Gianno & Freda

2016 Year-End Planning Newsletterfor Investors and Business Owners

By Mark Gianno, CPA CFP and the Cape Cod Staff (Dec. 2016) 508-778-5555

The Changing of the Guard…

The recently concluded Presidential and Congressional elections will likely result in significant changes to the federal income, estate and gift tax structures. For the first time in many years the Republican Party controls the Presidency and both houses of Congress. While no one without a Ouija Board can determine what *will* happen, this author believes that 2017 will bring lower individual and corporate income tax rates, and that the estate tax is doomed. Thus, deferring income into 2017 and accelerating expenses into 2016 is generally preferred (staying alive until the estate tax is repealed is also beneficial!). Comparing the campaign promises of Donald Trump to the U.S. House of Representatives "Tax Blueprint" (unveiled by House Republicans last summer) can provide some indication of likely future tax policy and investment strategies for individuals and businesses. Major changes are not expected until the second half of 2017, given the often torturous process of enacting new legislation. We will diligently follow the process and report the potential impacts to you as events unfold. We'll come back to consider 2017's most likely changes in tax policy later in this newsletter. But first, strategies to consider for year end 2016…..

INVESTOR PLANNING

It's Still About the Brackets...

We continue to emphasize the need for awareness of your marginal income tax bracket. Your marginal income tax bracket refers to the tax rate that will apply to your next dollar of income. Generally speaking, for higher bracket investors (adjusted gross income over $200,000) it pays to defer taxes into the next year, by deferring income into the next year and accelerating deductions into the current year. There are many items of income and expense you can control. Employees can defer bonuses, self-employed and small business owners can defer billings and receipts (especially effective for cash based businesses). However, remember that a payment received before year end cannot effectively be deferred by putting the check in a drawer and depositing it after year end. For deductions, you may be able to increase state income tax deductions, mortgage interest and real estate tax expense by making payments *before* year end.

Of course, higher income individuals should ensure that they are maximizing their retirement deferrals by fully contributing to their available retirement plans (still the only way I know to earn a deduction without giving your money to someone else!). In addition to IRAs, investors may have access to qualified retirement plans such as 401(k), 403(b) and 457 plans, SEP IRAs, and SIMPLE IRAs.

Consider this, in the 25% tax bracket, a $10,000 contribution to a retirement plan can save $2500 in income taxes, a certain 25% return on the money contributed to the plan – ***not a bad return!*** Be aware that, at higher income levels, the deduction for IRA contributions may be reduced or eliminated, especially for those covered by employer's plans.

Watch Those Capital Gains…

Because you have nearly complete control over when to sell your investments, capital gains and losses provide an ideal opportunity for deferring taxes. Review your transactions over the past year to determine if you have net capital gains. If so, consider if there are some unrealized losses in your portfolio that you can sell before year end to offset those gains. Be careful not to buy the same loss security 30 days before or after you sold it or your loss will be disallowed under the "wash sale" rules.

Also, be alert to capital gains distributions from your mutual funds. Like last year, continued

strength in stock markets have increased the value of investments inside many stock mutual funds. When the fund sells a stock in the portfolio for a gain it generates a capital gain inside the fund. Mutual funds are generally required to pay out those gains to shareholders before year end. So, late in the year you may be paid substantial capital gains subject to tax. Once again, harvesting losses can help to offset those gains.

Additional Taxes on Investments …

Since its introduction in 2013, more and more investors have incurred the 3.8% Medicare Tax on "Net Investment Income" (NII) imposed on higher tax bracket investors (adjusted gross income over $200,000). The NII tax applies to your capital gains, dividends, interest, royalties, annuity income, rents and other passive income. This tax particularly stings in a year that you recognize capital gains (which can impose a federal tax as high as 23.8% on higher income investors). Contributing to retirement plans, investing in tax-deferred and tax-exempt investments can help to reduce this tax by reducing taxable income. Note: the NII tax, introduced to pay for "Obamacare" is targeted for elimination in both the Trump Tax Plan and the House Tax Blueprint.

Ch-ch-ch-ch-changes
Turn and face the strange
Ch-ch-changes

Changes
- David Bowie

Change is inevitable, due to Trump's personal victory and the Republican Party's retaining solid control of the House (about 235 to 191) and a slight edge in the Senate (about 51 to 47). Both the President-elect and Congressional Republicans have announced strong support for tax reform. To be sure, there are differences in their plans, but their areas of agreement are likely to become law. Subject, of course, tochanges that may be made as the legislative process continues. For now….

LIKELY CHANGES FOR INVESTORS

Tax Bracket Changes …

It is expected that the current tax bracket structure will be replaced with three brackets, 12% for singles with taxable income up to $37,500 (couples to $75,000), 25% for singles with taxable income between $37,500 and $112,500 (couples $75,000 to $225,000) and 33% for singles with taxable income $112,500 and above (couples $225,000 and above). "Head of Household" filing status and personal exemptions are likely to be eliminated.

Deductions

The **standard deduction** increases dramatically under both the Trump and House plans, from the current $6,300 for individuals and $12,600 for couples to $15,000 for individuals and either $24,000 or $30,000 for couples. While the Trump plan calls for capping **itemized deductions** at $100,000 for single filers and $200,000 for joint filers, the House's Tax Blueprint calls for the elimination of all itemized deductions except charitable contributions and home mortgage interest.

The increased standard deduction means that the current 25% of returns with itemized deductions might drop to 10% or 5% of returns filed. Quite simply, the value of itemized deductions will decrease substantially. One result anticipated by economists at the Federal Reserve and in the real estate industry is that you and I will have less incentive to own

rather than rent our homes. A Federal Reserve economist in a recent paper estimates that eliminating the mortgage interest deduction could cause the average household to lose" 10.9% of the value of the house, with homeowners losing 11.5% and homebuyers 8.5%. Stay tuned on this potential change.

Capital Gains

While the Trump plan calls for retaining the 20% maximum capital gains tax rate, the House plan calls for eliminating the preferential rate for capital gains, instead allowing individual taxpayers to deduct 50% of their capital gains, dividends and interest income from taxable income.

Estate Taxes

The estate tax is doomed. Both plans support the repeal of estate and gift taxes. The Trump plan calls for a capital gains tax at death on estates valued in excess of $10 million.

It was never the intent of the estate tax to be a significant source of federal revenue (less than 1%). Rather, it was conceived as a means of accomplishing the social objective of limiting the concentration of wealth. Despite the estate tax, "the U.S. exhibits wider disparities of wealth between rich and poor than any other major developed nation."

At this time the form of repeal is unclear. Might the effective date be 2017 or later? Might the repeal be phased in over a period of years? If it is repealed, might it come back at some future time (as it did in 2010)? Could we see carryover basis or a capital gains tax at death? Could inheritances be characterized as taxable income (much as lottery winnings)?

So, while the election makes permanent estate tax repeal likely, much uncertainty remains. What to do? Unfortunately, for most, a "wait and see" approach is advisable. However, be mindful of the many non-tax reasons for estate planning. Trusts can provide valuable divorce and asset protection benefits. Trusts can also provide income tax savings by sprinkling income to beneficiaries in lower tax brackets. Protection from burgeoning elder financial abuse can be provided by co-trustees, successor trustees or trust protectors. Once again, estate tax law changes require that you review your existing plans. Call me to discuss the potential impact on your plan.

LIKELY CHANGES FOR BUSINESSES

Tax Bracket Changes …

Here, there is a mare's nest of proposals. For C corporations, the current 35% tax rate will drop to 15% (Trump plan) or 20% (House plan). However, most small businesses are sole-proprietors or "passthrough" entities such as partnerships, LLCs or S corporations. They pay no corporate tax. The question – does the income from these entities benefit by the 15% rate? According to one Trump policy advisor, it does if the entity elects to retain the earnings in the entity, and pay a second level of tax when the earnings are distributed to the owner (wait…what? Isn't the avoidance of two levels of tax the reason we chose a pass-through entity in the first place?). Additionally, there continues to be confusion around the term "reasonable compensation", as in the statement, "Income from a pass-through entity will be taxed at the lower rates after payment of reasonable compensation (subject to the graduated individual rates) to the owner-operator. How much compensation is reasonable?

Eliminating corporate tax expenditures

Both plans call for eliminating corporate tax

deductions and credits except the research credit. The most important of these deductions for closely-held businesses are the Sec. 179 deduction for the purchase of capital assets, accelerated depreciation, and tax deferral on like-kind exchanges and installment sales. In return, the House plan calls for immediate expensing of all capital expenditures while the Trump plan limits that expensing to manufacturing companies only. The legislative process will decide.

The impact of possible changes, to both individual and corporate income taxes, suggests the importance of reconsidering your choice of business entity, owner's compensation, dividend/distribution policies and more. Like I said, a mare's nest.

The ultimate shape of tax law changes will be affected by the need (or not) for bipartisan support and "buy-in" from stakeholders. If bipartisan support can be achieved, permanent tax reform can result. Alternatively, the Trump Administration can avoid the need for bipartisan support, following the example of both the Bush Administration in 2001 and the Obama Administration in 2010 and use the "budget reconciliation" path to tax reform. The advantage to the reconciliation path is that legislative passage requires only a simple majority in the Senate (making it impossible for the Democratic Party to block it by filibuster). The disadvantage is that provisions in budget reconciliations must expire at the end of the budget period, usually a ten-year window (recall the turmoil around year end-planning over thelast few years as the temporary tax changes passed under the Bush Administration reached sunset, only to be temporarily extended each year).

All of this legislative activity brings to mind the wise words of John Godfrey Saxe, who said in 1869, "Laws, like sausages, cease to inspire respect in proportion as we know how they are made." We are certainly in for a busy year ahead. For those of you without a Ouija Board or, if your crystal ball is cloudy, please call me anytime you have a question or concern. I'll be here, along with your favorites, Kathleen, Chloe, Katie and Donna, watching for developments that will impact you.

As the New Year approaches us with hopes anew, here is to wishing you and your family a wonderful year ahead.
Happy New Year!

Gianno & Freda
The Right Direction For All Your Financial Decisions
Gianno & Freda Financial Center • 235 Barnstable Rd. Hyannis, MA 02601
800-698-TAXX • 508-778-5555 • Fax: 508-778-5556
email: mark@giannoandfreda.com • giannoandfreda.com