Year-End Tax Planning and Looking Forward

November 17, 2014

Dear Clients and Friends:

Year-end tax planning is especially challenging this year because Congress has yet to act on a host of tax breaks that expired at the end of 2013. Some of these tax breaks may be retroactively reinstated and extended, but Congress may not decide the fate of these tax breaks until the very end of this year (and, possibly, not until next year). These breaks include, for individuals: the option to deduct state and local sales and use taxes instead of state and local income taxes; the above-the-line deduction for qualified higher education expenses; tax-free individual retirement account (IRA) distributions for charitable purposes by those age 70½ or older; and the exclusion for up to $2 million of mortgage debt forgiveness on a principal residence. For businesses, tax breaks that expired at the end of 2013 and may be retroactively reinstated and extended include: 50% bonus first-year depreciation for most new machinery, equipment and software; the $500,000 annual expensing limitation; the research tax credit; and the 15-year write-off for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. In addition, the taxpayers need to be prepared for the new requirements and responsibilities under the Patient Protection and Affordable Care Act (PPACA).

Post-Election Planning

Based on the November 4 voting results, Republicans increased their majority in the House and captured a majority in the Senate. The changes could give us a great opportunity for comprehensive tax reform in 2015 or 2016. The impact of the elections on the 2014 year-end tax planning was primarily on the so-called “tax extenders” package that includes various expired individual and business tax breaks, as previously discussed. It is not yet decided whether the final passage will happen in December or January next year when the new Congress meets and whether it will be retroactively restated to the beginning of 2014. Hill sources have recently indicated that the differences in the House and Senate’s extenders bills can be resolved easily. Making the research and development tax credit permanent in return for a two-year extension of the other expired tax breaks has been part of the latest buzz around how final negotiations will proceed. Although having an extenders package passed by Congress is almost expected, any single extender remains subject to being rejected in last-minute negotiations, making year-end tax planning decisions subject to changes until final congressional action.
In addition, several provisions of the PPACA could be modified or repealed in the 114th Congress. Those being considered for action in the near future include rolling back the 2.3 percent medical device excise tax and the 30-hour rule for treatment as a full-time employee for purposes of the employer-shared responsibility requirement. The latter change would especially affect current planning by employers to avoid liability under the employer mandate.

Lastly, for fiscal year (FY) 2014, the Internal Revenue Service (IRS) operated at the same funding rate as FY 2013, and it was approximately $850 million below FY 2010 levels. Congress is expected to approve an omnibus spending bill to fund the IRS through the end of FY 2015. The Republican-controlled 114th Congress will prepare the IRS budget for FY 2016.

Even it has been a challenging year for tax planning, we have compiled a checklist of additional actions based on current tax rules that may help you save tax dollars if you act before year-end. Not all actions will apply in your particular situation, but you (or a family member) will likely benefit from many of them. We can narrow down the specific actions that you can take once we have discussed a particular tailored plan with you.

**Traditional Year-End Tax Strategies:**

Traditional year-end planning techniques nevertheless remain important to maximize benefits in connection with what is new and to do so within the usual ebb and flow of the taxpayer’s personal economy. Posting income until 2015 and accelerating deductions into 2014 may enable you to claim larger deductions and tax credits.

The following techniques should be considered:

*Income Deferral/Acceleration:*

- Enter into/sell installment notes
- Defer/receive bonus in 2014
- Hold/sell assets appreciated in value
- Accelerate income to use available carryforward losses
- Consider disposing a passive activity to deduct passive loss carryover
- Increase basis in the pass-through business entity to deduct current year loss
- Accumulate/declare dividends
- Postpone/complete conversion from tradition IRA to Roth IRA
- Delay/accelerate debt forgiveness income
- Minimize/maximize distributions from retirement accounts
- Delay/accelerate billable services
- Structure/avoid mandatory like-kind exchange treatment
Deductions/Credit Acceleration/Deferral:

- Bunch itemized deductions into 2014 and take standard deduction in 2015/reverse steps
- Pay bills in 2014/postpone payments until 2015
- Pay last state estimated tax installment in 2014/delay payment until 2015
- Accelerate economic performance/postpone performance
- Consider adjusted gross income (AGI) limitations on deductions/credits
- Watch for limitations on investment interest deductions
- Match passive activity income and losses to maximize deduction on passive losses

**FOR BUSINESS**

Businesses looking to maximize tax benefits through 2014 year-end tax planning may want to consider the following general strategies:

1. Use the traditional timing techniques for income and deductions;
2. Special consideration of significant tax incentives that expired at the end of 2013 but may be extended through 2014;
3. Consider adopting a qualified retirement plan before the year end. As long as plan documents are executed before the end of the year, a deduction can be claimed for 2014 and funding delayed until the tax return due date; and
4. Reaction to certain recent tax developments from the IRS and the courts that may present either new tax-saving opportunities or pitfalls.

**SECTION 179 EXPENSING AND BONUS DEPRECIATION**

Many business owners are familiar with the benefits of Section 179 expensing and bonus depreciation. After December 31, 2013, enhanced Section 179 expensing expired, which is significant. The expensing and investment limitations were reduced from $500,000 and $2 million to $25,000 and $200,000. These qualified real property allowances and Section 179 deductions for off-the-shelf computer software also expired. Similarly, the bonus depreciation officially expired after 2013 except for certain non-commercial aircraft and longer production period property, which may be eligible for the 50 percent bonus depreciation through 2014. Uncertainty over the ultimate fate of enhanced Section 179 expensing and bonus depreciation impacts 2014 year-end planning, particularly as business owners contemplate purchases of equipment and supplies. Businesses considering qualified purchases need to weigh the benefits of making these purchases before year-end or postponing these purchases after 2014. Because enhanced Section 179 expensing and bonus depreciation are likely to be extended (and made retroactive to January 1, 2014), businesses may be able to take advantage of these incentives in 2014 and 2015. In addition, businesses should consider purchasing machinery and equipment before year-end, since, under the generally applicable half-year’s convention, a half-year worth of depreciation deduction is allowed for the first ownership year.
REPAIR REGULATIONS

Final regulations for treating costs related to tangible property (the so-called “repair regulations”) may open significant tax planning opportunities for some taxpayers. For acquisitions of tangible property, businesses may be able to take advantage of the “de minimis safe harbor election” (also known as the book-tax conformity election) to deduct the costs. The safe harbor applies to items that cost $5,000 or less (per item or invoice) and that are deducted on the company’s applicable financial statement (AFS) in accordance with a written accounting procedure. The de minimis limit is $500 per item or invoice for companies without an AFS.

Under the $5,000 de minimis safe harbor in the final regulations, taxpayers must have a written policy in place at the beginning of the year that specifies a dollar amount for following book treatment. The de minimis safe harbor is an annual election and not an accounting method, so it can be made and changed every year. Calendar-year taxpayers need to have a written policy in place by the end of 2014 to qualify for 2015. The annual election is made by filing a statement with the taxpayer’s income tax return. A written policy is not required if the company applies the $500 de minimis limit.

There is also a small taxpayer safe harbor election available to buildings with an unadjusted basis of $1 million or less. By making the election, the taxpayer can deduct the lesser of $10,000 or 2% of adjusted basis per year. The taxpayer must capitalize all the expenditures above the threshold. The regulations also provide a routine maintenance safe harbor. Under this safe harbor rule, the taxpayer is allowed to expense recurring activity that keeps the property in its “ordinarily efficient operating condition” and expected to be repeated within ten years. To adopt the routine maintenance safe harbor, the taxpayer is required to file a Form 3115, Application for Change in Accounting Method, with its annual income tax return and also have written accounting procedures in place.

In addition, there may be one-time opportunities for companies to write off previously disposed of assets or partial assets. Under prior guidance, when taxpayers repaired or replaced a structural component of a building (such as the roof, HVAC units, plumbing fixtures, etc.), both the original asset and the replacement asset were required to be capitalized and depreciated simultaneously, even though only one physical asset existed. The disposition rules now allow taxpayers to immediately deduct the remaining basis of original (or previously replaced) building structural components and systems as they are replaced.

Generally, the deduction must be taken in the year the asset is disposed; however, for a limited time, taxpayers can go back and recover the basis of “ghost assets” that may still be on the books from years past. The window to make this “late partial disposition election” is still open, through January 1, 2015, so taxpayers should review their fixed asset schedules for disposition opportunities and implement the final regulations on their 2014 tax returns. Furthermore, under the new regulations, it may be necessary to file multiple Forms 3115 to adopt these rules. The IRS has temporarily allowed filing multiple Forms 3115 to accommodate this need. It is highly recommended to take action now, since, after 2014, it may not be possible to file more than one Form 3115 in a five-year period and the opportunity to take the tax benefits may be lost.
**RESEARCH TAX CREDIT AND OTHER BUSINESS EXTENDERS**

The research tax credit also officially expired after 2013, but it may be retroactively revived by Congress. The research credit may be claimed for increase in business-related qualified research expenditures and for increases in payments to universities and other qualified organizations for basic research. The credit applies to the excess of qualified research expenditures for the tax year over the average annual qualified research expenditures measured over the four preceding years. For businesses that conduct research activities and paid qualified expenditures in California, the tax credit is still available.

In addition to the research tax credit, other business tax breaks also expired after 2013, including:

- Special expensing rules for film and television production
- Credit for employer-provided child care facilities and services
- Work Opportunity Tax Credit
- Employer wage credit for activated military reservists
- Railroad track maintenance credit
- Five-year Recognition period for S corporation built-in gains
- Indian employment credit
- Accelerated depreciation for business property on Indian reservations
- Election to expense mine safety equipment
- Credit for new energy-efficient homes
- Enhanced deduction for charitable contributions of food inventory
- Empowerment zone tax benefits
- Credit for electricity produced from renewable resources
- Cellulosic biofuel producer credit
- Energy efficient appliance credit for manufacturers
- Incentives for biodiesel, renewable diesel and alternative fuels
- 15-year straight line recovery for qualified leasehold improvements
- 15-year straight line recovery for qualified restaurant property
- 15-year straight line recovery for qualified retail improvements

The expired tax breaks affect a wide variety of businesses. Businesses may have utilized one or more of the expired tax incentives in past years. Like enhanced Section 179 expensing and bonus depreciation, it appears that taxpayers will not know the fate of these incentives until late in 2014 or in early 2015. Congress could, as it has in the past, renew these incentives in a comprehensive bill or it could proceed piecemeal. Therefore, some past strategies may continue to be valuable, especially if the extenders are renewed.

**MANUFACTURER’S DOMESTIC PRODUCTION ACTIVITY (AKA SECTION 199) DEDUCTION**

The Section 199 deduction allows taxpayers to deduct an amount equal to the lesser of a phase-in percentage of taxable income (adjusted gross income for individuals) or qualified production activities income. The deduction is calculated as a percentage (generally 9% under current law, subject to some exceptions) of qualifies production activities income. The deduction is often viewed as being under-utilized. Taxpayers should not let the complexity of the calculations deter potential tax savings under the deduction.
**Small Business Stock**

A full 100% gain exclusion is allowed for qualified small business stock that is acquired after September 27, 2010, and before January 1, 2014, and held for more than five years. Under current law, the percentage that is excluded is 50% (60% for empowerment zone stock) for qualifying stock acquired after December 31, 2013. Even with the reduced gain exclusion, it is still a worthwhile strategy. Taxpayers should consider making investments before year-end so that the required five-year holding period begins to run. It should be kept in mind that being even just one day short of the five-year holding period (starts from the acquisition date) can eliminate the tax benefits since no proration is allowed. However, certain exchanges of similar stock before the five-year period are allowed.

**Gearing Up for PPACA Requirements**

The health care reform law affects every business in some way. While small employers (generally defined as employers with fewer than 50 full-time employees, including full-time equivalent employees) are exempt from the PPACA’s employer mandate, small businesses should not overlook other provisions that could generate tax savings. Mid-size and larger businesses do fall under the employer mandate and other requirements; however, mid-size employers are exempt from the employer mandate for 2015. Employers qualify as mid-size if they employ on average at least 50 full-time employees, including full-time equivalents, but fewer than 100 full-time employees, including full-time equivalents. Mid-size employers also must satisfy other requirements to qualify for the transition relief. Under current rules, transition relief is only available for 2015 but it could be extended.

Business owners need to plan for how seasonal and other workers may affect their liability for the employer mandate. Seasonal workers, on-call employees, student workers, and others must be taken into account to determine the number of the employer’s full-time employees. The rules for seasonal workers and others are complex but they cannot be ignored.

*Internal Revenue Code (IRC) Section 6056 reporting:* Mid-size and larger businesses are responsible for new information reporting requirements. These employers must tell the IRS whether or not they offer health insurance to employees, among other criteria. These reporting requirements are effective for health insurance coverage offered, or not offered, in 2015. Small employers that are exempt from the employer mandate are also exempt from this reporting.

*Small business health care tax credit:* Owners of small businesses should not overlook a tax credit under IRC Section 45R that helps offset the cost of providing health insurance to employees. To be eligible for the tax credit, the small employer must have fewer than 25 full-time equivalent employees (FTEs). In addition, the average annual wages it pays to its employees for the year must be less than $50,000 per FTE. Finally, the premiums that the employer pays must be for coverage under a qualifying arrangement, and insurance generally must be obtained through the ACA’s SHOP Program (subject to some exceptions). If the number of FTEs exceeds 10 or if average annual wages exceed $25,000, the amount of the credit is reduced until it phases out.
**MYRAs**

The Treasury Department is expected to unveil a new retirement savings arrangement before the end of 2014. The new accounts are called myRA. These accounts will be offered through employers that elect to participate. Account holders will build savings for 30 years or until their myRA reaches $15,000, whichever comes first. After that, myRA balances will transfer to private-sector Roth IRAs. Small business owners should explore the benefits of offering myRAs to their employees. As more details are released, business owners can weigh the value of these new accounts. At the same time, business owners can explore other retirement savings vehicles, including Safe Harbor 401(k) plans, SIMPLE IRA plans, SEP plans, and payroll deduction IRAs.

**California Net Operating Losses (“NOLs”) Carryback**

Started last year in 2013, California allows taxpayers to carry back the NOL generated in that taxable year. Under the carryback provisions, taxpayers are allowed a two-year carryback as follows: 50% of the NOL generated in 2013, 75% of the NOL generated in 2014, and 100% of the NOL generated in 2015 and beyond.

*This will apply to individual taxpayers as well.*

**FOR INDIVIDUALS**

**Net Investment Income (NII) Tax**

For some individuals, the new net investment income tax has become part of their year-end tax planning. There are three categories of net investment income:

- Category 1: gross income from interest, dividends, annuities, royalties and rents, if the income is not derived in a trade or business;
- Category 2: income from a "trade or business" that is a passive activity, as determined under IRC Section 469, or is from a business as a financial trader; and
- Category 3: net gains from the sale of property, unless the property is held in a nonpassive trade or business.

Under IRC Section 469, individuals may group multiple activities into a single activity. Generally, an individual must meet the material participation standard for each activity. Grouping into a single activity can make it easier for a taxpayer to meet the standard by combining the taxpayer’s hours and participation. By grouping activities, a taxpayer may be able to avoid having income treated as net investment income.
The income thresholds for triggering the net investment income tax: $200,000 for single taxpayers; $250,000 for married couples filing a joint return; and $125,000 for married couples filing separately. All net investment income should be monitored for exposure to the NII tax. Taxpayers with potential NII tax liability should consider keeping income below the $200,000/$250,000/$125,000 thresholds if possible by spreading income out over a number of years or offsetting the income with both above-the-line and itemized deductions.

**Additional Medicare Tax**

The additional Medicare tax increases the employee share of Medicare tax by an additional 0.9 percent of covered wages in excess of certain threshold amounts. The tax also increases Medicare tax on self-employment income by an additional 0.9 percent of self-employment income in excess of the threshold amounts. The threshold amounts are $20,000 for single individuals (and heads of household); $250,000 for married couples filing a joint return; and $125,000 for married individuals filing returns.

This is now the second year for the additional Medicare tax. Taxpayers who now realize that they have had insufficient income tax withholding may require that their employer(s) take out an additional amount of income tax withholding, which would be applied against taxes shown on their individual income tax returns, including any additional Medicare tax liability. Taxpayers may also want to consider making estimated tax payments to avoid the penalties.

**Alternative Minimum Tax (AMT)**

The AMT is now permanently “patched.” The patch provides for increased exemption amounts and allows taxpayers to take all the non-refundable personal credits against regular and AMT liability. Even with the permanent patch, taxpayers should continue to review their AMT liabilities versus regular tax liabilities. For some taxpayers, AMT liability and regular tax liability may be roughly equal from year to year. Other taxpayers may find that they have had significant fluctuations in income or AMT-targeted tax benefits from year to year and could explore the benefit from being able to shift some AMT triggering items from an AMT year to a non-AMT year. Keep in mind that many tax breaks allowed for purposes of calculating regular taxes are disallowed for AMT purposes. These include the deduction for state property taxes on a taxpayer’s residence, state income taxes, miscellaneous itemized deductions, and personal exemption deductions. Other deductions, such as for medical expenses, are calculated in a more restrictive way for AMT purposes than for regular tax purposes in the case of a taxpayer who is over age 65 or whose spouse is over age 65 as of the close of the tax year. As a result, in some cases, deductions should not be accelerated.

**Retirement Accounts**

If you believe a Roth IRA is better than a traditional IRA and want to remain in the market for the long term, consider converting traditional IRA money invested in beaten-down stocks (or mutual funds) into a Roth IRA if eligible to do so. Keep in mind, however, that such a conversion will increase your adjusted gross income for 2014.
If you converted assets in a traditional IRA to a Roth IRA earlier in the year, the assets in the Roth IRA account may have declined in value, and if you leave things as is, you will wind up paying a higher tax than is necessary. You can back out of the transaction by recharacterizing the rollover or conversion, that is, by transferring the converted amount (plus earnings, or minus losses) from the Roth IRA back to a traditional IRA via a trustee-to-trustee transfer. You can later reconvert to a Roth IRA. Roth conversions may also be available in 401(k) accounts (check with your plan administrator).

If you have reached age 70-1/2, it is mandatory to take required minimum distributions (RMDs) from your IRA, 401(k), or other employer-sponsored retired plan. Failure to take a required withdrawal can result in a penalty of 50% of the amount of the RMD not withdrawn. If you turned age 70-1/2 in 2014, you can delay the first required distribution in 2015, but if you do, you will have to take a double distribution in 2015, the amount required for 2014 plus the amount required for 2015. Think twice before delaying a 2014 distribution to 2015; bunching income into 2015 might push you into a higher tax bracket or have a detrimental impact on various income tax deductions that are reduced at higher income levels. However, it could be beneficial to take both distributions in 2015 if you will be in a substantially lower bracket that year; for example, because you plan to retire late this year.

In addition, two year-end deadlines should be kept in mind: (1) The RMD for any given year is based on the retirement account balance on December 31 of the calendar year immediately before the year of distribution; and (2) The RMD for any year generally must take place by December 31 of that year. The interplay of these two deadlines will become important as baby boomers begin to retire with a greater number of retirement account balances to manage.

**Individual Tax Extenders**

Prospects for permanent extension of many of the so-called tax extenders also appear dim before year-end. However, there will likely be an extension of the extenders, probably for two years. That means extensions will be retroactive to January 1, 2014, because many of the extenders expired after December 31, 2013. For planning purposes, individuals should consider their tax strategies under one scenario that includes extension of the extenders and another that does not. Keep in mind that some of the extenders impact other provisions of the Tax Code.

The list of expired extenders is long. Among the more popular are the state and local general sales tax deduction, special mortgage debt forgiveness provisions, transit benefits parity, the higher education tuition deduction, IRA distributions to charities, the teachers’ classroom expense deduction and the mortgage insurance premium deduction. Some temporary individual incentives are available for 2014 and 2015 because they carry different expiration dates. They include the American Opportunity Tax Credit and the residential energy efficient credit.

Some extenders were made permanent by the American Taxpayer Relief Act of 2012. They include the student loan interest deduction, special enhancements to the earned income tax credit, the child tax credit, and the child and dependent care credit, as well as special enhancements to the adoption credit and adoption assistance programs.
NEW CONSIDERATIONS FROM PPACA

As of January 1, 2014, PPACA requires all individuals to carry health insurance or make a shared responsibility payment, unless exempt. For many, employer-provided health insurance will satisfy the individual mandate. Others will satisfy the individual mandate if they are covered by Medicare or Medicaid. Individuals who are not exempt will need to make a shared responsibility payment when they file their 2014 returns in 2015.

Generally, the shared responsibility payment amount is either a percentage of the individual's income or a flat dollar amount, whichever is greater. The amount owed is 1/12 of the annual payment for each month that a person or the person's dependents are not covered and are not exempt. For 2014, the payment amount is the greater of:

- 1 percent of the person's household income that is above the tax return threshold for his/her filing status; or
- A flat dollar amount, which is $95 per adult and $47.50 per child, limited to a maximum of $285.

The individual shared responsibility payment is capped at the cost of the national average premium for the bronze level health plan available through the Affordable Care Act Marketplace (Marketplace) in 2014.

The lack of health insurance does not automatically mean an individual must make a shared responsibility payment. The types of exemptions are broad. For example, an individual may have no affordable coverage options because the minimum amount he or she must pay for the annual premiums is more than eight percent of household income. An individual also may have a hardship that prevents him or her from obtaining coverage.

Some seven million individuals have obtained health insurance through the Marketplace. Many qualified for a special tax break to help offset the cost of coverage and many took advance payments of the credit. In these cases, individuals must reconcile the amount paid in advance with the amount of the actual credit computed when they file their tax returns. Life changes in 2014 may impact the final credit amount.

ESTATE AND GIFT PLANNING

The maximum federal unified estate and gift tax rate is 40 percent with an inflation-adjusted $5 million exclusion for gifts made and estates of decedents dying after December 31, 2012. The annual gift tax exclusion allows taxpayers to give up to an inflation-adjusted $14,000 to any individual, gift tax free, and without counting the amount of the gift toward the lifetime $5 million exclusion, adjusted for inflation. The applicable exclusion amount, as adjusted for inflation, is $5,340,000 for gifts made and estates of decedents dying in 2014 and rises to $5,430,000 in 2015. There is no limit on the number of individual donees to whom gifts may be made under the $14,000 exclusion. Spouses may split their gifts to each donee, effectively raising the per donee annual maximum exclusion to $28,000. Spouses may give an unlimited amount of gifts to one another without any gift tax imposed. You cannot carry over unused annual exclusions from one year to the next.

Gifts made before the end of the year can be sheltered by the annual gift tax exclusion and thereby save gift and estate taxes.
The transfers also may save family income taxes where income-earning property is given to family members in lower income tax brackets who are not subject to the kiddie tax.

**IMPORTANT LIFE CYCLE CHANGES THAT AFFECT YEAR-END TAX PLANNING**

In addition to changes in the tax law, taxpayers should also consider personal circumstances that changed during 2014, as well as what may change in 2015. These changes include:

- Change in filing status due to marriage, divorce, death or head of household changes
- Change in dependent such as new-born child or outgrown child
- Losses from casualty or theft
- Change in medical expenses
- Moving/relocation due to change in job
- College and other higher-education expenses
- Change in employer
- Start retirement
- Personal bankruptcy
- Inheritance

Every tax situation is different and requires a careful and comprehensive plan. We can assist you in aligning traditional year-end techniques with strategies for dealing with the uncertainties created by Congress’s delay in addressing the expired tax incentives. If you have questions or need assistance regarding your year-end tax planning, please do not hesitate to contact our tax professionals at taxalerts@windes.com or toll free at 844.4WINDES (844.494.6337).

Sincerely,

WINDES, INC.

[Signature]

James A. Cordova
Chairman of Tax and Accounting Services
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