2017-2018
TAX PLANNING GUIDE

YEAR-ROUND STRATEGIES TO MAKE THE TAX LAWS WORK FOR YOU

Possible tax law changes on the horizon

With Donald Trump in the White House and Republicans maintaining a majority in Congress comes the possibility of some dramatic changes in tax law. For example, individuals could see changes to their tax rates and breaks and the elimination of certain taxes, such as the Alternative Minimum Tax (AMT) and the estate tax.

As of the writing of this guide, however, these and other prospective tax law changes are still uncertain. Legislation might be signed into law later this year, but likely with many provisions not going into effect until 2018 or later. That doesn't mean there wouldn't be an impact on 2017 tax planning. There could be major incentives to defer income to 2018 and accelerate deductions into 2017.

What does this mean for you and your tax strategies? In your 2017 planning, you'll need to follow current tax law with an eye on what could happen in the future and be ready to act quickly if changes should warrant it. This guide provides an overview of some key tax provisions you need to be aware of and offers a variety of strategies for minimizing your taxes, as the tax environment now stands. Your tax advisor will be a key resource in the coming year; stay in touch with him or her to learn about the latest tax law developments and how they might affect your tax strategies for 2017.

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Start planning now to minimize 2017 taxes

Because of the higher tax rates that apply to "ordinary income," you need to be particularly careful in your planning. Ordinary income generally includes salary, income from self-employment or business activities, interest, and distributions from tax-deferred retirement accounts. Some of it may also be subject to employment tax, or you may have to pay the AMT, under which different tax rates apply. If possible, try to control to your tax advantage the timing of your ordinary income as well as your deductible expenses. *When* you receive income or incur an expense can affect how much tax you pay and when you have to pay it. Also keep in mind potential tax law changes. (See "What's new! Tax law uncertainty complicates timing strategies.")

AMT triggers

The top alternative minimum tax rate is 28%, compared to the top regular ordinary-income tax rate of 39.6%. (See Chart 7 on page 24.) But the AMT rate typically applies to a higher taxable income base.

So before taking action to time income and expenses, you should determine whether you're already likely to be subject to the AMT — or whether the actions you're considering might trigger it. Some deductions used to calculate regular tax aren't allowed under the AMT (see Chart 1) and thus can trigger AMT liability. Some income items also might trigger or increase AMT liability:

- Long-term capital gains and qualified dividend income, even though they're taxed at the same rate for both regular tax and AMT purposes,
- Accelerated depreciation adjustments and related gain or loss differences when assets are sold, and
- Tax-exempt interest on certain private-activity municipal bonds. (For an exception, see the AMT Alert on page 11.)

Finally, in certain situations exercising incentive stock options (ISOs) can trigger significant AMT liability. (See the AMT Alert on page 7.)

Avoiding or reducing AMT

With proper planning, you may be able to avoid the AMT, reduce its impact or even take advantage of its lower maximum rate. To determine the right timing strategies for your situation, work with your tax advisor to assess whether:

You could be subject to the AMT *this* year. Consider accelerating income into this year, which may allow you to benefit from the lower maximum AMT rate. And deferring expenses you can't deduct for AMT purposes may allow you to preserve those deductions. If you also defer expenses you *can* deduct for AMT purposes, the deductions may become more valuable because of the higher maximum regular tax rate. Finally, carefully consider the tax consequences of exercising ISOs.

You could be subject to the AMT *next* year. Consider taking the opposite approach. For instance, defer income to next year, because you'll likely pay a relatively lower AMT rate. And prepay expenses that will be deductible this year but that won't help you next year because they're not deductible for AMT purposes. Also, before year end consider selling any private-activity municipal bonds whose interest could be subject to the AMT.

If you pay AMT in one year on deferral items, such as depreciation adjustments, passive activity adjustments or the tax preference on ISO exercises, you may be entitled to a credit in a subsequent year. In effect, this takes into account timing differences that reverse in later years.

WHAT'S NEW!

Tax law uncertainty complicates timing strategies

Determining the right timing strategies in 2017 is especially challenging because changes that might be signed into law later this year could potentially affect both your income tax rate and what you can deduct — probably not for 2017 but for 2018, which would impact 2017 planning.

While rates may go down for many taxpayers, they could go up for some people. And itemized deductions could be subject to new caps, or some deductions might be eliminated. In addition, the alternative minimum tax (AMT) might be repealed. Consult your tax advisor for the latest information on these and other developments that may affect your timing strategies this year.

CHART 1

What itemized deductions are also deductible for AMT purposes?

Expense	Regular tax	AMT	For more information
State and local income tax	✔		See "Timing income and expenses" below and "Sales tax deduction" on page 4.
Property tax	✔		See "Home-related deductions" on page 12.
Mortgage interest	✔	✔	See "Home-related deductions" on page 12.
Interest on home equity debt *not* used to improve your principal residence	✔		See "Home-related deductions" on page 12.
Investment interest	✔	✔	See "Investment interest expense" on page 11.
Investment expenses	✔		See "Miscellaneous itemized deductions" at right.
Professional fees	✔		See "Miscellaneous itemized deductions" at right.
Unreimbursed employee business expenses	✔		See "Miscellaneous itemized deductions" at right.
Medical expenses	✔	✔	See "Health-care-related breaks" on page 4.
Charitable contributions	✔	✔	See page 16.

Timing income and expenses

Smart timing of income and expenses can reduce your tax liability, and poor timing can unnecessarily increase it. When you don't expect to be subject to the AMT in the current year or the next year, deferring income to the next year and accelerating deductible expenses into the current year may be a good idea. Why? Because it will defer tax, which usually is beneficial.

But when you expect to be in a *higher* tax bracket next year — or you expect tax rates to go up — the opposite approach may be beneficial: Accelerating income will allow more income to be taxed at your current year's lower rate. And deferring expenses will make the deductions more valuable, because deductions save more tax when you're subject to a higher tax rate.

Warning: The impact of the income-based itemized deduction reduction (see page 4) also should be taken into account when considering timing strategies.

Whatever the reason behind your desire to time income and expenses, here are some income items whose timing you may be able to control:

- Bonuses,
- Consulting or other self-employment income,
- U.S. Treasury bill income, and
- Retirement plan distributions, to the extent they won't be subject to early-withdrawal penalties and aren't required. (See page 21.)

And here are some expenses with potentially controllable timing:

- State and local income taxes,
- Property taxes,
- Mortgage interest,
- Margin interest, and
- Charitable contributions.

Warning: Prepaid expenses can generally be deducted only in the year to which they apply. For example, you can prepay (by Dec. 31) property taxes that relate to this year but that are due next year, and deduct the payment on your return for this year. But you generally can't prepay property taxes that relate to next year and deduct the payment on this year's return.

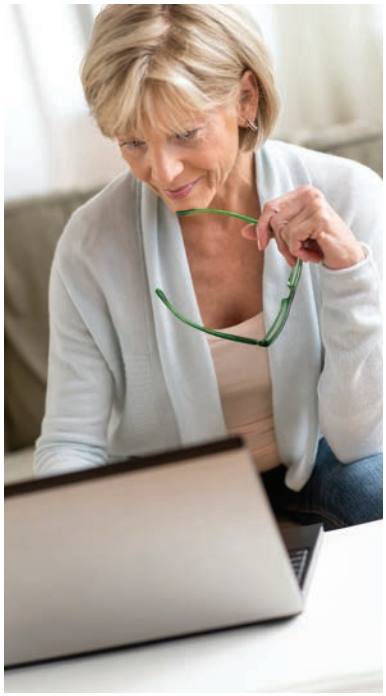
Miscellaneous itemized deductions

Many expenses that may qualify as miscellaneous itemized deductions are deductible for regular tax purposes only to the extent they exceed, in aggregate, 2% of your adjusted gross income (AGI). "Bunching" these expenses into a single year may allow you to exceed this "floor."

As the year progresses, record your potential deductions to date. If they're close to — or they already exceed — the 2% floor, consider paying accrued expenses and incurring and paying additional expenses by Dec. 31, such as:

- Deductible investment expenses, including advisory fees, custodial fees and publications,
- Professional fees, such as tax planning and preparation, accounting, and certain legal fees, and
- Unreimbursed employee business expenses, including vehicle costs, travel, and allowable meals and entertainment.

AMT ALERT! Miscellaneous itemized deductions subject to the 2% floor aren't deductible for AMT purposes. So don't bunch them into a year when you may be subject to the AMT.



Health-care-related breaks

If your medical expenses exceed 10% of your AGI, you can deduct the excess amount. Beginning in 2017, this floor also applies to taxpayers age 65 and older. (Previously, they could enjoy a 7.5% floor for regular tax purposes but were subject to the 10% floor for AMT purposes.) Eligible expenses may include:

- Health insurance premiums,
- Long-term care insurance premiums (limits apply),
- Medical and dental services,
- Prescription drugs, and
- Mileage (17 cents per mile driven for health care purposes in 2017).

Consider bunching nonurgent medical procedures (and any other services and purchases whose timing you can control without negatively affecting your or your family's health) into one year to exceed the 10% floor. If one spouse has high medical expenses and a relatively lower AGI, filing separately may allow that spouse to exceed the AGI floor and deduct some medical expenses that wouldn't be deductible if the couple filed jointly.

***AMT ALERT!* Because the AMT exemption for separate returns is considerably lower than the exemption for joint returns, filing separately to exceed the floor could trigger the AMT.**

Expenses that are reimbursable by insurance or paid through a tax-advantaged account such as the following aren't deductible:

HSA. If you're covered by a qualified high deductible health plan, you can contribute pretax income to an employer-sponsored Health Savings Account — or make deductible contributions to an HSA you set up yourself — up to $3,400 for self-only coverage and $6,750 for family coverage for 2017. Plus, if you're age 55 or older, you may contribute an additional $1,000. HSAs can bear interest or be invested, growing tax-deferred similar to an IRA. Withdrawals for qualified medical expenses are tax-free, and you can carry over a balance from year to year.

FSA. You can redirect pretax income to an employer-sponsored Flexible Spending Account up to an employer-determined limit — not to exceed $2,600 in 2017. The plan pays or reimburses you for qualified medical expenses. What you don't use by the plan year's end, you generally lose — though your plan might allow you to roll over up to $500 to the next year. Or it might give you a 2½-month grace period to incur expenses to use up the previous year's contribution. If you have an HSA, your FSA is limited to funding certain "permitted" expenses.

Sales tax deduction

The break allows you to take an itemized deduction for state and local *sales* taxes in lieu of state and local *income* taxes. The deduction can be valuable if you reside in a state with no or low income tax or you purchase a major item, such as a car or boat.

Except for major purchases, you don't have to keep receipts and track all the sales tax you actually pay. Your deduction can be determined using an IRS sales tax calculator that will base the deduction on your income and the sales tax rates in your locale plus the tax you actually pay on major purchases.

Limit on itemized deductions

If your AGI exceeds the applicable threshold, certain deductions are reduced by 3% of the AGI amount that exceeds the threshold (not to exceed 80% of otherwise allowable deductions). For 2017, the thresholds are $261,500 (single), $287,650 (head of household), $313,800 (married filing jointly) and $156,900 (married filing separately).

If your AGI is close to the threshold, AGI-reduction strategies (such as contributing to a retirement plan or HSA) may allow you to stay under it. If that's not possible, consider the reduced tax benefit of the affected deductions before implementing strategies to accelerate or defer deductible expenses. The limitation doesn't apply, however, to deductions for medical expenses, investment interest, or casualty, theft or wagering losses.

Employment taxes

In addition to income tax, you must pay Social Security and Medicare taxes on earned income, such as salary and bonuses. The 12.4% Social Security tax applies only up to the Social Security wage base of $127,200 for 2017. *All* earned income is subject to the 2.9% Medicare tax. Both taxes are split equally between the employee and the employer.

Self-employment taxes

If you're self-employed, you pay both the employee and employer portions of employment taxes on your self-employment income. The employer portion (6.2% for Social Security tax and 1.45% for Medicare tax) is deductible above the line.

As a self-employed taxpayer, you may benefit from other above-the-line deductions as well. You can deduct 100% of health insurance costs for yourself, your spouse and your dependents, up to your net self-employment income. You also can deduct contributions to a retirement plan and, if you're eligible, an HSA for yourself. Above-the-line deductions are particularly valuable because they're fully deductible and reduce your AGI and modified AGI (MAGI), which are the triggers for certain additional taxes and the phaseouts of many tax breaks.

Additional 0.9% Medicare tax

Another employment tax that higher-income taxpayers must be aware of is the additional 0.9% Medicare tax. It applies to FICA wages and net self-employment income exceeding $200,000 per year ($250,000 if married filing jointly and $125,000 if married filing separately). Be aware that this tax could be reduced or eliminated under health care or tax reform legislation.

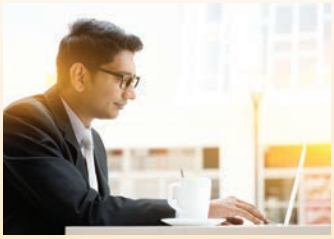
If your wages or self-employment income varies significantly from year to year or you're close to the threshold for triggering the additional Medicare tax, income timing strategies may help you avoid or minimize it. For example, if you're an employee, perhaps you can time when you receive a bonus, or you can defer or accelerate the exercise of stock options. If you're self-employed, you may have flexibility on when you purchase new equipment or invoice customers. If you're a shareholder-employee of an S corporation, you might save tax by adjusting how much you receive as salary vs. distributions. (See "Owner-employees" at right.)

Also consider the withholding rules. Employers must withhold the additional tax beginning in the pay period when wages exceed $200,000 for the calendar year — without regard to an employee's filing status or income from other sources. So your employer might withhold the tax even if you aren't liable for it — or it might *not* withhold the tax even though you *are* liable for it.

If you *don't* owe the tax but your employer *is* withholding it, you can claim a credit on your 2017 income tax return. If you *do* owe the tax but your employer *isn't* withholding it, consider filing a W-4 form to request additional *income* tax withholding, which can be used to cover the shortfall and avoid interest and penalties. Or you can make estimated tax payments.

Case Study I

Avoiding underpayment penalties



Michael worked full-time, but he also did some consulting on the side, and his busy season tended to be the last quarter of the year. He was always careful to make quarterly estimated tax payments on time, but when he met with his tax advisor about his 2016 tax return, he learned he might be subject to underpayment penalties. Why? Because his consulting income spiked at the end of the year, and he hadn't paid enough tax during the year through estimated tax payments and withholding. Unless he can satisfy one of the exceptions, he will be subject to the underpayment penalty.

Here are some strategies that Michael's advisor suggested he could use to avoid facing underpayment penalties for 2017:

Know the minimum payment rules. To avoid penalties, your estimated payments or withholding must equal at least 90% of your tax liability for 2017 or 110% of your 2016 tax (100% if your 2016 AGI was $150,000 or less or, if married filing separately, $75,000 or less).

Use the annualized income installment method. This method often benefits taxpayers who have large variability in income by month due to bonuses, investment gains and losses, or seasonal income (if it's skewed toward late in the year). Annualizing computes the tax due based on income, gains, losses and deductions through each estimated tax period.

Estimate your tax liability and increase withholding. If you determine you've underpaid, consider having the tax shortfall withheld from your salary or year end bonus by Dec. 31. Because withholding is considered to have been paid ratably throughout the year, this is often a better strategy than making up the difference with an increased quarterly tax payment, which may still leave you exposed to penalties for earlier quarters.

Michael's advisor also pointed out that Michael can incur interest and penalties if he's subject to the additional 0.9% Medicare tax and it isn't withheld from his pay and he doesn't make sufficient estimated tax payments.

Owner-employees

There are special considerations if you're a business owner who also works in the business, depending on its structure:

Partnerships and limited liability companies. Generally, all trade or business income that flows through to you for income tax purposes is subject to self-employment taxes — even if the income isn't distributed to you. But such income may not be subject to self-employment taxes if you're a limited partner or the LLC member equivalent. Check with your tax advisor on whether the additional 0.9% Medicare tax on earned income or the 3.8% NIIT (see page 8) will apply.

S corporations. Only income you receive as salary is subject to employment taxes and, if applicable, the 0.9% Medicare tax. To reduce these taxes, you may want to keep your salary relatively — but not unreasonably — low and increase your distributions of company income, because distributions generally aren't taxed at the corporate level or subject to the 0.9% Medicare tax or 3.8% NIIT.

C corporations. Only income you receive as salary is subject to employment taxes and, if applicable, the 0.9% Medicare tax. Nevertheless, you may prefer to take more income as salary (which is deductible at the corporate level) as opposed to dividends (which aren't deductible at the corporate level yet are still taxed at the shareholder level and could be subject to the 3.8% NIIT) if the overall tax paid by both the corporation and you would be less.

Warning: The IRS is cracking down on misclassification of corporate payments to shareholder-employees, so tread carefully. ❖

Do you know the tax consequences of your exec comp?

If you're an executive or other key employee, you might receive stock-based compensation, such as restricted stock, restricted stock units (RSUs) or stock options (either incentive or nonqualified), or nonqualified deferred compensation (NQDC). The tax consequences of these types of compensation can be complex — subject to ordinary income, capital gains, employment and other taxes. So smart tax planning is critical. Keep in mind that proposed tax law changes such as changes to tax rates, repeal of the AMT, and reduction or repeal of the 0.9% additional Medicare tax or NIIT could affect the tax consequences — and associated planning strategies — related to exec comp. Check with your tax advisor for the latest information.

Restricted stock

Restricted stock is stock that's granted subject to a substantial risk of forfeiture. Income recognition is normally deferred until the stock is no longer subject to that risk or you sell it. When the restriction lapses, you pay taxes on the stock's fair market value (FMV) at your ordinary-income rate. (The FMV will be considered FICA income, so it also could trigger or increase your exposure to the additional 0.9% Medicare tax. See page 5.)

But you can instead make a Section 83(b) election to recognize ordinary income when you *receive* the stock. This election, which you must make within 30 days after receiving the stock, can be beneficial if the income at the grant date is negligible or the stock is likely to appreciate significantly before income would otherwise be recognized. Why? Because the election allows you to convert future appreciation from ordinary income to long-term capital gains income and defer it until the stock is sold.

There are some potential disadvantages of a Sec. 83(b) election, however. First, you must prepay tax in the current year — which also could push you into a higher income tax bracket and trigger or increase your exposure to the additional 0.9% Medicare tax. But if your company is in the earlier stages of development, the income recognized may be relatively small.

Second, any taxes you pay because of the election can't be refunded if you eventually forfeit the stock or you sell it at a decreased value. However, you'd have a capital loss when you forfeited or sold the stock.

Third, when you sell the shares, any gain will be included in net investment income and could trigger or increase your liability for the 3.8% NIIT. (See page 8.)

Work with your tax advisor to map out whether the Sec. 83(b) election is appropriate for you in each particular situation.

RSUs

RSUs are contractual rights to receive stock (or its cash value) after the award has vested. Unlike restricted stock, RSUs aren't eligible for the Sec. 83(b) election. So there's no opportunity to convert ordinary income into capital gains.

But they do offer a limited ability to defer income taxes: Unlike restricted stock, which becomes taxable immediately upon vesting, RSUs aren't taxable until the employee actually receives the stock. So rather than having the stock delivered immediately upon vesting, you may be able to arrange with your employer to delay delivery.

This will defer income tax and may allow you to reduce or avoid exposure to the additional 0.9% Medicare tax (because the RSUs are treated as FICA income). However, any income deferral must satisfy the strict requirements of Internal Revenue Code (IRC) Section 409A.

Incentive stock options

ISOs allow you to buy company stock in the future (but before a set expiration date) at a fixed price equal to or greater than the stock's FMV at the date of the grant. Therefore, ISOs don't provide a benefit until the stock appreciates in value. If it does, you can buy shares at a price *below* what they're then trading for, as long as you've satisfied the applicable ISO holding periods.

ISOs receive tax-favored treatment but must comply with many rules. Here are the key tax consequences:

- You owe no tax when ISOs are granted.
- You owe no regular income tax when you exercise the ISOs.
- If you sell the stock *after* holding the shares at least one year from the exercise date and two years from the grant date, you pay tax on the sale at your long-term capital gains rate. You also may owe the NIIT. (See page 8.)
- If you sell the stock *before* long-term capital gains treatment applies, a "disqualifying disposition" occurs and any gain is taxed as compensation at ordinary-income rates. (Disqualified dispositions aren't, however, subject to the additional 0.9% Medicare tax.)

***AMT ALERT!* If you don't sell the stock in the year of exercise, a tax "preference" item is created for the difference between the stock's FMV and the exercise price (the "bargain element") that can trigger the AMT. A future AMT credit, however, should mitigate this AMT hit. Consult your tax advisor because the rules are complex.**

If you've received ISOs, plan carefully when to exercise them and whether to immediately sell shares received from an exercise or to hold them. Waiting to exercise ISOs until just before the expiration date (when the stock value may be the highest, assuming the stock is appreciating) and holding on to the stock long enough to garner long-term capital gains treatment often is beneficial. But there's also market risk to consider. Plus, acting earlier can be advantageous in several situations:

- Exercise early to start the holding period so you can sell and receive long-term capital gains treatment sooner.
- Exercise when the bargain element is small or when the market price is close to bottoming out to reduce or eliminate AMT liability.
- Exercise annually so you can buy only the number of shares that will achieve a breakeven point between the AMT and regular tax and thereby incur no additional tax.
- Sell in a disqualifying disposition and pay the higher ordinary-income rate to avoid the AMT on potentially disappearing appreciation.

On the negative side, exercising early accelerates the need for funds to buy the stock, exposes you to a loss if the shares' value drops below your exercise cost, and may create a tax cost if the preference item from the exercise generates an AMT liability. See Case Study II.

The timing of ISO exercises could also positively or negatively affect your liability for the higher ordinary-income tax rates, the 20% long-term capital gains rate and the NIIT. With your tax advisor, evaluate the risks and crunch the numbers to determine the best strategy for you.

Case Study II

Watch out for falling stock prices after exercising ISOs

Jada was granted incentive stock options to buy 50,000 shares of her company's stock at $15 a share.

When she first became eligible one year later, Jada exercised 10,000 shares at the trading price of $25. She might be subject to an AMT liability as high as $28,000. That's because the exercise results in a $100,000 tax preference item on the bargain element (the difference between the $250,000 trading price and the $150,000 exercise price), which could be taxed at the top AMT rate of 28%. This might be a problem, because exercising the option doesn't generate any cash with which to pay the tax.

The problem is magnified if the stock price drops after the exercise. For example, if Jada pays the AMT but the trading price per share later falls back to $15, she'll have paid the tax even though the selling price of her shares is equal to the price she paid for them. Fortunately, she'll be able to claim a credit in future years for the AMT paid.

Nonqualified stock options

The tax treatment of NQSOs is different from the tax treatment of ISOs: NQSOs create compensation income (taxed at ordinary-income rates) on the bargain element when exercised (regardless of whether the stock is held or sold immediately), but they don't create an AMT preference item.

You may need to make estimated tax payments or increase withholding to fully cover the tax on the exercise. Keep in mind that an exercise could trigger or increase exposure to top tax rates, the additional 0.9% Medicare tax and the NIIT.

NQDC plans

These plans pay executives in the future for services to be currently performed. They differ from qualified plans, such as 401(k)s, in several ways. For example, unlike 401(k) plans, NQDC plans can favor highly compensated employees, but plan funding isn't protected from the employer's creditors. (For more on 401(k)s, see page 20.)

One important NQDC tax issue is that employment taxes (see page 4) are generally due once services have been performed and there's no longer a substantial risk of forfeiture — even though compensation may not be paid or recognized for income tax purposes until much later. So your employer may withhold your portion of the employment taxes from your salary or ask you to write a check for the liability. Or it may pay your portion, in which case you'll have additional taxable income. ***Warning:*** The additional 0.9% Medicare tax could also apply. ❖

Taxes shouldn't be the main driver of your investment decisions

Tax treatment of your investments varies dramatically based on such factors as type of investment, type of income it produces, how long you've held it and whether any special limitations or breaks apply. It's also possible that tax law changes could affect the tax treatment of investments. Of course, taxes should never be the primary driver of your investment decisions. But tax rate uncertainty makes buying and selling securities ever more challenging.

3.8% NIIT

Taxpayers with modified adjusted gross income (MAGI) over $200,000 per year ($250,000 if married filing jointly and $125,000 if married filing separately) may owe the net investment income tax on top of whatever other tax they owe on their investment income. The NIIT equals 3.8% of the lesser of your net investment income or the amount by which your MAGI exceeds the applicable threshold. Net investment income can include capital gains, dividends, interest and other investment-related income (but not self-rental income from an active trade or business). The rules are somewhat complex, so consult your tax advisor for more information.

Many of the strategies that can help you save or defer income tax on your investments can also help you avoid or defer NIIT liability. And because the threshold for the NIIT is based on MAGI, strategies that reduce your MAGI — such as making retirement plan contributions (see page 20) — could also help you avoid or reduce NIIT liability. Finally, keep in mind that the NIIT could be reduced or eliminated under health care or tax reform legislation.

Case Study III

Mutual fund capital gains distributions: A taxable event

Silvia purchases 500 shares of an equity mutual fund on Dec. 1, 2017, at $100 per share, for a total investment of $50,000. The next week, the fund makes a capital gains distribution of $15 per share. Silvia ends up with capital gains of $7,500, reportable on her 2017 return. It doesn't matter whether the actual value of the shares has increased or even decreased since Silvia purchased them, or whether she reinvests the proceeds back into the same fund.

Why? The distribution itself is a taxable event. If capital gains distributions from the mutual fund are reinvested in the fund, the distribution itself doesn't change Silvia's value in the fund. It simply increases the number of shares she owns, yet now at a lower per-share value.

Capital gains tax and timing

Although time, not timing, is generally the key to long-term investment success, timing can have a dramatic impact on the tax consequences of investment activities. Your long-term capital gains rate might be as much as 20 percentage points lower than your ordinary-income rate. The long-term gains rate applies to investments held for more than 12 months. The applicable rate depends on your income level and the type of asset you've sold. (See Chart 2 on page 10.) Holding on to an investment until you've owned it more than a year may help substantially cut tax on any gain.

Remember: Appreciating investments that don't generate current income aren't taxed until sold, deferring tax and perhaps allowing you to time the sale to your tax advantage — such as in a year when you have capital losses to absorb the capital gain. Or, if you've cashed in some big gains during the year and want to reduce your 2017 tax liability, before year end look for unrealized losses in your portfolio and consider selling them to offset your gains. Both long- and short-term gains and losses can offset one another.

***AMT ALERT!* Substantial net long-term capital gains can trigger the AMT.**

Wash sale rule

If you want to achieve a tax loss with minimal change in your portfolio's asset allocation, keep in mind the wash sale rule. It prevents you from taking a loss on a security if you buy a substantially identical security (or an option to buy such a security) within 30 days before or after you sell the security that created the loss. You can then recognize the loss only when you sell the replacement security.

Fortunately, there are ways to avoid triggering the wash sale rule and still achieve your goals. For example, you can:

- Sell the security and immediately buy securities of a different company in the same industry or shares in a mutual fund that holds securities much like the ones you sold,
- Sell the security and wait 31 days to repurchase the same security, or
- Before selling the security, purchase additional shares of that security equal to the number you want to sell at a loss, and then wait 31 days to sell the original portion.

Alternatively, you can do a bond swap, where you sell a bond, take a loss and then immediately buy another bond of similar quality and duration from a different issuer. Generally, the wash sale rule doesn't apply because the bonds aren't considered substantially identical. Thus, you can achieve a tax loss with virtually no change in economic position.

Warning: You can't avoid the wash sale rule by selling stock at a loss in a taxable account and purchasing the same stock within 30 days in a tax-advantaged retirement account.

Loss carryovers

If net losses exceed net gains, you can deduct only $3,000 ($1,500 if married filing separately) of the net losses per year against other income (such as wages, self-employment and business income, dividends and interest).

You can carry forward excess losses until death. Loss carryovers can be a powerful tax-saving tool in future years if you have a large investment portfolio, real estate holdings or a closely held business that might generate substantial future capital gains.

Finally, remember that capital gains distributions from mutual funds can also absorb capital losses.

0% rate

The 0% rate applies to long-term gain that would be taxed at 10% or 15% based on the taxpayer's ordinary-income rate. If you have adult children in one of these tax brackets, consider transferring appreciated assets to them so they can sell the assets and enjoy the 0% rate. This strategy can be even more powerful if you'd be subject to the 3.8% NIIT and/or the 20% long-term capital gains rate if you sold the assets.

Warning: If the child will be under age 24 on Dec. 31, first make sure he or she won't be subject to the "kiddie tax." (See page 19.) Also consider any gift tax consequences. (See page 22.)

Paying attention to details

If you don't pay attention to the details, the tax consequences of a sale may be different from what you expect. For example, the trade date, not the settlement date, of publicly traded securities determines the year in which you recognize the gain or loss.

And if you bought the same security at different times and prices and want to sell high-tax-basis shares to reduce gain or increase a loss to offset other gains, be sure to specifically identify which block of shares is being sold.

Mutual funds

Investing in mutual funds is an easy way to diversify your portfolio. But beware of the tax pitfalls. First, mutual funds with high turnover rates can create income that's taxed at ordinary-income rates. Choosing funds that provide primarily long-term gains can save you more tax dollars because of the lower long-term rates.

Second, earnings on mutual funds are typically reinvested, and unless you or your investment advisor increases your basis accordingly, you may report more gain than required when you sell the fund. Brokerage firms are required to track (and report to the IRS) your cost basis in mutual funds acquired during the tax year.

Third, buying equity mutual fund shares late in the year can be costly tax-wise. Such funds often declare a large capital gains distribution at year end, which is a taxable event. If you own the shares on the distribution's record date, you'll be taxed on the full distribution amount even if it includes significant gains realized by the fund *before* you owned the shares. And you'll pay tax on those gains in the current year — even if you reinvest the distribution. (See Case Study III.)

Small business stock

By purchasing stock in certain small businesses, you can diversify your portfolio. You also may enjoy preferential tax treatment:

Conversion of capital loss to ordinary loss. If you sell qualifying Section 1244 small business stock at a loss, you can treat up to $50,000 ($100,000, if married filing jointly) as an ordinary, rather than a capital, loss — regardless of your holding period. This means you can use it to offset ordinary income, reducing your tax by as much as 39.6% of this portion of the loss. Sec. 1244 applies only if total capital invested isn't more than $1 million.

Tax-free gain rollovers. If within 60 days of selling qualified small business (QSB) stock you buy other QSB stock with the proceeds, you can defer the tax on your gain until you dispose of the new stock. The rolled-over gain reduces your basis in the new stock. For determining long-term capital gains treatment, the new stock's holding period includes the holding period of the stock you sold. To be a QSB, a business must be engaged in an active trade or business and must not have assets that exceed $50 million, among other requirements.

Exclusion of gain. Generally, taxpayers selling QSB stock are allowed to exclude up to 50% of their gain if they've held the stock for more than five years. But, depending on the acquisition date, the exclusion may be greater: The exclusion is 75% for stock acquired after Feb. 17, 2009, and before Sept. 28, 2010, and 100% for stock acquired on or after Sept. 28, 2010.

The taxable portion of any QSB gain will be subject to the lesser of your ordinary-income rate or 28%, rather than the normal long-term gains rate. (See Chart 2.) Thus, if the 28% rate and the 50% exclusion apply, the effective rate on the QSB gain will be 14% (28% × 50%).

Keep in mind that all three of these tax benefits are subject to additional requirements and limits. Consult your tax and financial advisors to be sure an investment in small business stock is right for you.

Passive activities

If you've invested in a trade or business in which you don't materially participate, remember the passive activity rules. Why? Passive activity *income* may be subject to the 3.8% NIIT, and passive activity *losses* generally are deductible only against income from other passive activities. You can carry forward disallowed losses to the following year, subject to the same limits.

To avoid passive activity treatment, you must "materially participate" in the activity, which typically means you must participate in the trade or business more than 500 hours during the year or demonstrate that your involvement constitutes substantially all of the participation in the activity. (Special rules apply to real estate; see page 13.) To help ensure your hours claim will be able to withstand IRS scrutiny, carefully track and document your time. Contemporaneous recordkeeping is better than records that are created after-the-fact.

If you don't pass the material participation test, consider:

Increasing your involvement. If you can exceed 500 hours, the activity no longer will be subject to passive activity rules.

Grouping activities. You may be able to group certain activities together to be treated as one activity for tax purposes and exceed the 500-hour threshold. But the rules are complex, and there are potential downsides to consider.

Looking at other activities. If you have passive losses, one option is to limit your participation in another activity that's generating income, so that you don't meet the 500-hour test. Another is to invest in another income-producing trade or business that will be passive to you. Under both strategies, you'll have passive income that can absorb some or all of your passive losses.

Disposing of the activity. This generally allows you to deduct *all* passive losses — including any loss on disposition (subject to basis and capital loss limitations). But, again, the rules are complex.

Income investments

Qualified dividends are taxed at the favorable long-term capital gains tax rate rather than at your higher ordinary-income tax rate.

Interest income, however, generally is taxed at ordinary-income rates. So stocks that pay qualified dividends may be more attractive tax-wise than other income investments, such as CDs and taxable bonds. But there are exceptions.

Some dividends, for example, are subject to ordinary-income rates. These include certain dividends from:

- Real estate investment trusts (REITs),
- Regulated investment companies (RICs),
- Money market mutual funds, and
- Certain foreign investments.

CHART 2

What's the maximum capital gains tax rate[1]?

Assets held	2017[2]
12 months or less (*short term*)	Taxpayer's ordinary-income tax rate
More than 12 months (*long term*)	
■ 39.6% ordinary-income tax bracket	20%
■ 25%, 28%, 33% or 35% ordinary-income tax bracket	15%
■ 10% or 15% ordinary-income tax bracket	0%
Some key exceptions	
Long-term gain on collectibles, such as artwork and antiques	28%
Long-term gain attributable to certain recapture of prior depreciation on real property	25%
Gain on qualified small business (QSB) stock held more than 5 years	
■ Acquired on or before Feb. 17, 2009	14%[3]
■ Acquired after Feb. 17, 2009, and before Sept. 28, 2010	7%[4]
■ Acquired on or after Sept. 28, 2010	0%

[1] These tax rates might be affected by tax law changes.

[2] In addition, the 3.8% NIIT applies to net investment income to the extent that modified adjusted gross income (MAGI) exceeds $200,000 (singles and heads of households), $250,000 (married filing jointly) or $125,000 (married filing separately).

[3] Effective rate based on 50% exclusion from a 28% rate.

[4] Effective rate based on 75% exclusion from a 28% rate.

The tax treatment of bond income varies. For example:

- Interest on U.S. government bonds is taxable on federal returns but exempt by law on state and local returns.
- Interest on state and local government bonds is excludable on federal returns. If the bonds were issued in your home state, interest also may be excludable on your state return, depending on the state.
- Corporate bond interest is fully taxable for federal and state purposes.
- Bonds (except U.S. savings bonds) with original issue discount (OID) build up "interest" as they rise toward maturity. You're generally considered to earn a portion of that interest annually — even though the bonds don't pay this interest annually — and you must pay tax on it.

Keep in mind that state and municipal bonds usually pay a lower interest rate. See Case Study IV.

AMT ALERT! ***Tax-exempt interest from private-activity municipal bonds can trigger or increase AMT liability. However, any income from tax-exempt bonds issued in 2009 and 2010 (along with 2009 and 2010 re-fundings of bonds issued after Dec. 31, 2003, and before Jan. 1, 2009) is excluded from the AMT.***

Case Study IV

Tax-exempt or taxable bonds? It's a question of yield

Working with his financial advisor, Tyson decides he needs more bonds in his investment portfolio. He's in the 39.6% bracket, so he's leaning toward municipal bonds. After all, municipal bond interest will be tax-free on Tyson's federal return.

But the fact that an investment is tax-exempt doesn't necessarily make it a better choice than a comparable taxable investment. Municipal bonds typically offer lower yields than comparable corporate bonds. To make a fair comparison, Tyson needs to calculate the tax-equivalent yield — which incorporates tax savings into the municipal bond's yield — using this formula:

Tax-equivalent yield = actual yield / (1 – Tyson's marginal tax rate).

For example, Tyson considers a municipal bond with a 4.00% yield and a comparable corporate bond that offers a 6.25% yield. Because he's in the 39.6% tax bracket, the municipal bond's tax-equivalent yield is .04 / (1 – .396) = .0662, or 6.62%. In terms of the amount of income he'll get to keep, the municipal bond is a slightly better choice. If the municipal bond is also exempt from state and local taxes, it's an even better choice. But Tyson also needs to consider factors such as risk and how well the bond will help achieve his overall investment goals.

Investment interest expense

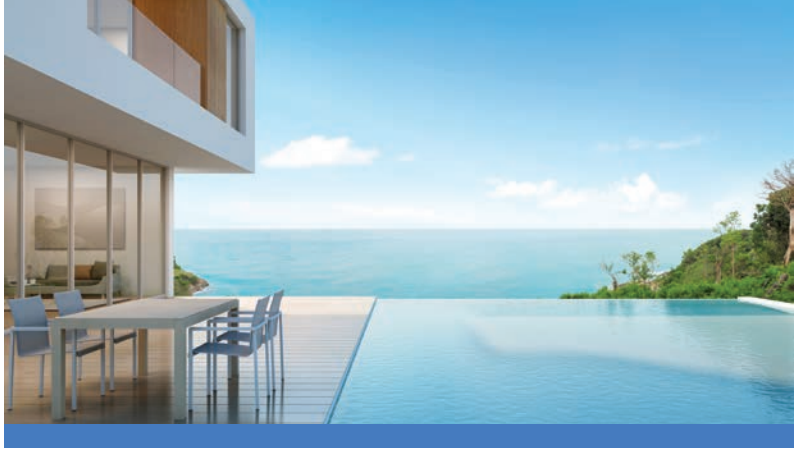
Investment interest — interest on debt used to buy assets held for investment, such as margin debt used to buy securities — generally is deductible for both regular tax and AMT purposes. But special rules apply.

Your investment interest deduction is limited to your net investment income, which, for the purposes of this deduction, generally includes taxable interest, nonqualified dividends and net short-term capital gains (but not long-term capital gains), reduced by other investment expenses. Any disallowed interest is carried forward, and you can deduct it in a later year if you have excess net investment income.

You may elect to treat net long-term capital gains or qualified dividends as investment income in order to deduct more of your investment interest. But if you do, that portion of the long-term capital gain or dividend will be taxed at ordinary-income rates.

Payments a short seller makes to the stock lender in lieu of dividends may be deductible as an investment interest expense. But interest on debt used to buy securities that pay tax-exempt income, such as municipal bonds, isn't deductible.

Also keep in mind that passive interest expense — interest on debt incurred to fund passive activity expenditures — becomes part of your overall passive activity income or loss, subject to limitations. ❖



How real estate can reduce your tax bite

There are many ways you can maximize the tax benefits associated with owning a principal residence, vacation home or rental property — or maintaining a home office. Tax planning is particularly important for higher-income individuals who are planning to sell real estate in 2017. And keep an eye on possible tax law changes: Some real estate deductions could disappear while others might become less valuable. In addition, some tax rates could change and certain taxes could be eliminated, possibly affecting tax planning related to real estate investments.

Home-related deductions

There are many tax benefits to home ownership — among them, various deductions. But the income-based limit on itemized deductions (see page 4) could reduce your savings:

Property tax deduction. If you're looking to accelerate or defer deductions, property tax is one expense you may be able to time. (See page 3.)

***AMT ALERT!* Property tax isn't deductible for AMT purposes. If you're subject to the AMT this year, a prepayment may hurt you because you'll lose the benefit of the deduction.**

Mortgage interest deduction. You generally can deduct (for both regular tax and AMT purposes) interest on up to a combined total of $1 million of mortgage debt incurred to purchase, build or improve your principal residence and a second residence. Points paid related to your *principal* residence also may be deductible.

Home equity debt interest deduction. Interest on home equity debt used for any purpose (debt limit of $100,000) may be deductible. So consider using a home equity loan or line of credit to pay off credit cards or auto loans, for which interest isn't deductible and rates may be higher.

***AMT ALERT!* If home equity debt isn't used for home improvements, the interest isn't deductible for AMT purposes and could trigger or increase AMT liability.**

Energy-related breaks. A wide variety of breaks designed to encourage energy efficiency and conservation expired Dec. 31, 2016. Consult your tax advisor for the latest information on whether any have been extended.

Home office deduction

If your home office is your principal place of business (or used substantially and regularly to conduct business) and that's the only use of the space, you generally can deduct a portion of your mortgage interest, property taxes, insurance, utilities and certain other expenses, and the depreciation allocable to the space. Or you may be able to use the simplified method for calculating the deduction.

Using the simplified option, you can deduct $5 per square foot for up to 300 square feet (maximum of $1,500 per year). Although you can't depreciate the portion of your home that's used as an office — as you could filing Form 8829 — you can claim allowable mortgage interest, property taxes and casualty losses in full as itemized deductions on Schedule A, without needing to apportion them between personal and business use of your home.

If you're an employee, the business use of your home office must be for your employer's benefit and your home office expenses are a miscellaneous itemized deduction. This means you'll enjoy a tax benefit only if these expenses plus your other miscellaneous itemized expenses exceed 2% of your AGI. (See page 3.)

If you're self-employed, however, you can deduct qualified home office expenses from your self-employment income. The 2% floor doesn't apply.

Home rental rules

If you rent out all or a portion of your principal residence or second home for less than 15 days, you don't have to report the income. But expenses directly associated with the rental, such as advertising and cleaning, won't be deductible.

If you rent out your principal residence or second home for 15 days or more, you'll have to report the income. But you also may be entitled to deduct some or all of your rental expenses — such as utilities, repairs, insurance and depreciation. Exactly what you can deduct depends on whether the home is classified as a rental property for tax purposes (based on the amount of personal vs. rental use):

Rental property. You can deduct rental expenses, including losses, subject to the real estate activity rules discussed at right. You can't deduct any interest that's attributable to your personal use of the home, but you can take the personal portion of property tax as an itemized deduction.

Nonrental property. You can deduct rental expenses only to the extent of your rental income. Any excess can be carried forward to offset rental income in future years. You also can take an

itemized deduction for the personal portion of both mortgage interest and property taxes. In some situations, it may be beneficial to reduce personal use of a residence so it will be classified as a rental property. (See Case Study V.)

Home sales

When you sell your principal residence, you can exclude up to $250,000 ($500,000 if married filing jointly) of gain if you meet certain tests. Gain that qualifies for exclusion will also be excluded from the 3.8% NIIT. (See page 8.) To support an accurate tax basis, maintain thorough records, including information on your original cost and subsequent improvements, reduced by any casualty losses and depreciation claimed based on business use. ***Warning:*** Gain that's allocable to a period of "non-qualified" use generally isn't excludable.

Losses on the sale of any personal residence aren't deductible. But if part of your home is rented out or used exclusively for your business, the loss attributable to that portion may be deductible.

Because a second home is ineligible for the gain exclusion, consider converting it to rental use before selling. It can be considered a business asset, and you may be able to defer tax on any gains through an installment sale or a Section 1031 exchange. Or you may be able to deduct a loss, but only to the extent attributable to a decline in value *after* the conversion.

Real estate activity rules

Income and losses from investment real estate or rental property are passive by definition — unless you're a real estate professional. Why is this important? Passive activity income may be subject to the 3.8% NIIT, and passive activity losses are generally deductible only against income from other passive activities, with the excess being carried forward.

To qualify as a real estate professional, you must annually perform:

- More than 50% of your personal services in real property trades or businesses in which you materially participate, and
- More than 750 hours of service in these businesses during the year.

Each year stands on its own, and there are other nuances to be aware of. If you're concerned you'll fail either test and be subject to the NIIT or stuck with passive losses, consider increasing your hours so you'll meet the test. Keep in mind that special rules for spouses may help you meet the 750-hour test. ***Warning:*** The IRS has successfully challenged claims of real estate professional status in instances where the taxpayer didn't keep adequate records of time spent.

Case Study V

Converting a personal residence to a rental property may save taxes

Mia owns a vacation home that in 2017 she uses a few times and rents out several weeks, collecting a total of $20,000 in rent. Her mortgage interest is $10,000, her property taxes are $8,000, and her other home-related expenses are $12,000, for a total of $30,000 of expenses. Mia rents out another property that she doesn't use personally. It generates net income of $10,000.

If Mia's personal use of the vacation home is enough that it's considered a residence for tax purposes, her rental expense deduction would be limited to the $20,000 in rental income. If, based on her use of the home, her expenses are 20% personal and 80% rental, she can deduct 20% of her interest and taxes, or $3,600, as itemized deductions. Her rental expenses are $24,000 (80% of $30,000). She can use $20,000 of those expenses to offset her rental income, but she can't deduct the rental loss of $4,000 — she can only carry it forward. So, her 2017 deductions related to the home total $23,600.

But if Mia's personal use is low enough that the home is considered a rental property, she'll save some tax. Let's say her expenses are 10% personal and 90% rental. The rental portion of interest, taxes and other expenses is $27,000 (90% of $30,000), resulting in a $7,000 loss, which, because her rental income from her other rental property is sufficient to absorb it, is fully deductible. Although she can't deduct her personal portion of interest, she can take her 10% personal portion of property taxes, or $800, as an itemized deduction. Mia's total current deductions related to the home increase to $27,800.

Depreciation-related breaks

Three valuable depreciation-related breaks are available to real estate investors:

1. 50% bonus depreciation. This additional first-year depreciation allowance is available for qualified improvement property. The break has been extended through 2019, but it's scheduled to drop to 40% for 2018 and 30% for 2019.

2. Section 179 expensing election. This allows you to deduct (rather than depreciate over a number of years) qualified leasehold-improvement, restaurant and retail-improvement property. The expensing limit for 2017 is $510,000, subject to a phaseout if your qualified asset purchases for the year exceed $2.03 million. (These amounts are adjusted annually for inflation.)

3. Accelerated depreciation. This break allows a shortened recovery period of 15 years — rather than 39 years — for qualified leasehold-improvement, restaurant and retail-improvement property.

Tax-deferral strategies

It's possible to divest yourself of appreciated investment real estate but defer the tax liability. Such strategies may even help you keep your income low enough to avoid triggering the 3.8% NIIT and the 20% long-term capital gains rate. Consider these deferral strategies:

Installment sale. An installment sale allows you to defer gains by spreading them over several years as you receive the proceeds. ***Warning:*** Ordinary gain from certain depreciation recapture is recognized in the year of sale, even if no cash is received.

Sec. 1031 exchange. Also known as a "like-kind" exchange, this technique allows you to exchange one real estate investment property for another and defer paying tax on any gain until you sell the replacement property. Discuss the limits and risks with your tax advisor. ❖

Business owners must look out for their future when tax planning

Tax planning is a juggling act for business owners. You have to keep your eye on your company's income and expenses and applicable tax breaks (especially if you own a pass-through entity). But you also need to look out for your own financial future. For example, you should take advantage of retirement plans that allow you to make larger nontaxable contributions than you could make as an employee. And you need to develop an exit plan so that taxes don't trip you up when you sell your business or transfer it to the next generation.

Retirement saving

If most of your money is tied up in your business, retirement can be a challenge. So if you haven't already set up a tax-advantaged retirement plan, consider doing so this year. If you might be subject to the 3.8% NIIT (see page 8), this may be particularly beneficial because retirement plan contributions can reduce your MAGI and thus help you reduce or avoid the NIIT.

Keep in mind that, if you have employees, they generally must be allowed to participate in the plan, provided they work enough hours and meet other qualification requirements. Here are a few options that may enable you to make substantial contributions:

Profit-sharing plan. This is a defined contribution plan that allows discretionary employer contributions and flexibility in plan design. You can make deductible 2017 contributions (see Chart 3 for limits) as late as the due date of your 2017 income tax return, including extensions — provided your plan exists on Dec. 31, 2017.

SEP. A Simplified Employee Pension is a defined contribution plan that provides benefits similar to those of a profit-sharing plan. But you can establish a SEP in *2018* and still make deductible 2017 contributions as late as the due date of your 2017 income tax return, including extensions. (See Chart 3 for contribution limits.) Another benefit is that a SEP is easier to administer than a profit-sharing plan.

Defined benefit plan. This plan sets a future pension benefit and then actuarially calculates the contributions needed to attain that benefit. The maximum annual benefit for 2017 is generally $215,000 or 100% of average earned income for the highest three consecutive years, if less. Because it's actuarially driven, the 2017 contribution needed to attain the projected future annual benefit may exceed the maximum contributions allowed by other plans, depending on your age and the desired benefit. For this reason, a business owner age 50 or older with a younger staff should consider a defined benefit plan.

You can make deductible 2017 defined benefit plan contributions until the due date of your 2017 income tax return, including extensions — provided your plan exists on Dec. 31, 2017. ***Warning:*** Employer contributions generally are required and must be paid quarterly if there was a shortfall in funding for the prior year.

Exit planning

An exit strategy is a plan for passing on responsibility for running the company, transferring ownership and extracting

CHART 3

Profit-sharing plan vs. SEP: How much can you contribute?

Profit-sharing plan	SEP
2017 maximum contribution: $54,000 or $60,000.	**2017 maximum contribution:** $54,000.
Additional limits: You can't contribute more than 25% of your compensation generally, but you can contribute 100% up to the 401(k) limits if the plan includes a 401(k) arrangement. To qualify for the $60,000 limit, your plan must include a 401(k) arrangement and you must be eligible to make catch-up contributions (that is, be age 50 or older).	**Additional limits:** You can't contribute more than 25% of your eligible compensation (net of the deduction for the contribution if you're self-employed). To make the maximum contribution, your eligible compensation must be at least $216,000 ($270,000 before the deduction if you're self-employed).

Note: *Other factors may further limit your maximum contribution.*

your money from the business. This requires planning well in advance of the transition. Here are the most common exit options:

Buy-sell agreement. When a business has more than one owner, a buy-sell agreement can be a powerful tool. The agreement controls what happens to the business when a specified event occurs, such as an owner's retirement, disability or death. Among other benefits, a well-drafted agreement:

- Provides a ready market for the departing owner's shares,
- Prescribes a method for setting a price for the shares, and
- Allows business continuity by preventing disagreements caused by new owners.

A key issue with any buy-sell agreement is providing the buyer(s) with a means of funding the purchase. Life or disability insurance often helps fulfill this need and can give rise to several tax issues and opportunities.

One of the biggest advantages of life insurance as a funding method is that proceeds generally are excluded from the beneficiary's taxable income. There are exceptions, however, so be sure to consult your tax advisor.

Succession within the family. You can pass your business on to family members by giving them interests, selling them interests or doing some of each. Be sure to consider your income needs, the tax consequences, and how family members will feel about your choice.

Under the annual gift tax exclusion, you can gift up to $14,000 of ownership interests under your gift tax annual exclusion without using up any of your lifetime gift and estate tax exemption. Valuation discounts may further reduce the taxable value of the gift. But a gift and estate tax repeal has been proposed, so it's possible that in the future you might be able to transfer your business to the next generation free of federal tax. Check with your tax advisor for the latest information. (See page 22 for more on gift and estate planning.)

Management buyout. If family members aren't interested in or capable of taking over your business, one option is a management buyout. This can provide for a smooth transition because there may be little learning curve for the new owners. Plus, you avoid the time and expense of finding an outside buyer.

ESOP. If you want rank and file employees to become owners as well, an employee stock ownership plan may be the ticket. An ESOP is a qualified retirement plan created primarily to purchase your company's stock. Whether you're planning for liquidity, looking for a tax-favored loan or wanting to supplement an employee benefit program, an ESOP can offer many advantages.

Sale to an outsider. If you can find the right buyer, you may be able to sell the business at a premium. Putting your business into a sale-ready state can help you get the best price. This generally means transparent operations, assets in good working condition and a healthy balance sheet.

Sale or acquisition

Whether you're selling your business as part of an exit strategy or acquiring another company to help grow your business, the tax consequences can have a major impact on the transaction's success or failure. Here are a few key tax considerations:

Asset vs. stock sale. With a corporation, sellers typically prefer a stock sale for the capital gains treatment and to avoid double taxation. (For more on capital gains tax, see page 8.) Buyers generally want an asset sale to maximize future depreciation write-offs and avoid potential liabilities.

Tax-deferred transfer vs. taxable sale. A transfer of corporation ownership can be tax-deferred if made solely in exchange for stock or securities of the recipient corporation in a qualifying reorganization. But the transaction must comply with strict rules.

Although it's generally better to postpone tax, there are some advantages to a taxable sale:

- The parties don't have to meet the technical requirements of a tax-deferred transfer.
- The seller doesn't have to worry about the quality of buyer stock or other business risks of a tax-deferred transfer.
- The buyer enjoys a stepped-up basis in its acquisition's assets.

Installment sale. A taxable sale might be structured as an installment sale if the buyer lacks sufficient cash or pays a contingent amount based on the business's performance. An installment sale also may make sense if the seller wishes to spread the gain over a number of years — which could be especially beneficial if it would allow the seller to stay under the thresholds for triggering the 3.8% NIIT or the 20% long-term capital gains rate. But an installment sale can backfire on the seller. For example:

- Depreciation recapture must be reported as gain in the year of sale, no matter how much cash the seller receives.
- If tax rates increase, the overall tax could wind up being more.

Of course, tax consequences are only one of many important considerations when planning a sale or acquisition. ❖

Charitable giving: How to make the most of this tax planning tool

Giving to charity can provide not only large tax deductions, but also the satisfaction of doing good. On top of that, it's one of the most flexible tax planning tools because you can control the timing to best meet your needs. Well-planned gifts also can save estate tax while allowing you to take care of your heirs in the manner you choose. But you must keep in mind various limits that could reduce the tax benefits of your donation.

Cash donations

Outright gifts of cash (which include donations made via check, credit card and payroll deduction) are the easiest. The substantiation requirements depend on the gift's value:

- Gifts under $250 can be supported by a canceled check, credit card receipt or written communication from the charity.
- Gifts of $250 or more must be substantiated by the charity.

Deductions for cash gifts to public charities can't exceed 50% of your adjusted gross income (AGI). The AGI limit is 30% for cash donations to nonoperating private foundations. Contributions exceeding the applicable AGI limit can be carried forward for up to five years.

AMT ALERT! ***Charitable contribution deductions are allowed for AMT purposes, but your tax savings may be less if you're subject to the AMT. For example, if you're in the 39.6% tax bracket for regular income tax purposes but the 28% tax bracket for AMT purposes, your deduction may be worth only 28% instead of 39.6%.***

Stock donations

Appreciated publicly traded securities you've held more than one year are long-term capital gains property, which can make one of the best charitable gifts. Why? Because you can deduct the current fair market value and avoid the capital gains tax you'd pay if you sold the property. This will be especially beneficial to taxpayers facing the 3.8% NIIT (see page 8) or the top 20% long-term capital gains rate this year.

Donations of long-term capital gains property are subject to tighter deduction limits, however — 30% of AGI for gifts to public charities, 20% for gifts to nonoperating private foundations.

Don't donate stock that's worth *less* than your basis. Instead, sell the stock so you can deduct the loss and then donate the cash proceeds to charity.

IRA donations

Taxpayers age 70½ or older are allowed to make direct contributions from their

CHART 4

How much can you deduct for your donation?

Cash. This includes not just actual cash but gifts made by check, credit card or payroll deduction. You may deduct 100%.
Ordinary-income property. Examples include stocks and bonds held one year or less, inventory, and property subject to depreciation recapture. You generally may deduct only the lesser of fair market value or your tax basis.
Long-term capital gains property. You may deduct the current fair market value of appreciated stocks, bonds and other securities and real estate held more than one year.
Tangible personal property. Your deduction depends on the situation: ■ If the property *isn't* related to the charity's tax-exempt function (such as an antique donated for a charity auction), your deduction is limited to your basis. ■ If the property *is* related to the charity's tax-exempt function (such as an antique donated to a museum for its collection), you can deduct the fair market value.
Vehicle. Unless it's being used by the charity, you generally may deduct only the amount the charity receives when it sells the vehicle.
Use of property. Examples include use of a vacation home and a loan of artwork. Generally, you receive no deduction because it isn't considered a completed gift. There may, however, be ways to structure the gift to enable you to get a deduction.
Services. You may deduct only your out-of-pocket expenses, not the fair market value of your services. You can deduct 14 cents per charitable mile driven.

Note: *Your annual charitable donation deductions may be reduced if they exceed certain limits based on your AGI, the type of donation and the type of charity receiving the donation. If you receive some benefit from the charity in connection with your donation, such as services or products, your deduction must be reduced by the value of the benefit you receive. Various substantiation requirements also apply. Consult your tax advisor for additional details.*

IRA to qualified charitable organizations, up to $100,000 per tax year. A charitable deduction can't be claimed for the contributions. But the amounts aren't deemed taxable income and can be used to satisfy an IRA owner's RMD. (See page 21.)

To take advantage of the exclusion from income for IRA contributions to charity on your 2017 tax return, you'll need to arrange a direct transfer by the IRA trustee to an eligible charity by Dec. 31, 2017. Donor-advised funds and supporting organizations aren't eligible recipients.

Making gifts over time

If you don't know which charities you want to benefit but you'd like to start making large contributions now, consider a private foundation. It offers you significant control over how your donations ultimately will be used. You must comply with complex rules, however, which can make foundations expensive to run. Also, the AGI limits for deductibility of contributions to nonoperating foundations are lower.

If you'd like to influence how your donations are spent but avoid a foundation's downsides, consider a donor-advised fund (DAF). Many larger public charities and investment firms offer them. ***Warning:*** To deduct your DAF contribution, you must obtain a written acknowledgment from the sponsoring organization that it has exclusive legal control over the assets contributed.

Charitable remainder trusts

To benefit a charity while helping ensure your own financial future, consider a CRT. Here's how it works:

- For a given term, the CRT pays an amount to you annually (some of which generally is taxable).
- At the term's end, the CRT's remaining assets pass to one or more charities.
- When you fund the CRT, you receive an income tax deduction for the present value of the amount that will go to charity.
- The property is removed from your estate.

A CRT can also help diversify your portfolio if you own non-income-producing assets that would generate a large capital gain if sold. Because a CRT

is tax-exempt, it can sell the property without paying tax on the gain and then invest the proceeds in a variety of stocks and bonds.

You may owe capital gains tax when you receive the payments, but, because the payments are spread over time, much of the liability will be deferred. Plus, a portion of each payment might be considered tax-free return of principal. This may help you reduce or avoid exposure to the 3.8% NIIT and the 20% top long-term capital gains rate.

You can name someone other than yourself as income beneficiary or fund the CRT at your death, but the tax consequences will be different.

Charitable lead trusts

To benefit charity while transferring assets to loved ones at a reduced tax cost, consider a CLT. It works as follows:

- For a given term, the CLT pays an amount to one or more charities.
- At the term's end, the CLT's remaining assets pass to one or more loved ones you name as remainder beneficiaries.
- When you fund the CLT, you make a taxable gift equal to the present value of the amount that will go to the remainder beneficiaries.
- The property is removed from your estate.

For gift tax purposes, the remainder interest is determined assuming that the trust assets will grow at the Section 7520 rate. The lower the Sec. 7520 rate, the smaller the remainder interest and the lower the possible gift tax — or the less of your lifetime gift tax exemption you'll have to use up. If the trust's earnings outperform the Sec. 7520 rate, the excess earnings will be transferred to the remainder beneficiaries gift- and estate-tax-free.

Because the Sec. 7520 rate currently is still quite low but has been beginning to rise with other interest rates, now may be a good time to lock in a relatively low rate while still available and take the chance that your actual return will outperform it. Also keep in mind, however, that a gift and estate tax repeal has been proposed, which would reduce the benefits of a CLT. (For more on gift and estate taxes, see page 22.)

You can name yourself as the remainder beneficiary or fund the CLT at your death, but the tax consequences will be different.

Qualified charities

Before you donate, it's critical to make sure the charity you're considering is indeed a qualified charity — that it's eligible to receive tax-deductible contributions.

The IRS's online search tool, Exempt Organizations (EO) Select Check, can help you more easily find out whether an organization is eligible to receive tax-deductible charitable contributions. You can access EO Select Check at irs.gov/app/eos. Information about organizations eligible to receive deductible contributions is updated monthly.

Also, don't forget that political donations aren't deductible. ❖

Investing in a child's financial future

One of the biggest goals of most parents is that their children become financially secure adults. To pave the way, it's important to show young people the value of saving and provide them with the best education possible. By taking advantage of tax breaks available to you and your children, you can do both. If you're a grandparent, you also may be able to take advantage of some of these breaks — or help your grandchildren take advantage of them.

IRAs for teens

One of the best ways to get children on the right financial track is to set up IRAs for them. Their retirement may seem too far off to warrant saving now, but IRAs can be perfect for teenagers precisely because they likely will have many years to let their accounts grow tax-deferred or tax-free.

The 2017 contribution limit is the lesser of $5,500 or 100% of earned income. A teen's *traditional* IRA contributions typically are deductible, but distributions will be taxed. *Roth* IRA contributions aren't deductible, but qualified distributions will be tax-free.

Choosing a Roth IRA is typically a no-brainer if a teen doesn't earn income that exceeds the standard deduction ($6,350 for 2017 for single taxpayers), because he or she will likely gain no benefit from the ability to deduct a traditional IRA contribution. Even above that amount, the teen probably is taxed at a very low rate, so the Roth will typically still be the better answer. (For more information on Roth IRAs, see page 20.)

If your children or grandchildren don't want to invest their hard-earned money, consider *giving* them up to the amount they're eligible to contribute. But keep the gift tax in mind. (See page 22.)

If they don't have earned income and you own a business, consider hiring them. As the business owner, you can deduct their pay, and other tax benefits may apply. ***Warning:*** The children must be paid in line with what you'd pay nonfamily employees for the same work.

529 plans

Section 529 plans provide another valuable tax-advantaged savings opportunity. You can choose a prepaid tuition plan to secure current tuition rates or a tax-advantaged savings plan to fund college expenses beyond just tuition. Here are some of the possible benefits of such plans:

- Although contributions aren't deductible for federal purposes, any growth is tax-deferred. (Some states do offer breaks for contributing.)
- The plans usually offer high contribution limits, and there are no income limits for contributing.
- There's generally no beneficiary age limit for contributions or distributions.
- You can control the account, even after the child is of legal age.
- You can make tax-free rollovers to another qualifying family member.
- A special break for 529 plans allows you to front-load five years' worth of annual gift tax exclusions and make up to a $70,000 contribution (or $140,000 if you split the gift with your spouse).

Prepaid tuition vs. savings plan

With a 529 *prepaid tuition plan*, if your contract is for four years of tuition, tuition is guaranteed regardless of its cost at the time the beneficiary actually attends the school. One downside is that there's uncertainty in how benefits will be applied if the beneficiary attends a different school. Another is that the plan doesn't cover costs other than tuition, such as room and board.

A 529 *college savings plan*, on the other hand, can be used to pay a student's expenses at most post-secondary educational institutions. Distributions used to pay qualified expenses (such as tuition, mandatory fees, books, supplies, computer equipment, software, Internet service and, generally, room and board) are income-tax-free for federal purposes and typically for state purposes as well, thus making the tax deferral a permanent savings.

The biggest downside may be that you don't have direct control over investment decisions; you're limited to the options the plan offers. Additionally, for funds already in the plan, you can make changes to your investment options only twice during the year or when you change beneficiaries. For these reasons, some taxpayers prefer Coverdell ESAs. (See page 19.)

But each time you make a *new* contribution to a 529 savings plan, you can select a different option for that contribution, regardless of how many times you contribute throughout the year. And every 12 months you can make a tax-free rollover to a different 529 plan for the same child.

ESAs

Coverdell Education Savings Accounts are similar to 529 savings plans in that contributions aren't deductible for federal purposes, but plan assets can grow tax-deferred and distributions used to pay qualified education expenses are income-tax-free.

One of the biggest ESA advantages is that tax-free distributions aren't limited to college expenses; they also can fund elementary and secondary school costs. Another advantage is that you have more investment options.

ESAs are worth considering if you want to fund elementary or secondary education expenses or would like to have direct control over how and where your contributions are invested. But the $2,000 contribution limit is low, and it's phased out based on income. The limit begins to phase out at a modified adjusted gross income (MAGI) of $190,000 for married couples filing jointly and $95,000 for other filers. No contribution can be made when MAGI hits $220,000 and $110,000, respectively.

Also, amounts left in an ESA when the beneficiary turns age 30 generally must be distributed within 30 days, and any earnings may be subject to tax and a 10% penalty.

Gifts and the "kiddie tax"

If you'd like to help your grandchildren (or other minors) fund their college education but you don't want to be subject to the limitations of a 529 plan or an ESA, you can transfer cash, stocks and bonds to a Uniform Gifts (or Transfers) to Minors Act (UGMA/UTMA) account:

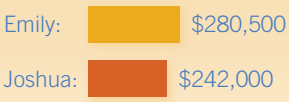
- Although the transfer is irrevocable, you maintain control over the assets, until the beneficiary age at which the UGMA/UTMA account terminates (age 18 or 21 in most states).
- The transfer qualifies for the annual gift tax exclusion. (See page 22.)

Case Study VI

It's never too early to save for retirement

Roth IRAs can be perfect for teenagers — just look at how much difference starting contributions early can make: Both Emily and Joshua contribute $5,500 per year to their Roth IRAs through age 66. But Emily starts contributing when she gets her first job at age 16, while Joshua waits until age 23, after he's graduated from college and started his career. Emily's additional $38,500 of early contributions results in a nest egg at full retirement age of 67 that's nearly $600,000 larger!

Total contributions made



Balance at age 67

Note: *This example is for illustrative purposes only and isn't a guarantee of future results. The figures presume $5,500 is contributed at the end of each year over the ages shown and a 6% rate of return. See page 20 for more information on Roth IRAs.*

But UGMA/UTMA accounts are less attractive from an income tax perspective than they used to be: The income shifting that once — when the "kiddie tax" applied only to those under age 14 — provided families with significant tax savings now offers much more limited benefits. Today, the kiddie tax generally applies to children under age 19 and to full-time students under age 24 (unless the students provide more than half of their own support from earned income).

For children subject to the kiddie tax, any unearned income beyond $2,100 (for 2017) is taxed at their parents' marginal rate, assuming it's higher. Keep this in mind before transferring income-generating assets to them, whether directly or via an UGMA/UTMA account.

ABLE accounts

Achieving a Better Life Experience accounts offer a tax-advantaged way to fund qualified disability expenses for a beneficiary who became blind or disabled before age 26. For federal purposes, tax treatment is similar to that of Section 529 college savings plans.

American Opportunity credit

When your child enters college, you may not qualify for the American Opportunity credit because your income is too high (phaseout range of $80,000 – $90,000; $160,000 – $180,000 for joint filers), but your child might. The maximum credit, *per student,* is $2,500 per year for the first four years of postsecondary education. And both the credit and a tax-free 529 plan or ESA distribution can be taken as long as expenses paid with the distribution aren't used to claim the credit.

If your dependent child claims the credit, you must forgo your dependency exemption for him or her (and the child can't take the exemption). But because of the exemption phaseout, you might lose the federal benefit of your exemption anyway:

- If your exemption *is* fully phased out, there likely is no downside to your child taking the credit.
- If your exemption *isn't* fully phased out, compare the tax savings your child would receive from the credit with the savings you'd receive from the exemption to determine which break will provide the greater overall savings for your family.

Your tax advisor can help you run the numbers. ❖

Retirement plans can minimize taxes and help maximize investment returns

It's true that the amount high-income taxpayers are allowed to contribute to tax-advantaged retirement plans is limited. However, the exponential power of tax-deferred (or in the case of Roth accounts, tax-free) compounding makes these plans hard to pass up. And consider this: Contributions to a traditional plan reduce your AGI and, therefore, could help preserve your eligibility for certain tax breaks and avoid triggering certain taxes or higher rates. But be careful when taking retirement plan distributions — they could have the opposite effect. To fully leverage retirement plan advantages, look ahead and watch out for tax traps.

Retirement plan contributions

Contributing the maximum you're allowed (see Chart 5) to an employer-sponsored defined contribution plan, such as a 401(k), is likely a smart move:

- Contributions are typically pretax, reducing your modified adjusted gross income (MAGI). This in turn can help you reduce or avoid exposure to the 3.8% NIIT. (See page 8.)
- Plan assets can grow tax-deferred — meaning you pay no income tax until you take distributions.
- Your employer may match some or all of your contributions.

If you participate in a 401(k), 403(b) or 457 plan, it may allow you to designate some or all of your contributions as Roth contributions. While Roth contributions don't reduce your current MAGI, qualified distributions will be tax-free. Roth contributions may be especially beneficial for higher-income earners, who are ineligible to contribute to a Roth IRA.

Roth IRA conversions

If you have a traditional IRA, consider whether you might benefit from converting some or all of it to a Roth IRA. A conversion can allow you to turn tax-*deferred* future growth into tax-*free* growth. It also can provide estate planning advantages.

CHART 5

Retirement plan contribution limits for 2017

	Regular contribution	Catch-up contribution[1]
Traditional and Roth IRAs	$ 5,500	$ 1,000
401(k)s, 403(b)s, 457s and SARSEPs[2]	$ 18,000	$ 6,000
SIMPLEs	$ 12,500	$ 3,000

[1] For taxpayers age 50 or older by the end of the tax year.

[2] Includes Roth versions where applicable.

***Note:** Other factors may further limit your maximum contribution. If you're a business owner or self-employed, you may be able to set up a plan that allows you to make much larger contributions. See Chart 3 on page 14.*

Unlike other retirement plans, Roth IRAs don't require you to take distributions during your lifetime, so you can let the entire balance grow tax-free over your lifetime for the benefit of your heirs.

There's no income-based limit on who can convert to a Roth IRA. But the converted amount is taxable in the year of the conversion. Whether a conversion makes sense for you depends on factors such as:

- Your age,
- Whether the conversion would push you into a higher income tax bracket or trigger the 3.8% NIIT,
- Whether you can afford to pay the tax on the conversion,
- Your tax bracket now and expected tax bracket in retirement, and
- Whether you'll need the IRA funds in retirement.

Your tax advisor can run the numbers and help you decide if a conversion is right for you this year.

If you *don't* have a traditional IRA, consider a "back door" Roth IRA: You set up a traditional account and make a nondeductible contribution to it. You then wait until the transaction clears and convert the traditional account to a Roth account. The only tax due will be on any growth in the account between the time you made the contribution and the date of conversion.

Early withdrawals

With a few exceptions, retirement plan distributions before age 59½ are subject to a 10% penalty on top of

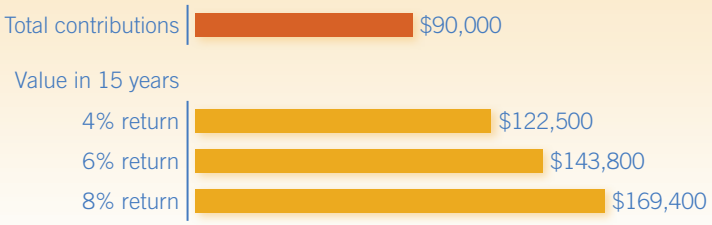
Case Study VII

Making the most of catch-up contributions

Gerardo is 49 and for many years has been making the maximum 401(k) plan contribution because he wants to leverage all of the tax-advantaged savings opportunities available to him. Because he'll turn 50 this year, his tax advisor suggests he start making "catch-up" contributions.

Catch-up contributions are extra amounts taxpayers age 50 or older (by the end of the tax year) can contribute to retirement accounts. The catch-up contribution limit depends on the type of retirement plan. (See Chart 5.)

Taking full advantage of catch-ups can make a big difference. Let's say Gerardo makes his maximum $6,000 catch-up contribution to his traditional 401(k) for 2017. He then continues making that same $6,000 contribution for the next 14 years, until he reaches age 65. The boost to his retirement savings will depend on his investment return. But even at a relatively low return rate, he'll still see a notable increase in his nest egg. And the increase will be even greater if he continues to make the maximum catch-up contribution as it rises under inflation indexing.



Note: *This example is for illustrative purposes only, not a guarantee of future results. Values are approximate and presume contributions are made ratably throughout the year.*

any income tax that ordinarily would be due on a withdrawal. This means that, if you're in the top tax bracket of 39.6%, you can lose almost half of your withdrawal to taxes and penalties — and more than half if you're also subject to state income taxes and/or penalties. Additionally, you'll lose the potential tax-deferred future growth on the withdrawn amount.

If you have a Roth account, you can withdraw up to your contribution amount without incurring taxes or penalties. But you'll be losing the potential tax-*free* growth on the withdrawn amount.

So if you're in need of cash, consider tapping your taxable investment accounts rather than dipping into your retirement plan. (See page 8 for information on the tax treatment of investments.)

Leaving a job

When you change jobs or retire, avoid taking a lump-sum distribution from your employer's retirement plan because it generally will be taxable — and potentially subject to the 10% early-withdrawal penalty. Here are options that will help you avoid current income tax and penalties:

Staying put. You may be able to leave your money in your old plan. But if you'll be participating in a new employer's plan or you already have an IRA, this may not be the best option. Why? Because keeping track of multiple plans can make managing your retirement assets more difficult. Also consider how well the old plan's investment options meet your needs.

A rollover to your new employer's plan. This may be a good solution if you're changing jobs, because it may leave you with only one retirement plan to keep track of. But also evaluate the new plan's investment options.

A rollover to an IRA. If you participate in a new employer's plan, this will require keeping track of two plans. But it may be the best alternative because IRAs offer nearly unlimited investment choices.

If you choose a rollover, request a direct rollover from your old plan to your new plan or IRA. If the funds are sent to you by check, you'll need to make an indirect rollover (that is, deposit the funds into a new IRA) within 60 days to avoid tax and potential penalties. ***Warning:*** If you don't do a direct rollover, the check you receive from your old plan will, unless an exception applies, be net of 20% federal income tax withholding. If you don't roll over the gross amount (making up for the withheld amount with other funds), you'll be subject to income tax — and potentially the 10% penalty — on the difference.

Required minimum distributions

In the year in which you reach age 70½, you must begin to take annual required minimum distributions from your IRAs (except Roth IRAs) and, generally, from your defined contribution plans. If you don't comply, you can owe a penalty equal to 50% of the amount you should have withdrawn but didn't. (An RMD deferral is allowed for the initial year, but you'll have to take two RMDs the next year.) You can avoid the RMD rule for a non-IRA Roth plan by rolling the funds into a Roth IRA.

So, should you take distributions between ages 59½ and 70½, or take more than the RMD after age 70½? Waiting to take distributions until age 70½ generally is advantageous because of tax-deferred compounding. But a distribution (or larger distribution) in a year your tax bracket is low may save tax. Be sure, however, to consider the lost future tax-deferred growth and, if applicable, whether the distribution could: 1) cause Social Security payments to become taxable, 2) increase income-based Medicare premiums and prescription drug charges, or 3) affect other tax breaks with income-based limits.

Warning: While retirement plan distributions aren't subject to the additional 0.9% Medicare tax (see page 5) or 3.8% NIIT, they *are* included in your MAGI. That means they could trigger or increase the NIIT, because the thresholds for that tax are based on MAGI.

If you've inherited a retirement plan, consult your tax advisor about the distribution rules that apply to you. ❖

Estate planning: Uncertainty is in the air

As difficult as it is, accumulating wealth is only the first step to providing a financially secure future for your family. You also need to develop a comprehensive estate plan. The earlier you begin, the more options you'll have to grow and transfer your wealth in a way that minimizes taxes and leaves the legacy you desire. But uncertainty is in the air this year; repeals of the estate, gift and generation-skipping transfer (GST) taxes have been proposed. If those changes are signed into law, these rules and strategies may no longer be applicable. Consult with your tax advisor for the latest information.

Estate tax

The estate tax rate remains at 40%. The estate tax exemption has increased to $5.49 million for 2017 (see Chart 6), and it's currently scheduled to continue to be adjusted annually for inflation.

To avoid unintended consequences, review your estate plan in light of the changing exemption. A review will allow you to make the most of available exemptions and ensure your assets will be distributed according to your wishes.

Gift tax

The gift tax continues to follow the estate tax exemption and rate. (See Chart 6.) Any gift tax exemption used during life reduces the estate tax exemption available at death. Using up some of your exemption during life can be tax-smart, depending on your situation and goals.

You also can exclude certain gifts of up to $14,000 per recipient each year ($28,000 per recipient if your spouse elects to split the gift with you or you're giving community property) without depleting any of your gift and estate tax exemption. This is the same as the 2016 amount. (The exclusion is adjusted for inflation annually, but it increases only in $1,000 increments, so it typically goes up only every few years. It might go up again for 2018.)

Warning: You need to use your 2017 exclusion by Dec. 31. The exclusion doesn't carry over from year to year. For example, if you don't make an annual exclusion gift to your granddaughter this year, you can't add $14,000 to your 2018 exclusion to make a $28,000 tax-free gift to her next year.

GST tax

The GST tax generally applies to transfers (both during your lifetime and at death) made to people more than one generation below you, such as your grandchildren. This is in addition to any gift or estate tax due. The GST tax continues to follow the estate tax exemption and rate. (See Chart 6.)

The GST tax exemption can be a valuable tax-saving tool for taxpayers with large estates whose children also have — or may eventually have — large estates. With proper planning, they can use the exemption to make transfers to grandchildren and avoid any tax at their children's generation.

State taxes

A federal estate tax deduction is available for state estate taxes paid. Keep in mind that some states impose estate tax at a lower threshold than the federal government does.

To avoid unexpected tax liability or other unintended consequences, it's critical to consider state law. Consult a tax advisor familiar with the law of your particular state.

Exemption portability

If one spouse dies and part (or all) of his or her estate tax exemption is unused at his or her death, the estate can elect to permit the surviving spouse to use the deceased spouse's remaining estate tax exemption.

Warning: Portability is available only for the most recently deceased spouse. It doesn't apply to the GST tax exemption and isn't recognized by many states.

CHART 6

Transfer tax exemptions and rates[1]

Year	Estate tax exemption[2]	Gift tax exemption	GST tax exemption	Estate, gift and GST tax rate
2016	$ 5.45 million	$ 5.45 million	$ 5.45 million	40%
2017	$ 5.49 million	$ 5.49 million	$ 5.49 million	40%
Future years	Indexed for inflation	Indexed for inflation	Indexed for inflation	40%

[1] Repeals of the estate, gift and GST taxes have been proposed.

[2] Less any gift tax exemption already used during life.

And it must be elected on an estate tax return for the deceased spouse — even if no tax is due.

The portability election will provide flexibility if proper planning hasn't been done before the first spouse's death. But portability doesn't protect future growth on assets from estate tax like applying the exemption to a credit shelter trust does. Trusts offer other benefits as well, such as creditor protection, remarriage protection, GST tax planning and state estate tax benefits.

So married couples should still consider marital and credit shelter trusts — and transferring assets to each other to the extent necessary to fully fund them at the first death. Transfers to a spouse (during life or at death) are tax-free under the marital deduction, assuming he or she is a U.S. citizen.

Case Study VIII

Why annual exclusion gifts can be a powerful tax-saver

In 2017, Angela and Phil combine their $14,000 annual exclusions so that their three children and their children's spouses, along with their six grandchildren, each receive $28,000. The result is that $336,000 is removed from the couple's estates free of taxes.

If the same amounts were transferred to the recipients upon Angela's or Phil's death instead — and no estate or GST tax exemption were available — the tax hit, at the current 40% rate, would be $134,400 in federal estate taxes and $67,200 in GST taxes. So the annual exclusion gifts could potentially save the family $201,600 in taxes. If they maximize their annual exclusion gifts each year, just think about how much tax they could save!

Tax-smart giving

Giving away assets now will help reduce the size of your taxable estate. Here are some strategies for tax-smart giving:

Choose gifts wisely. Consider both estate and income tax consequences and the economic aspects of any gifts you'd like to make:

- To minimize *estate tax*, gift property with the greatest future appreciation potential.
- To minimize *your beneficiary's income tax*, gift property that hasn't appreciated significantly while you've owned it.
- To minimize *your own income tax*, don't gift property that's declined in value. Instead, consider selling the property so you can take the tax loss and then gifting the sale proceeds.

Plan gifts to grandchildren carefully. Annual exclusion gifts are generally exempt from the GST tax, so they also help you preserve your GST tax exemption for other transfers. For gifts to a grandchild that don't qualify for the exclusion to be tax-free, you generally must apply both your GST tax exemption and your gift tax exemption.

Gift interests in your business or an FLP. If you own a business, you can leverage your gift tax exclusions and exemption by gifting ownership interests, which may be eligible for valuation discounts. So, for example, if the combined discount is 30%, in 2017 you can gift an ownership interest equal to as much as $20,000 tax-free because the discounted value doesn't exceed the $14,000 annual exclusion.

Another way to potentially benefit from valuation discounts is to set up a family limited partnership. You fund the FLP with assets such as public or private stock and real estate, and then gift limited partnership interests. ***Warning:*** The IRS may challenge valuation discounts; a professional, independent valuation is recommended. The IRS also scrutinizes FLPs, so be sure to properly set up and operate yours.

Pay tuition and medical expenses. You may pay these expenses without the payment being treated as a taxable gift to the student or patient, as long as the payment is made directly to the provider.

Make gifts to charity. Donations to qualified charities aren't subject to gift tax and may provide an income tax deduction. (See page 16.)

Trusts

Trusts can provide significant tax savings while preserving some control over what happens to the transferred assets. You may want to consider these:

- A *credit shelter (or bypass) trust* helps married couples minimize estate tax and provides additional benefits.
- A *qualified terminable interest property (QTIP) trust* can benefit first a surviving spouse and then children from a prior marriage.
- A *qualified personal residence trust (QPRT)* allows you to give your home to your children today — removing it from your taxable estate at a reduced gift tax cost (provided you survive the trust's term) — while you retain the right to live in it for a certain period.
- A *grantor-retained annuity trust (GRAT)* works on the same principle as a QPRT but allows you to transfer other assets; you receive payments back from the trust for a certain period.

Finally, a GST — or "dynasty" — trust can help you leverage both your gift and GST tax exemptions, and it can be an excellent way to potentially lock in the currently high exemptions while removing future appreciation from your estate.

Insurance

Along with protecting your family's financial future, life insurance can be used to pay estate taxes, equalize assets passing to children who aren't involved in a family business, or pass leveraged funds to heirs free of estate tax. Proceeds are generally income-tax-free to the beneficiary. And with proper planning, you can ensure proceeds are excluded from your taxable estate. ❖

CHART 7

2017 individual income tax rate schedules[1]

Tax rate	Regular tax brackets			
	Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
10%	$ 0 – $ 9,325	$ 0 – $ 13,350	$ 0 – $ 18,650	$ 0 – $ 9,325
15%	$ 9,326 – $ 37,950	$ 13,351 – $ 50,800	$ 18,651 – $ 75,900	$ 9,326 – $ 37,950
25%	$ 37,951 – $ 91,900	$ 50,801 – $ 131,200	$ 75,901 – $ 153,100	$ 37,951 – $ 76,550
28%	$ 91,901 – $ 191,650	$ 131,201 – $ 212,500	$ 153,101 – $ 233,350	$ 76,551 – $ 116,675
33%	$ 191,651 – $ 416,700	$ 212,501 – $ 416,700	$ 233,351 – $ 416,700	$ 116,676 – $ 208,350
35%	$ 416,701 – $ 418,400	$ 416,701 – $ 444,550	$ 416,701 – $ 470,700	$ 208,351 – $ 235,350
39.6%	Over $ 418,400	Over $ 444,550	Over $ 470,700	Over $ 235,350
Tax rate	**AMT brackets**			
	Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
26%	$ 0 – $ 187,800	$ 0 – $ 187,800	$ 0 – $ 187,800	$ 0 – $ 93,900
28%	Over $ 187,800	Over $ 187,800	Over $ 187,800	Over $ 93,900
AMT exemptions				
	Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
Amount	$ 54,300	$ 54,300	$ 84,500	$ 42,250
Phaseout[2]	$ 120,700 – $ 337,900	$ 120,700 – $ 337,900	$ 160,900 – $ 498,900	$ 80,450 – $ 249,450

[1] These tax rates might be affected by tax law changes.

[2] The AMT income ranges over which the exemption phases out and only a partial exemption is available. The exemption is completely phased out if AMT income exceeds the top of the applicable range.

***Note:** Consult your tax advisor for AMT rates and exemptions for children subject to the "kiddie tax."*

CHART 8

2017 corporate income tax rate schedule[1]

Tax rate	Tax brackets
15%	$ 0 – $ 50,000
25%	$ 50,001 – $ 75,000
34%	$ 75,001 – $ 100,000
39%	$ 100,001 – $ 335,000
34%	$ 335,001 – $ 10,000,000
35%	$ 10,000,001 – $ 15,000,000
38%	$ 15,000,001 – $ 18,333,333
35%	Over $ 18,333,333

[1] These tax rates might be affected by tax law changes.

***Note:** Qualified personal service corporations are taxed at a flat 35% rate.*

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