under Code Sec. 280A(c)(5) carried over from a prior tax year during which the taxpayer calculated and substantiated actual Code Sec. 280A expenses. He can deduct the carried-over amount in the next succeeding tax year in which he calculates and substantiates actual Code Sec. 280A expenses. (Rev Proc 2013-13, Sec. 4.08(3))

Electing the Safe Harbor

A taxpayer may elect from tax year to tax year whether to use the safe harbor method or calculate and substantiate actual expenses under Code Sec. 280A. A taxpayer elects the safe harbor by using the method to compute the deduction for the qualified business use of a home on his timely filed, original federal income tax return for the tax year. Once made, an election for the tax year is irrevocable. A change from using the safe harbor method in one year to actual expenses in a succeeding tax year (or vice-versa) is not a change in accounting methods. (Rev Proc 2013-13, Sec. 4.03)

One-Year Rule for Prepaid Expenses

The final regulations under Sec. 263(a) issued in January 2004 included a 12-month rule (Regs. Sec. 1.263(a)-4(f)), whereby taxpayers are not required to capitalize an expense if it is paid or incurred (see Regs. Sec. 1.263(a)-4(j)) to create a right or benefit that does not extend beyond the earlier of (1) 12 months after the first date of the right or benefit or (2) the end of the tax year following the tax year in which the expense was paid or incurred.

Regs. Sec. 1.263(a)-4(f)(6) makes it clear that, for an accrual-method taxpayer, the 12-month rule does not eliminate the other requirements for deduction – all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Corporation X, an accrual-method taxpayer with a calendar tax year, made two prepayments in June 2005. One payment was for a fire and casualty insurance policy; the other was for equipment rental. Both payments covered the period July 1, 2005 to June 30, 2006. X is not required to capitalize the portion of the insurance payment attributable to 2006 because of the 12-month rule, and the portion can be deducted in 2005 because the all-events test is met, the amount is determinable with reasonable accuracy, and economic performance was satisfied on payment. The portion of the rental payment attributable to 2006 does not have to be capitalized because of the 12-month rule and, with the all-events and determinable-with-reasonable-accuracy requirements met, it can be deducted in 2005 if the payment satisfies the requirements for the economic performance recurring-item exception under Regs. Sec. 1.461-5.

The Sec. 263(a) regulations provided that for the first tax year ending on or after December 31, 2003, taxpayers wishing to change their accounting method to a method consistent with the regulations can make the change using the automatic consent procedure described in Rev. Proc. 2002-9. Accordingly, for example, a calendar-year taxpayer could make a change to apply the 12-month rule beginning with its tax year ended December 31, 2003, by filing Form 3115, Application for Change in Accounting Method, by the due date (including extensions) of its 2003 return.

Rev. Proc. 2004-23 was issued later. It provided additional guidance for completing Form 3115 under the automatic consent procedure to change to an accounting method to conform to the Sec. 263(a) regulations for the first tax year ending on or after December 31, 2003. Taxpayers could also use the procedure to correspondingly change their accounting methods to use the economic performance 3½-month rule or recurring-item exception in conjunction with the items changed under the 12-month rule, by including this information on the same Form 3115. The availability of the automatic consent procedure to change to the 12-month rule and to use the 3½-month rule or recurring-item exception was later extended by Rev. Proc. 2005-9 for taxpayers' second tax year ending on or after December 31, 2003.

Rev. Proc. 2006-12 was issued on December 21, 2005. It allows taxpayers to change, under the automatic consent procedure, to an accounting method provided under the Sec. 263(a) regulations beginning with tax years ending on or after December 31, 2005. However, a major departure form Rev. Proc. 2004-23 and 2005-9 was made. Rev. Proc. 2006-12 only applies to taxpayers changing to an accounting method provided under the Sec. 263(a) regulations; it does not apply to taxpayers changing their method using the economic performance 3½-month rule or recurring-item exception. Rev. Proc. 2006-12 states:

Thus, for a change in method of accounting utilizing the 3½-month rule or the recurring-item exception in conjunction with a change to a method provided by the final regulations, a taxpayer must file two separate applications for a change in method of accounting – an application for a change in method of accounting under this revenue procedure to change to the method of accounting provided in the final regulations, and a separate application for a change in method of accounting under Rev. Proc. 97-27 for a change in method of accounting utilizing the 3½-month rule or the recurring-item exception.

Accordingly, in the example above, to change to an accounting method under which X could deduct in 2005 the insurance premium and equipment rental payments attributable to 2006, X would have to file two Forms 3115 – one under the automatic consent procedure by the due date of the 2005 return to change to the 12-month rule for both payments, and the other under the advance consent procedure, which would have to be filed by December 31, 2005 to permit X to use the recurring-item exception to deduct its equipment rental payment.

It appears the IRS made this significant change due to its findings that change to the use of the 3½-month rule or recurring-item exception when it is necessary to comply with the economic performance requirement in conjunction with a change to the 12-month rule was often not being made, and when made the exception may not have been applied correctly. It also appears that the IRS is proposing to modify Rev. Proc. 2006-12 to allow taxpayers in this situation to file one Form 3115 for both changes (instead of two) under the advance consent procedure. Rev. Proc. 2006-12 was modified by Rev. Proc. 2006-37 to allow taxpayers to file one Form 3115 for both changes.

Deduction for Manufacturing/Production Activities

For tax years beginning after 2004, the Act provides a deduction that is equal to a percentage of the income earned from manufacturing (and certain other production activities) undertaken in the U.S. The deduction equals the lesser of:

- A percentage of the lesser of the qualified production activities income of the taxpayer for the tax year or taxable income without regard to this deduction, for the tax year. The percentage is 3% for tax years beginning in 2005 and 2006, 6% for tax years beginning in 2007-2009, and 9% thereafter.
- 50% of the sum of wages paid by the taxpayer and the elective deferrals, that are made by the taxpayer during the calendar year that ends in the tax year. (W-2 wages only include amounts that are properly allocable to domestic production gross receipts).

Qualified production activities income is equal to domestic production gross receipts reduced by the sum of:

- the costs of goods sold that are allocable to such receipts, other deductions, expenses, or losses that are directly allocable to such receipts, and
- a ratable portion of other deductions, expenses, and losses that are not directly allocable to such receipts or to another class of income.

Domestic production gross receipts are gross receipts of a taxpayer that are derived from:

- any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the U.S.,
- any sale, exchange or other disposition, or any lease, rental or license, of qualified films produced by the taxpayer,
- any sale, exchange or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the U.S.,
- construction activities performed in the U.S., or
- engineering or architectural services performed in the U.S. for construction projects located in the U.S.

Domestic production gross receipts do not include any gross receipts derived from the sale of food or beverages prepared by the taxpayer at a retail establishment, or the transmission or distribution of electricity, natural gas, or potable water.

Qualifying production property includes any tangible personal property, computer software and sound recordings. In order to be a qualified film, 50% of the total compensation relating to the production of the film must be for services performed in the U.S. by actors, production personnel, directors and producers.

The deduction is available to C corporations, S corporations, partnerships, sole proprietorships, co-operatives, and estates and trusts, and subject to an adjustment, is allowed for AMT purposes.

Who Must Use Accrual Method

C corporations, partnerships having a C corporation as a partner and tax shelters cannot use the cash method and must instead use the accrual method. However, this rule does not apply to a corporation or partnership (assuming it is not a tax shelter) if a not-more-than-$5 million average annual gross receipts test is met. "Tax shelter" means, among other things, a partnership or S corporation, interests in which are sold through an offering registered with a state or federal agency, or more than 35% of whose losses are allocable to limited partners and certain other non-active participants.

Small Business Exceptions to Required Accrual Accounting
The accrual method generally is also mandatory for purchases and sales where inventories must be used. However, qualifying small businesses with 3-year average annual gross receipts of more than $1 million but not more than $10 million that are not prohibited from using the cash method under Code Sec. 448 (such as tax shelters, and C corporations with more than $5 million average gross receipts, as discussed above) and otherwise would have to keep inventories and use accrual accounting may, instead, use the cash method for an eligible trade or business. Under this IRS relief, the following types of qualifying small businesses may use the cash method for all of their trades and businesses:

- One whose principal business activity for its immediately preceding tax year is other than mining, manufacturing, wholesale trade, retail trade, or information industries.
- Service providers, including those providing property incident to those services.
- Fabricators or modifiers of tangible personal property upon demand in accordance with customer design or specifications.

Qualifying small businesses that come within any of these categories may use the cash method even for parts of their businesses, such as retailing or wholesaling, which otherwise would not qualify for the cash method.

IRS also allows taxpayers with average annual gross receipts of $1 million or less to use the cash method, with fewer restrictions than under the $10 million exception discussed above. For instance, retailers and wholesalers with gross receipts up to $1 million may use the cash method, but those with gross receipts between $1 million and $10 million generally may not.

Businesses that use the cash method under the exceptions generally include amounts in income attributable to open accounts receivable (i.e., receivables due in 120 days or less) as amounts are actually or constructively received. Businesses permitted to use the cash method under these exceptions that do not want to account for inventories must treat all inventoriable items (e.g., items purchased for resale and raw materials purchased for use in producing finished goods) in the same manner as nonincidental materials and supplies under Reg § 1.162-3 (i.e., deductible only in the year in which they are actually consumed and used in the taxpayer's business).

Qualifying small business taxpayers that want to use the cash method and/or not account for inventories as described above must follow the automatic-change-in-accounting-method provisions of Rev. Proc. 2008-36, 2008-33 IRB 340, as modified by Rev. Proc. 2009-39, 2009-38 IRB, with certain modifications.

"S" Corporation Shareholder Compensation

The IRS is on the lookout for S Corporations that fail to pay reasonable salaries to shareholders who perform services for the corporation. The failure to pay adequate salaries to shareholder-employees is a red flag for an audit.

The IRS can reclassify as salaries any distributions to the shareholders. Determining what a reasonable salary is may be more art than science, but the attempt must be made.

Because the IRS's goal is to collect FICA tax on the salaries, one solution is to pay the maximum amount of wages subject to FICA tax, assuming, of course this is a reasonable salary, based on the shareholder-employee's services actually rendered. A smaller salary may be justified for an executive in a startup or a relatively small corporation. The salary should also consider the shareholder-employee's experience and skill, the geographical region, customer base, number of employees, and time committed to the corporation. What is a reasonable salary depends on the facts of each case. No test is conclusive. It often becomes a judgment call by the IRS. Comparable salaries from industry data are usually appropriate.

The tax court in several instances allowed statistical data from an industry and region to be used as guidance for reasonable compensation. There is no IRS rule that insolates the S Corporation from an audit on this issue. A reasonable salary depends on all the facts and circumstances in each individual case. If the S Corporation is a personal service corporation with one employee, the shareholder-employee, then a case can be made that the entire net earnings of the corporation should be salary. At the other extreme, if the S Corporation is a construction company with large amounts of capital equipment, then a good deal of the corporate earnings are a return on this capital and a reasonable salary may be just a small percentage of corporate earnings.

The reclassification of a distribution to salary results in increased taxes to you in the form of payroll taxes.

The lost revenue is of great concern to the IRS. In May, 2005, the office of the Treasury Inspector General for the administration reported that in 2000 alone, more than 36,000 single-shareholder S Corporations with profits excess $100,000 paid no salaries or payroll taxes. Another 40,000 with profits between $50,000 and $100,000 did not pay any salaries.

We have seen an extreme increase in audits related to this issue. The IRS compares the officer compensation line item on the S Corporation return to the profit of the S Corporation and will typically audit those returns that show little if any officer compensation.

Shareholder Loans to "S" Corporations

On October 17, 2008 the IRS finalized regulations on the treatment of open account debt between S Corporations and their shareholders. If a shareholder's basis in S Corporation shareholder debt has been reduced by his or her share of the S Corporation losses and the S Corporation makes a distribution or pays off the debt with an amount in excess of the remaining basis, gain must be recognized.

A capital gain will result if the debt is evidenced by a written note. If the S Corporation repays the debt and the shareholder lends more money later in the year for purposes of avoiding the gain, each payment is treated as an individual transaction, and the two payments are not netted for purposes of determining basis in debt at the end of the year. When the debt of the S Corporation to the shareholder is paid off in installments, each installment is allocated between return of capital and gain based on the proportion of the shareholder's basis in the debt to its face amount. Under the final regulations, open account debt would be defined as shareholder advances not evidenced by separate written instruments for which the principal amount of the aggregate advances does not exceed $25,000 at the close of any day during the S Corporation's tax year. If the running balance exceeds $25,000, the entire principal amount of that debt would no longer be open account debt. The principal amount would be treated as debt evidenced by a written instrument.

Regulation 1.1367-2(a) states that generally, if shareholder advances are not evidenced be separate written instruments for which the principal amount of the aggregate advances does not exceed $25,000 and repayments on the advances, the debt is called open account debt and treated as a single debt. However, ordinary income results on the S Corporation's repayment of the open account debt.

Although ordinary income is a disadvantage of not evidencing loans, an advantage is that multiple loans and repayments made throughout the year are considered open account debt and are netted at the end of the year rather than gain occurring on repayment of each individual debt. The final regulations generally are proposed to apply to shareholder advances to S Corporations made on or after October 20, 2008.

If the indebtedness is evidenced by a note, the repayment is treated as a sale or exchange. Accordingly, if the note is a capital asset in the shareholder's hands the excess of the amount repaid over basis is taxed as capital gain. (Rev. Rul. 64-162, 1964-1 C.B. 304).

However, if the debt is not evidenced by a note, there is no sale or exchange when the debt is paid. Thus, a payment by an S Corporation of a debt to a shareholder that is carried on an open account, will be ordinary income to the extent of the amount paid over the applied basis (Rev. Rul. 68-537, 1968-2 C.B. 372).

If a shareholder's advances are not evidenced by a separate written instrument, net of repayments, exceed an aggregate outstanding principal amount of $25,000 at the close of the S Corporation's tax year, for any later tax year, the aggregate principal amount is treated as indebtedness evidenced by a separate written instrument, with the result that the indebtedness is not open account debt and is subject to all basis adjustment rules applicable to basis of indebtedness of an S Corporation to a shareholder. However, in this case the gain would be ordinary as there is no written note it is merely deemed a written note for purposes of the timing of taxability. Should you find yourself in this situation, you should draw up actual notes so that the gain would be capital gain.

Economic Substance Doctrine Clarified

Under pre-2010 Reconciliation Act law, courts denied claimed tax benefits under two closely related nonstatutory doctrines that evolved in judicial decisions. Under the "economic substance" doctrine, courts generally denied claimed tax benefits if the transaction that gave rise to those benefits lacked economic substance independent of tax considerations – even though the purported activity actually occurred. A common law doctrine that often was considered together with the economic substance doctrine was the business purpose doctrine. The business purpose doctrine involved a subjective inquiry into the taxpayer's motives, i.e., whether the taxpayer intended the transaction to serve some useful non-tax purpose.

There was a lack of uniformity as to the proper application of the economic substance doctrine. Some courts applied a conjunctive test that required a taxpayer to establish the presence of both economic substance (i.e. the objective component) and business purpose (i.e. the subjective component) for the transaction to be given effect. Under a narrower approach used by some courts either a business purpose or economic substance was sufficient to have the transaction respected. Under a third approach economic substance and business purpose were viewed as simply more precise factors to consider in determining if a transaction had any practical economic effects other than the creation of tax benefits. In 2006, the Federal Circuit Court stated that while the economic substance doctrine could well apply if the taxpayer's sole subjective motivation was tax avoidance, even if the transaction had economic substance, a lack of economic substance was sufficient to disqualify the transaction without proof that the taxpayer's sole motive was tax avoidance. In 2009, the 5th Circuit also adopted the view that a lack of economic substance alone was sufficient to disqualify the transaction without regard to the taxpayer's motive.

The 2010 Reconciliation Act provides statutory rules for applying the economic substance doctrine.

The 2010 Reconciliation Act also defines the economic substance doctrine as the common law doctrine under which the Federal income tax benefits of a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

Testing a Transaction Under the Codified Economic Substance Doctrine
Under the 2010 Reconciliation Act, a transaction to which the economic substance doctrine is relevant (see below) has economic substance only if:

- The transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
- The taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into the transaction. (This list is referred to as the economic substance test list.)

The determination of whether the economic substance doctrine is relevant to a transaction is made as if this provision was never enacted. Thus, the provision does not change current law standards in determining when to utilize an economic substance analysis.

THINGS TO CONSIDER BEFORE THE END OF 2016

- ☑ Use up expiring loss and credit carryovers.
- ☑ Increase basis in Partnership or S-corporation to make possible 2016 loss deduction.
- ☑ Buy equipment by December 31st to get depreciation deductions in 2016.
- ☑ Apply bunching strategy to "miscellaneous" itemized deductions, medical expenses, and other itemized deductions in order to increase deductible amounts.
- ☑ Increase withholding to eliminate estimated tax penalty.
- ☑ Set up self-employed retirement plan.
- ☑ Make gifts taking advantage of $14,000 gift tax exclusion.
- ☑ Avoid personal-holding company tax by making dividend payments.
- ☑ Minimize income tax on social security benefits.
- ☑ Dispose of passive activity in order to free-up suspended losses.
- ☑ Make IRA contributions as early as possible.
- ☑ Delay late year mutual fund investments until after the fund's dividend date.
- ☑ Maximize your contribution to a tax-deferred retirement plan.

2016 TAX RATE SCHEDULE

	Taxable Income	Tax
Married Individuals Filing Joint Returns and Surviving Spouses	Not over $18,550	10% of taxable income
	Over $18,550 but not over $75,300	$1,855 plus 15% of the excess over $18,550
	Over $75,300 but not over $151,900	$10,368 plus 25% of the excess over $75,300
	Over $151,900 but not over $231,450	$29,518 plus 28% of the excess over $151,900
	Over $231,450 but not over $413,350	$51,792 plus 33% of the excess over $231,450
	Over $413,350 but not over $466,950	$111,818 plus 35% of the excess over $413,350
	Over $466,950	$130,578 plus 39.6% of the excess over $466,950
Heads of Household	Not over $13,250	10% of taxable income
	Over $13,250 but not over $50,400	$1,325 plus 15% of the excess over $13,250
	Over $50,400 but not over $130,150	$6,898 plus 25% of the excess over $50,400
	Over $130,150 but not over $210,800	$26,835 plus 28% of the excess over $130,150
	Over $210,800 but not over $413,350	$49,417 plus 33% of the excess over $210,800
	Over $413,350 but not over $441,000	$116,258 plus 35% of the excess over $413,350
	Over $441,000	$125,936 plus 39.6% of the excess over $441,000
Unmarried Individuals (Other Than Surviving Spouses and Heads of Household)	Not over $9,275	10% of taxable income
	Over $9,275 but not over $37,650	$928 plus 15% of the excess over $9,275
	Over $37,650 but not over $91,150	$5,184 plus 25% of the excess over $37,650
	Over $91,150 but not over $190,150	$18,559 plus 28% of the excess over $91,150
	Over $190,150 but not over $413,350	$46,279 plus 33% of the excess over $190,150
	Over $413,350 but not over $415,050	$119,935 plus 35% of the excess over $413,350
	Over $415,050	$120,530 plus 39.6% of the excess over $415,050
Married Individuals Filing Separate Returns	Not over $9,275	10% of taxable income
	Over $9,275 but not over $37,650	$928 plus 15% of the excess over $9,275
	Over $37,650 but not over $75,950	$5,184 plus 25% of the excess over $37,650
	Over $75,950 but not over $115,725	$14,759 plus 28% of the excess over $75,950
	Over $115,725 but not over $206,675	$25,896 plus 33% of the excess over $115,725
	Over $206,675 but not over $233,475	$55,909 plus 35% of the excess over $206,675
	Over $233,475	$65,289 plus 39.6% of the excess over $233,475

2017 TAX RATE SCHEDULE

	Taxable Income	Tax
Married Individuals Filing Joint Returns and Surviving Spouses	Not over $18,650	10% of taxable income
	Over $18,650 but not over $75,900	$1,865 plus 15% of the excess over $18,650
	Over $75,900 but not over $153,100	$10,452 plus 25% of the excess over $75,900
	Over $153,100 but not over $233,350	$29,752 plus 28% of the excess over $153,100
	Over $233,350 but not over $416,700	$52,222 plus 33% of the excess over $233,350
	Over $416,700 but not over $470,700	$112,728 plus 35% of the excess over $416,700
	Over $470,700	$131,628 plus 39.6% of the excess over $470,700
Heads of Household	Not over $13,350	10% of taxable income
	Over $13,350 but not over $50,800	$1,335 plus 15% of the excess over $13,350
	Over $50,800 but not over $131,200	$6,952 plus 25% of the excess over $50,800
	Over $131,200 but not over $212,500	$27,052 plus 28% of the excess over $131,200
	Over $212,500 but not over $416,700	$49,816 plus 33% of the excess over $212,500
	Over $416,700 but not over $444,550	$117,202 plus 35% of the excess over $416,700
	Over $444,550	$126,950 plus 39.6% of the excess over $444,550
Unmarried Individuals (Other Than Surviving Spouses and Heads of Household)	Not over $9,325	10% of taxable income
	Over $9,325 but not over $37,950	$933 plus 15% of the excess over $9,325
	Over $37,950 but not over $91,900	$5,226 plus 25% of the excess over $37,950
	Over $91,900 but not over $191,650	$18,714 plus 28% of the excess over $91,900
	Over $191,650 but not over $416,700	$46,644 plus 33% of the excess over $191,650
	Over $416,700 but not over $418,400	$120,910 plus 35% of the excess over $416,700
	Over $418,400	$121,505 plus 39.6% of the excess over $418,400
Married Individuals Filing Separate Returns	Not over $9,325	10% of taxable income
	Over $9,325 but not over $37,950	$932 plus 15% of the excess over $9,325
	Over $37,950 but not over $76,550	$5,226 plus 25% of the excess over $37,950
	Over $76,550 but not over $116,675	$14,876 plus 28% of the excess over $76,550
	Over $116,675 but not over $208,350	$26,111 plus 33% of the excess over $116,675
	Over $208,350 but not over $235,350	$56,364 plus 35% of the excess over $208,350
	Over $235,350	$65,814 plus 39.6% of the excess over $235,350