

# tax report

JANUARY 2017



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## How Will Your Investment Earnings Be Taxed?

If you're like many people, you have investments in different types of accounts. Knowing how your investment earnings in each type of account will be taxed can help you better plan to minimize your tax exposure.

### Taxable Investment Accounts

The concept of "basis" is essential to understanding the calculation of capital gains and losses on the sale of securities held in a taxable account. Basis is generally the price you paid for your shares of stock or a mutual fund, adjusted for any reinvested dividends or capital gain distributions, as well as for any costs of the purchase. (Reinvested dividends and capital gain distributions are added to basis because they are taxed in the year of distribution.) To calculate gain or loss, you compare your basis in the securities to the amount realized on the sale.

For federal tax purposes, long-term capital gains are taxed at lower rates than ordinary income, such as interest on a savings account or a taxable bond.

### Long-term Capital Gain Rates

- 10% and 15% ordinary rate brackets 0%
- 25% – 35% ordinary rate brackets 15%
- 39.6% ordinary rate bracket\* 20%

\* Some higher income taxpayers may incur an additional 3.8% net investment income tax.

You generally must hold your shares for more than one year before selling them to qualify a capital gain as long term. If a capital gain is generated by an asset held for one year or less, the gain generally is taxed at ordinary

income tax rates. Note that dividends can qualify for the long-term capital gains rates when certain tax law conditions are met.

### Tax-deferred Accounts

You don't pay taxes on capital gains, dividends, and interest earned on investments held in a traditional individual retirement account (IRA) or an employer's qualified retirement plan while the earnings

remain in your account. However, when you receive distributions from these accounts, both contributions and earnings will be taxed at ordinary income tax rates (except to the extent of any after-tax contributions).

### Roth Accounts

Roth IRAs and Roth 401(k) accounts have unique tax aspects. For both, contributions are made with after-tax dollars and investment earnings are tax deferred, but any distributions will be income tax free if all requirements are met. Generally, for tax-free treatment, you must maintain a Roth account for five tax years *and* make withdrawals after age 59½ (or meet certain other limited requirements). ■



## Late Rollover Relief

The IRS has announced help for retirement savers who miss the 60-day window for "indirect rollovers" of retirement funds.

Generally, taxpayers who want to transfer retirement funds tax free from one workplace retirement plan or individual retirement account (IRA) to another may either arrange for a "direct" trustee-to-trustee transfer or take the distribution and contribute it to the new account within 60 days. Taxpayers who choose the "indirect" method but miss the 60-day deadline risk taxation of the distribution and, potentially, an additional 10% early withdrawal penalty.

However, the IRS will now allow taxpayers to avoid taxes and penalties if they certify to the receiving plan or IRA — using a model letter or one substantially similar to it — that they missed the deadline because of financial institution error, check misplacement, erroneous deposit, or another reason on the IRS's list. The IRS reserves the right to later challenge the rollover under certain circumstances.

## short takes

### Charitable Donations of Food Inventory

Generally, when a business donates inventory to a charity, a tax deduction may be claimed for an amount equal to the inventory's cost (basis). However, certain donations of food inventory may be eligible for an enhanced, above-basis deduction. The food must be "apparently wholesome" (as defined in the rules) and used by the charity for the care of the ill, the needy, or infants. Additionally, the deduction generally may not exceed 15% of the taxpayer's aggregate net income from all trades or businesses from which those contributions were made for that tax year (for C corporations, 15% of taxable income).

### "Reasonable Compensation" Need Not Be Low

If you own a C corporation, you know that your company is allowed to deduct your "reasonable" compensation. If the IRS deems the compensation to be unreasonable, payments may be recharacterized as a nondeductible dividend. However, "reasonable" doesn't necessarily mean "low." Instead, the IRS looks at a number of factors, including duties performed, relationship of compensation to gross and net income of the business, your compensation history, and the salary policy for all employees.

*The general information in this publication is not intended to be nor should it be treated as tax, legal, investment, accounting, or other professional advice. Before making any decision or taking any action, you should consult a qualified professional advisor who has been provided with all pertinent facts relevant to your particular situation.*

## Defer Income Through an Installment Sale

Structuring the sale of property so that payments will be received in installments can allow the seller to defer taxes on capital gains. Here are the general rules.

### Requirements

Generally, whenever at least one payment is to be received after the close of the tax year in which the sale occurs, the IRS requires the seller to use the installment method to calculate taxable gain for the year.\* Under this method, the taxable portion of payments received during the year is arrived at by calculating the "gross profit ratio" — generally the gross profit divided by the total contract price — and then multiplying that ratio by the installments received during the year.

For example, if the seller's profit is \$20,000 and the sale price is \$100,000, the gross profit ratio would be 20% ( $\$20,000/\$100,000$ ). Therefore, 20% of each payment is gain that is included in gross income.



### Restrictions

The installment method may not be used by dealers, for loss sales, or for sales of publicly traded securities. Also, restrictions apply for sales to "related persons." Additionally, sellers should be aware that where depreciation has been taken, some or all of the gain would be taxed as ordinary income in the year of sale. ■

\* Unless the taxpayer elects to recognize all the income in the first year or if the transaction is not eligible for the installment method

## Income in the Sharing Economy

If you provide car rides or rent out a spare bedroom for extra income, you may be part of the growing "sharing economy," in which individuals generate extra income by selling goods and services to contacts provided through the Internet. But whatever the source, this extra income will need to be accounted for at tax time.

Generally, income is taxable whether or not you receive a Form 1099-MISC (*Miscellaneous Income*), Form W-2 (*Wage and Tax Statement*), or some other form of income statement. However, how you generate income will affect how you account for that income and claim deductions against it.

Important issues to consider include the following:

■ *Employee versus independent contractor.* This is an important distinction to the IRS — one that controls your ongoing income tax and employment tax obligations. The determination of whether you are considered an employee or an

independent contractor will depend upon a number of different factors — rather than simply the label given to the arrangement by the parties.

■ *Withholding and estimated tax payments.* If you are an employee and you are unable to cover any additional tax obligations arising from your extra income through increased withholding, you may have to make estimated tax payments throughout the year.

■ *Depreciation.* If you use property, such as a car or a house, for business purposes, you may be able to take deductions for depreciation.

■ *Home rentals.* Special rules apply to rental income and allowable deductions from renting an apartment or a house.

■ *Business expenses.* Though you may deduct legitimate business expenses, you generally may not deduct personal, living, or family expenses.

We can help you sort through the relevant tax issues. ■

# Back to School (as an Adult)

You may be considering going back to school as an adult — whether to add depth to your current area of expertise or to pursue a different career path. If so, you'll want to analyze your options carefully and know which tax breaks are available.

## How Much Will It Cost?

As a first step, estimate your anticipated costs. These include not only tuition but also books, fees, transportation, and any day care you may need to secure for children and other dependents. Also factor in any time you may need to spend out of work while you obtain your education and perhaps search for a new job.

## Financial Aid

Financial aid generally comes in the form of either scholarships or, more frequently, federal loans. To apply for financial aid, you'll need to complete the *Free Application for Federal Student Aid* (FAFSA). If you're married, both your and your spouse's assets and income will be counted in determining your expected family contribution and the amount of aid that may be available to you.

**Scholarships.** Scholarships are generally not taxable as long as the recipient is a degree candidate at a qualifying educational organization, the award is not payment for services, and the award is used for tuition and required expenses (such as fees, books, supplies, and equipment) and not for room and board.

**Education loans.** If you take out a loan, you may be able to deduct a portion of your loan interest payments. Up to \$2,500 of interest expense per year on qualified higher education loans is potentially deductible. Among other requirements, the student must be a degree candidate carrying at least half the normal full-time course load. The deduction is subject to phaseout for taxpayers at higher income levels.

## Home Equity Loans

If you choose to use a home equity loan to pay higher education expenses, you may be able to deduct the interest on the loan. Generally, interest on a home equity loan may qualify for an *itemized* deduction if the underlying debt doesn't exceed \$100,000 (\$50,000 for a married taxpayer filing separately) and all

mortgages on the home do not exceed the home's fair market value.

## Employer Assistance

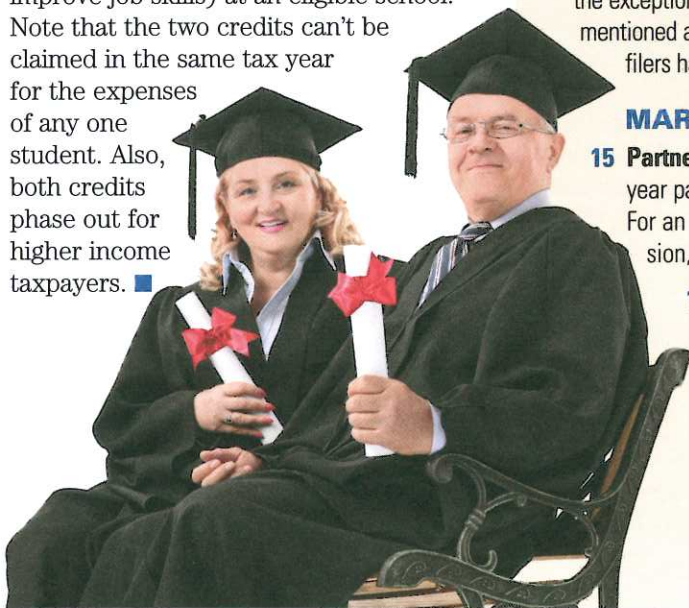
If your current employer has a valid educational assistance program in place, then employer-paid expenses are excludable from your income up to an annual maximum of \$5,250. The education need not be job related.

Employer-paid educational expenses may also be excludable if the education helps you (1) maintain or improve skills required in the business or (2) meet the express requirements of your employer or the law as a condition of retaining your salary, status, or employment.

If you choose to go it alone and pay such expenses yourself, know that they must be claimed as a miscellaneous itemized deduction, meaning they are deductible only to the extent that they — along with your other miscellaneous expenses — exceed 2% of your adjusted gross income.

## Tax Credits

If you cannot claim a deduction for education expenses, consider two other tax breaks for education expenses. The American Opportunity Tax Credit is available for up to \$2,500 per year for the payment of qualified tuition and related expenses for the *first four years of post-secondary education*. The Lifetime Learning Credit, worth up to \$2,000 annually, is available for any post-high school education (including graduate-level courses and courses to acquire or improve job skills) at an eligible school. Note that the two credits can't be claimed in the same tax year for the expenses of any one student. Also, both credits phase out for higher income taxpayers. ■



## Calendar of Filing Dates



### JANUARY

- 16 Individuals:** Pay last installment of 2016 estimated tax with Form 1040-ES. Or file 2016 income tax return and make full payment of any balance due by January 31, 2017.
- 31 Employers:** Distribute copies of Form W-2 for 2016 to employees and also file copies with the Social Security Administration.
- 31 Businesses:** Distribute Forms 1099 (or other information statements) to recipients of certain payments made in 2016. See us for more details.
- 31 Employers:** File Forms 1099-MISC if you are reporting nonemployee compensation payments in box 7.
- 31 Employers:** File Form 941, Employer's Quarterly Federal Tax Return; quarterly deposit due.
- 31 Employers:** File Form 940, Employer's Annual Federal Unemployment Tax Return, for 2016.

### FEBRUARY

- 10 Employers:** Deferred due date of Forms 940 and 941, if timely deposits were made.
- 15 Businesses:** Distribute Forms 1099-B, 1099-S, and certain Forms 1099-MISC to recipients of specified payments made in 2016. See us for more details.
- 28 Businesses:** File 2016 Forms 1099 (with the exception of certain 1099-MISC forms mentioned above) with the IRS. Electronic filers have until March 31 to file.

### MARCH

- 15 Partnerships:** File 2016 calendar-year partnership return (Form 1065). For an automatic six-month extension, file Form 7004.
- 15 S corporations:** File 2016 calendar-year S corporation return (Form 1120S). See us for more details about an automatic six-month extension.

## Like-kind Exchanges

If you are considering a trade of one property for another, you should consider how the tax law's "like-kind" rules would apply to the transaction. These rules provide for the deferral of otherwise taxable gain on certain types of trades.

### General Rules

The like-kind exchange rules permit property owners to trade certain appreciated property held for investment or for use in a trade or business for similar like-kind property without recognizing taxable gain. Instead, the owner transfers his or her "basis" (generally, the cost of the original property, plus improvements) to the new property.

**Example.** Bill exchanges land with a basis of \$200,000 for other investment property valued at \$240,000. Bill's taxable gain would typically be \$40,000 because he received \$240,000 in value for an asset with a basis of \$200,000. Under the

like-kind exchange rules, he currently has no gain to report, but his basis in the new property is \$200,000.

### Restrictions

Eligibility requires that properties exchanged be of "like kind." However, this requirement is broadly defined, so exchanges of real estate or of personal (non-real estate) property will generally qualify. However, some types of property — such as inventory and securities — won't qualify for like-kind exchange treatment. And if the exchange involves cash or other non-qualifying property, the receiving party will generally have to recognize gain to that extent.

Additionally, if the exchange is with a "related party" — generally, certain family members or a greater than 50%-owned corporation or partnership — gain must be recognized if either property is disposed of within two years.

### Vacation Property

The IRS has established a safe harbor rule for vacation homes, which are not typically held for investment/business use. The IRS won't challenge vacation home exchanges if the owner meets certain tests concerning length of ownership and rental/personal use throughout the relevant time periods.

Contact us if you would like to discuss these rules in more detail. ■

