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Client Tax Letter

Tax Saving and Planning Strategies *from your* Trusted Business Advisor℠

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What's Inside

Special Report on the Protecting Americans from Tax Hikes Act of 2015

1 Deducting Sales Taxes
2 IRA Charitable Donations
2 Higher Education Tax Breaks
3 Tax-Free Investment Gains
3 Business Tax Benefits
4 Deducting IRA Contributions
5 Fun and Games… and Taxes
6 Portability in Estate Planning

Special Report on the Protecting Americans from Tax Hikes Act of 2015

Last December, President Obama signed the Protecting Americans from Tax Hikes (PATH) Act of 2015 into law. The new law contains several tax benefits for individuals and companies.

What's more, PATH was not a simple "extenders" act, continuing certain tax breaks for a year or two. On the contrary, PATH converted many tax code provisions from temporary to permanent, retroactive to the beginning of 2015. Therefore, you can have much more confidence in future tax plans regarding these provisions. (Other tax code provisions that had expired, or were scheduled to expire, were extended for two or five years, retroactive to 2015.)

This issue of the *CPA Client Tax Letter* covers some of the main tax rules that have been affected. If you have questions about these and other tax code items that were set to expire in 2015 or later years, contact our office for details. ■

Deducting Sales Taxes

Taxpayers who itemize deductions on Schedule A of IRS Form 1040 can deduct some state and local tax payments from their income. Among the formerly impermanent tax deductions that are now permanent is the option to deduct sales instead of income taxes.

Example: Marge and Nick Palmer always itemize deductions on their joint tax return. Generally, the Palmers deduct the state income tax they pay. In 2016, though, their income will drop, and so will the state income tax they owe. The Palmers are making some large purchases during the year, paying steep amounts of sales tax. For 2016 and future years, the Palmers can deduct the sales tax they pay instead of the state income tax they pay, if the amount of sales tax exceeded their income tax.

continued on page 2

continued from page 1

This tax provision obviously helps people who live in a state with no income tax; other taxpayers also may benefit. A taxpayer may deduct the actual amount of sales taxes paid during the year or, alternatively, may use tables created by the IRS to determine the allowable deduction. If a taxpayer uses the tables to determine the deduction, he or she can add the tax paid on certain items (cars and boats, for example) to the amount from the IRS tables. ■

IRA Charitable Donations

For most people, using IRA dollars for charity is a two-step process. You take money from your IRA, reporting taxable income. Then, you donate it to the charity or charities of your choice, perhaps claiming a tax deduction for the contribution.

The new PATH law establishes the permanence of qualified charitable distributions (QCDs), which go directly from IRAs to recipient organizations. They're available only to IRA owners age 70½ or older. Such individuals can use QCDs every year now, up to $100,000 per year.

Once IRA owners reach age 70½, they usually must take certain amounts of required minimum distributions (RMDs) each year or pay a 50% penalty on any shortfall. QCDs count toward RMDs.

Example: Joyce Harris, age 72, has a 2016 RMD of $20,000. If Joyce, who gives $5,000 to charities each year, makes those donations directly from her IRA, that $5,000 counts toward her RMD for the year, so she'll only have to withdraw another $15,000 from her IRA in 2016. She'll report only $15,000 of taxable income, not $20,000, but she won't get a tax deduction for the $5,000 flowing from her IRA to charities.

Why would Joyce do this? There are several situations in which using a QCD could pay off. Perhaps most important, Joyce will be able to satisfy her $20,000 RMD obligation yet only report $15,000 of income, thus, reducing what otherwise would be her adjusted gross income (AGI) by $5,000. For some taxpayers, QCDs can eliminate any addition to AGI from their required IRA distributions. A lower AGI, in turn, can offer many benefits throughout your tax return. Our office can go over your specific situation to see if using an IRA for donations after age 70½ would be tax-effective for you. ■

Higher Education Tax Breaks

In 2009, Congress replaced the Hope Scholarship Tax Credit with the American Opportunity Tax Credit (AOTC). Compared with the Hope credit, the AOTC offers more annual tax savings and is available to people with higher incomes. Moreover, the AOTC can be claimed during a student's first four years of higher education, whereas the Hope credit was limited to the first two years.

The AOTC was scheduled to expire after 2017, but the PATH Act makes it permanent. Under the AOTC, the maximum tax saving is $2,500 per student per year; that amount requires you to spend at least $4,000 per student in a calendar year. In addition, 40% of the AOTC (up to $1,000) is refundable, which means you can receive a check from the IRS if you owe no tax.

Money you pay for tuition and related fees counts for calculating the tax credit. Such qualified expenses also include expenditures for course materials, which means books, supplies and equipment needed for a course of study. An expenditure for a computer also would qualify for the credit if the computer is needed as a condition of enrollment or attendance at the educational institution.

To get the full AOTC, your modified adjusted gross income (MAGI) must be $80,000 or less, or $160,000 or less if you file a joint return. The credit phases out for taxpayers with MAGI over those amounts, with no credit allowed if your MAGI is over $90,000 or $180,000 if you file a joint return.

529 plans

These plans, offered by most states, allow contributions to grow, tax-free.

Did You Know?

Among student who began their studies full-time at a four-year institution in 2007, about 40% had completed bachelor's degrees at their first school after four years. About 60% had completed their degrees after six years. Thus, among students who earned bachelor's degrees within six years, one-third took more than four years to do so.

Source: The College Board

Withdrawals also are untaxed to the extent of qualified higher education expenses.

Previously, computers and related equipment were considered "qualified," for this purpose, only if they were required by the school for course attendance or enrollment. Under the PATH Act, outlays for computers, peripheral equipment, Internet access and computer software are classed as qualified expenses, even if they are not specifically required. Thus, if you buy a computer or related items for college, you can take money from the student's 529 plan to cover the costs without owing any tax or penalty.

ABLE accounts

Another PATH provision affects ABLE accounts, sometimes known as 529A plans. ABLE accounts are for individuals with special needs; tax-free distributions allow beneficiaries to pay for disability-related expenses without sacrificing government assistance benefits. Formerly, ABLE beneficiaries were limited to their home state's plan, but now any state's ABLE plan will be acceptable. ■

Tax-Free Investment Gains

For more than 20 years, Section 1202 of the tax code has offered benefits to investors in certain small companies. Generally, non-corporate investors can use this tax break if they buy stock in companies that met specified criteria. After a holding period of at least 5 years, any gain on a sale will be taxed favorably.

Originally, the tax exclusion applied to 50% of the gain. In 2010, the exclusion was temporarily increased to 100%, for purchases after September 27 of that year; the 100% exclusion was extended but expired after 2014. Now the 100% exclusion on the sale of qualified small business stock (QSBS) is permanent. Another temporary measure—exclusion of QSBS gain from the alternative minimum tax—also is permanent under the PATH Act.

Trusted Advice

Qualified Small Business Stock

Several requirements apply to the 100% tax exclusion on gains from selling small business stock. They include the following:

- You must acquire stock in a C corporation, originally issued after Sept 27, 2010.
- The corporation must have total gross assets of $50 million or less at all times after August 9, 1993, and before it issued the stock.
- The company's gross assets immediately after it issued the stock must have been no more than $50 million.
- During substantially all the time you hold the stock, the corporation meets the active business requirements (that is, the corporation is an eligible corporation that uses at least 80% [by value] of its assets in the active conduct of one or more qualified trades or businesses).
- With some specified exceptions, you must have acquired the stock at its original issue, directly or through an underwriter.

With the recent increase in capital gains tax rates for high-income taxpayers and the possible imposition of the 3.8% Medicare surtax, tax-free gains from a profitable investment may be appealing. ■

Business Tax Benefits

The tax code includes Section 179, which permits first-year deduction (expensing) of amounts spent for business equipment. This provision formerly allowed annual deductions up to $25,000. After $200,000 of equipment outlays, the allowance phased out, dollar-for-dollar.

Congress had raised these amounts sharply in recent years, but the increases expired periodically, going back to the original amounts. The latest expiration occurred at the end of 2014, so the smaller limit was officially in effect until passage of the PATH Act in late 2015.

Now, the higher Section 179 limits are permanent. For 2016, expensing up to $500,000 of equipment is allowed, and the phaseout doesn't begin until $2,010,000 of purchases. Both the $500,000 and $2,010,000 amounts will be indexed for inflation.

continued on page 4

continued from page 3

Example 1: ABC Corp. spends $600,000 on equipment in 2016. The company can deduct $500,000, the permanent Section 179 cap, while the other $100,000 can be depreciated under other rules.

Example 2: XYZ Corp. spent $2,110,000 on equipment in 2016. That's $100,000 over the $2,010,000 limit, so Section 179 expensing is reduced by that $100,000, from $500,000 to $400,000. If the company expenses $400,000, it can depreciate the remaining $1,710,000 under other rules.

The PATH Act includes off-the-shelf computer software as Section 179 property, which was not always the case.

Beyond expensing under Section 179, "bonus" depreciation has allowed additional first-year depreciation deductions for amounts spent on certain business equipment. That provision, which expired after 2014, has not been made permanent; instead, it was extended through 2019. For 2015 through 2017, 50% of the relevant cost may be deducted. That number will fall to 40% in 2018 and 30% in 2019.

R&D tax credit

The PATH Act also gave permanent status to the research & development tax credit (R&D credit), retroactive to 2015. This credit can be used by companies that increase their qualified research expenses. Qualified research expenses includes the costs of in-house qualified research and amounts paid to outside contractors for qualified research. If the credit can't be used currently, it can be carried forward or transferred in an acquisition.

Technology-based companies may be the main users of this tax credit, but firms in all fields may get some benefit. Tracking R&D costs to qualify for the credit can be complex, however. Our office can help your business set up the procedures to make the most of this tax break.

Cadillac health plans

As part of the Affordable Care Act, employer-provided health insurance deemed to provide excessive benefits will be subject to a special tax. This tax was supposed to take effect for tax years beginning after 2017, but the PATH Act postpones the start date for two years. This gives employers more time to evaluate their health plans and phase in any changes.

In addition, the new tax law provides that a company paying the so-called "Cadillac" plan tax will be able to deduct the amount paid from its income tax. Thus, the actual cost of the Cadillac plan tax may be reduced. ■

Deducting IRA Contributions

The deadline for 2016 IRA contributions is April 17, 2017. Workers and their spouses who are under age 70½ at year-end 2016 can each contribute up to $5,500, or $6,500 for those 50 and older. For traditional IRAs, income limits don't apply.

That is, those named can make contributions of these amounts to a traditional IRA. Whether those contributions will be tax-deductible is another matter. In any case, investment earnings inside an IRA will be untaxed until money is withdrawn.

Deduction limits based on plan participation

Worker not covered by plan. If a worker is not covered by an employer's retirement plan in 2016, IRA contributions are deductible. Income is not an issue.

Example 1: Nora Dixon, age 29, works for a small computer graphics company that does not offer a retirement plan to its employees. Nora's husband Oliver, also 29, is a physical therapist who is not covered by a retirement plan. Both Dixons can deduct traditional IRA contributions up to $5,500 each for 2016, no matter how much they earn.

Worker covered by plan. However, for workers who were covered by an employer plan, income will determine deductibility. To deduct the maximum amount as a single filer, your modified adjusted gross income (MAGI) for 2016 must be $61,000 or less; you can take a partial deduction with MAGI up to $71,000. Over $71,000 of MAGI, single filers who are covered by an employer plan can't deduct any IRA contribution. (For plan-participating married people filing jointly, the 2016 MAGI ceilings are $98,000 for a maximum deduction and $118,000 for a partial deduction.)

Example 2: Paul and Rhona Benson, both age 44, are each covered by a retirement plan at their jobs. The Bensons end up with MAGI of $108,000 in 2016. That's 50% of the way through the phase-out range for joint tax returns. Thus, Paul and Rhona can each contribute up to $5,500 to traditional IRAs for 2016, and they can each take a $2,750 tax deduction: 50% of the maximum.

One spouse covered by plan. Among married couples with higher incomes, one spouse might be able to deduct all or part of an IRA contribution. That would be the case if one spouse is covered by an employer plan, but the other spouse isn't. The spouse who is not covered can deduct a full 2016 IRA contribution with joint MAGI up to

$184,000, or a partial deduction with MAGI up to $194,000.

Example 3: Sheila Ford, age 65, is covered by an employer plan at work, while her husband Greg, 68, is retired. Their 2016 MAGI is $175,000. Both Fords can make a $6,500 traditional IRA contribution for 2016. However, because their joint MAGI is over $118,000, Sheila can't take any tax deduction. Greg, on the other hand, is not covered by an employer plan, so he can take a full $6,500 tax deduction because their joint MAGI is under $184,000.

Note that traditional IRA contributions are available only to workers and spouses under age 70½. In this example, Greg would not be able to make any IRA contribution if he were age 72, for example.

The Roth alternative

A taxpayer that can make a deductible traditional IRA contribution can instead make a contribution to a Roth IRA. Roth IRA contributions are never tax-deductible. However, after you've had a Roth IRA for five years and reach age 59½, all distributions are tax-free. Our office can go over the tax aspects with you to help you decide between a nondeductible Roth IRA and a potentially tax-deductible traditional IRA contribution. ■

Fun and Games… and Taxes

As 2016 began, people were lining up to buy tickets for the Powerball lottery, which eventually reached a total prize of $1.58 billion. Many states have lotteries, and countless participants win prizes, albeit usually much smaller than the Powerball jackpot. Are such winnings taxable? The answer, in a word, is yes. (As an exception to this rule, some states exempt their lottery winnings from state income tax.)

According to the IRS, lotteries are a form of gambling, along with pastimes such as raffles, horse racing, and casino games. Cash winnings are taxable income, as is the fair value of prizes such as cars and trips. All of your gambling winnings must be declared on Form 1040 of your tax return as "Other Income."

Gambling winnings are taxed as ordinary income, with tax rates as high as 39.6%. Some large winnings, such as lottery payouts, can be spread over many years, which also spreads the tax bill. Taking a smaller amount in consecutive years may reduce the effective tax rate on those winnings.

How winnings are reported

Depending on the activity, gambling winnings of a certain size will be reported by the payer on Form W-2G, which is sent to you as well as to the IRS. Larger winnings are subject to withholding, generally at a 25% federal rate; state tax also may be withheld.

Example: Lois Martin wins $10,000 in her state's lottery. Of her winnings, $2,500 (25%) is withheld for the IRS while $500 (5%) is withheld for her state. Thus, Lois receives $7,000 upfront. When Lois files her tax return for the year, her $10,000 lottery income, as well as the $2,500 and $500 amounts paid in tax, will be included in calculating her federal and state income tax obligation.

Gain from losses

Suppose, in this scenario, that Lois buys $10 worth of lottery tickets every week, or $520 a year. Can she net that amount against her winnings, to reduce the tax she'll owe?

Not directly. The amount to be reported under "Other Income" is the gross amount of your gambling winnings for the year. That includes all of your winnings, not just those reported on Form W-2G. Note that this amount will be counted in your adjusted gross income (AGI), and an increased AGI may reduce your ability to use certain tax benefits elsewhere on your tax return.

In order to get any tax benefit from her $520 in lottery purchases, Lois must itemize deductions on Schedule A of her Form 1040. On this form, her lottery purchases can be included under "Other Miscellaneous Deductions." Thus, Lois will reduce her taxable income from her lottery win and trim her tax bill.

The gambling losses that Lois can report on Schedule A are not limited to lottery purchases, even if her only winnings are from a lottery. She can report all of her losses from casinos, horse races, and Super Bowl bets, and so on, up to the $10,000 she has reported as winnings. That is, the gambling losses you report on Schedule A of Form 1040 can be no greater than the gambling winnings you report.

Suppose Lois has $11,000 in gambling losses for the year. She can deduct losses up to the

amount of winnings she reports: $10,000 in this example. The excess $1,000 can't be carried over to future years.

On the bright side, gambling losses aren't subject to the various limitations on some miscellaneous itemized deductions.

Loss lessons

As is the case with any tax deduction, you'll need evidence to support the amount of the gambling losses you claim, in case your return is questioned. Your best plan is to keep a detailed log of all gambling activities, showing winnings and expenses, as well as tangible items such as lottery tickets and betting slips. Moreover, you should use gambling losses as tax deductions only if the total of all your itemized deductions exceeds the standard deduction you're entitled to claim. ■

Portability in Estate Planning

The federal estate tax exemption for deaths in 2016 is $5.45 million. Married couples may be able to pass twice that amount—$10.9 million—to their heirs without triggering estate tax. Some planning is necessary to reach the higher level, but a relatively new tax code provision, known as *portability*, can simplify the process.

Traditional tactics

For decades, estate tax planning for married couples with substantial net worth involved asset shifting and trust creation.

Example 1: George Hall owns a small business valued at $4 million. George's other assets (real estate, retirement plans, investments, etc.) total $3 million. If George dies and leaves everything to his wife, Irene, no estate tax will be due. Bequests to spouses usually avoid estate tax.

In this scenario, Irene would inherit George's $7 million estate. Including the proceeds from a life insurance policy and her own wealth, Irene might have a net worth of $10 million.

Assuming Irene dies with that $10 million a few years later, when the estate tax exemption has risen to $6 million, her estate would be $4 million over the limit. With the current 40% estate tax rate on nonexempt assets, Irene's estate would owe $1.6 million in federal estate tax (40% of $4 million), reducing the net payout to the Halls' children, who are Irene's heirs.

To avoid this tax, the Halls might set up trusts, to receive some assets at the first spouse's death, untaxed because of the estate tax exemption. George also might shift some assets to Irene, so that a tax-effective trust could be funded regardless of which spouse is the first to die.

Easier does it

Recently, the concept of estate tax exemption portability has been introduced to the Internal Revenue Code. Under the portability rules, the surviving spouse can use the decedent spouse's unused estate tax exemption if the executor of the decedent spouse's estate makes a portability election on the decedent spouse's estate tax return. Trusts and asset transfers can still be used, but they may not be necessary.

Example 2: George Hall keeps his $7 million in total assets, which he leaves to Irene, as in example 1. At his death in 2016, the executor of George's estate files a federal estate tax return, IRS Form 706, making the portability election.

In example 2, George has used none of his estate tax exemption, so all $5.45 million is transferred to Irene. If she dies in a year when the exemption amount is $6 million, Irene will have an $11.45 million federal estate tax exemption: her own $6 million plus $5.45 million from George. (These examples all assume that neither spouse made any taxable gifts.) If Irene dies with $10 million in net worth, her $11.45 million exemption will allow it all to go to their children, free of federal estate tax.

Our office can help you determine whether using portability makes sense in your overall wealth transfer planning. ■

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