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In This Issue...

Special Issue:

Protecting Americans from Tax Hikes (PATH) Act of 2015

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Brandon S. Collier, Editor

Collier & Associates, Inc.
30195 Chagrin Blvd., Suite #100
Cleveland, Ohio 44124
Phone: 216/765-1199
Fax: 216/831-8279
Email: newsletter@collieradvisors.com
Website: www.collieradvisors.com

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Special Issue

Protecting Americans from Tax Hikes (PATH) Act of 2015

On December 18, Congress passed and the President signed a bipartisan agreement on tax extenders and some new provisions. This will end the frustrating cycle of having to wait until the end of the year to see if our favored tax law changes would renew or expire. Most of these rules have been made permanent, although some have only been extended a few more years. When we say made permanent, this means of course, permanent until a future Congress sees fit to again change the rules. The PATH Act is loaded with Christmas goodies.

The new rules are very detailed and beyond the scope of a Newsletter such as this. We are covering the deductions and credits that will appeal to the most Newsletter readers and their family members, but first, a brief review of the difference between the two.

A Tax Deduction is Good; a Tax Credit is Better: The value of a tax deduction depends on the tax bracket on your last dollar earned (your "marginal tax bracket"). For example, if your income is high enough that you are in the highest (39.6%) federal tax bracket, a dollar of deduction reduces your taxable income by a dollar and that reduces your tax bill by 39.6 cents. If you are in the 28% bracket, a dollar of deduction would save you 28 cents. But a tax credit is different. A tax credit reduces your tax on a dollar-for-dollar basis. A dollar of credit therefore reduces your tax by a full dollar, regardless of whether your tax bracket was 28% or 39.6%.

Enhanced Expensing Under Tax Code Section 179 Made Permanent: Your equipment vendors will be elated. Starting in 2015, the first $500,000 of depreciable property can be expensed in the year of purchase rather than depreciated over the item's longer useful life. This was the rule in 2014, but like Cinderella at the Ball, the clock struck midnight on January 1, 2015, and the 179 limit dropped back to $25,000. The property can be new or used property, but it must be placed in service (not merely purchased) in the year for which you are claiming the deduction. If you bought a large amount of equipment in 2015, congratulations. You receive a retroactive tax break. The $500,000 will be indexed for inflation starting in 2016. Lastly, a new change makes air conditioning and heating units placed in service beginning in 2016 eligible for Section 179 expensing.

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Bonus First-Year Depreciation Extended Through 2019: If for some reason (such as building out a new office) you have more than $500,000 of 179 expensing, you can once again claim first-year "bonus" depreciation equal to 50% of the remaining purchase price of new (not used) property. The 50% rule applies for property placed in service in 2015-2017. It drops to 40% in 2018 and finally 30% in 2019.

Bonus Depreciation for Autos and Trucks is Likewise Revived for 2015-2019: Under the stingy depreciation rules that apply for automobiles, the first year deduction for passenger cars placed in service in 2015 is only $3,160. It's $3,460 for light trucks and SUVs with a gross (loaded) vehicle weight rating of 6,000 pounds or less. These amounts are indexed for inflation but rise slowly. For vehicles placed in service in 2015-2017, the $8,000 bonus depreciation rule applies, taking the first year deductions up to $11,160 and $11,460 (assuming 100% business driving). For 2018, the $8,000 drops to $6,400, and in 2019 in drops to $4,800, before once again phasing out.

Qualified Leasehold Improvements: Under sections 168(e)(3) and 168(k)(3) of the tax code, certain improvements made to an interior portion of a commercial building are qualified leasehold improvements and can now be depreciated over a reduced 15-year period, rather than the traditional 39-year period. To be "qualified" the improvement must: (1) be made under or pursuant to a lease by the lessee or lessor, (2) the interior portion is to be occupied exclusively by the lessee (or any sublessee), and (3) the improvement is placed in service more than three years after the date the building was first placed in service. Unfortunately, most leases between related parties (i.e., where the doctor owns both the building and the practice) won't count. In addition to the faster 15-year depreciation, qualified leasehold improvements are also eligible for $500,000 of expensing under Section 179 starting in 2015. And, interestingly, bonus depreciation will apply to the improvements even if there is no qualified lease. We take this to mean that even though these aren't qualified leasehold improvements eligible for 15-year depreciation and Section 179 expensing, "non-qualified" improvements will remain subject to 39-year depreciation but will get the benefit of 50% first-year bonus depreciation.

Reduction in S Corporation Built-In Gains Period Permanently Reduced from 10 to 5 Years: This is significant. An S corp is not subject to tax, but instead passes through its taxable income to its shareholders. If the corporation was formed as a C corp and later converts to an S corp, when that corporation sells off its assets at a gain (such as on a practice sale) the S corp will be continue to be taxed as a C Corp -- at the highest corporate rate of 35% -- unless the sale occurs at least 10 years following the conversion. That's been the standard rule, but lately Congress has flirted with a shorter time period of five years. The 5-year rule has now become permanent. It begins on the first day of the first tax year that the S conversion went into effect. Therefore, if your C corp converted to S status effective January 1, 2011, you will avoid the 35% corporate tax if your practice is sold on or after January 1, 2016.

State and Local Tax Deduction Made Permanent: This had expired at the end of 2014, but now applies for 2015 and future years. Taxpayers have a choice. They can claim an itemized deduction for either state and local income tax or a deduction for state and local sales tax. This is terrific for people living in a state without an income tax. You can elect to deduct the actual amount of sales taxes paid or an amount given by the IRS. Keep your receipts, because the actual amount paid will be substantially greater than the IRS's number.

Non-Taxable Charitable IRA Contributions Made Permanent: This had expired at the end of 2014 and many Newsletter subscribers (and charities) have been waiting to see if it would be revived. The good news is that it was revived and made permanent. If you are over age 70-1/2, you can direct up to $100,000 from your IRA to a charity, get credit for your required minimum distribution, and pay no income tax. The distribution is not taken into account as income which would adversely affect your Medicare Part B premiums and Social Security taxability. Qualified plans continue to be discriminated against in this regard. If you have a big plan and a small IRA, consider taking an in service distribution from the plan to the IRA and then making the charitable contribution from the IRA.

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Rollovers from Retirement Plans to SIMPLE IRAs Are Now Permitted: This includes 401(k) plans, traditional IRAs, governmental 457 plans and others. Only contributions made to those plans after December 18, 2015 (the effective date of the PATH law) can be rolled over, and the original plan must have been in effect for at least two years prior to the rollover. This could be useful for someone looking to improve their creditor protection by rolling their traditional IRAs into their practice SIMPLE plans. However, it will not help solve a "cream in the coffee" problem in a Roth IRA conversion, as pre-tax amounts in all IRAs, including SIMPLE IRAs, are taken into account in determining the taxable and tax-free portion of the Roth conversion.

Improvements to 529 Plans: Starting in 2015, the definition of "qualified higher education expenses" (for which tax-free distributions are permitted) includes computer equipment, software and internet services. Also, a refund of tuition paid from the 529 plan will not be taxable if the money is re-contributed to the 529 plan within 60 days.

Elimination of State Residency Requirement for ABLE Accounts: The original law required that the account be opened in the individual's home state. But, as with 529 plans, the accounts will now be allowed in any state. If the individual's home state offers lousy investment options, they can now shop elsewhere.

Exclusion for Work College Program Payments: Scholarships are not and have not been included in gross income. However, if the educational institution pays the student to teach or for research, those payments were generally treated as taxable income. Under the PATH Act, if these payments are made after December 18, 2015, they will be excluded from income.

Discharge of Home Mortgage Debt is Excludible from Income through 2016: A discharged debt typically creates taxable income. But, if the discharged debt was up to $2,000,000 of a mortgage on your principal residence, it was not includible in income. This provision had expired at the end of 2014 and has been reinstated for 2015 and 2016.

Mortgage Insurance Premiums are Deductible for 2015 and 2016: This had expired at the end of 2014 but is now extended for two more years. The insurance deduction phases out as the taxpayer's gross income rises from $100,000 to $110,000.

Work Opportunity Tax Credit Extended Through 2019: This is a tax credit for hiring veterans and those who've been long-term family assistance (LTFA) recipients. For veterans, the credit is 40% of first year wages up to a max of $6,000, or substantially more if the veteran suffered a service disability or has been unemployed for a long time. For welfare recipients, the credit is a percentage of wages (40% in year 1 and 50% in year 2) up to $10,000.

Captive Insurance Companies Will Look Slightly More Attractive: Under Section 831(b) of the tax code, a small "captive" insurance company does not pay tax on its premium income if the premiums don't exceed $1,200,000. The captive is only taxed on its investment income, and dividends ultimately paid out to the owners should be taxed at the lower dividend rate. Starting January 1, 2017, the premium threshold will rise to $2,200,000. Collier & Associates does not operate a captive insurance company. We are agnostic on this concept, though we are aware of several clients who have created a captive. We doubt any of them pay anywhere close to the current $1,200,000 premium threshold. If organized conservatively, this **may** pass muster, but be prepared for an audit and a fight.

Credit for Residential "Qualified Energy Property" Extended for 2015 and 2016: This is a tax credit for homeowners making improvements to their pre-existing principal residence for things like insulation, roofing, water heaters, HVAC units, windows, skylights and doors. The credit is 10% of the cost up to $500 for the improvements. Windows are limited to $200 of the credit. This is a lifetime credit, so it may have already been used up. One change going forward is that for 2016, exterior windows, skylights and doors must meet Version 6.0 of the Department of Energy's Star program requirements.

Residential Energy-Efficient Solar Credit Extended and Phased Out: The credit is 30%

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of the cost of qualifying residential solar energy property – equipment that uses solar energy to produce electricity, to heat or cool (or provide hot water) for a structure, but not for heating swimming pools. The 30% credit was set to expire after 2016, but has been extended for five more years. However, in the last two years (2020 and 2021, the credit drops to 26% and 22%).

Extension of Deduction for Energy Efficient Commercial Building Property: The deduction (generally $1.80 per square foot, but 60 cents per square foot in some cases) is effective for items that are part of the building's interior lighting systems, the heating, cooling, ventilation, and hot water systems, or the building envelope - and are placed in service in 2015 and 2016. This gives building owners an extra incentive for upgrading their systems - and for those building new structures, to design them in an energy-efficient manner. The deduction is available whether the building is new or used.

Alternative Fuel Vehicle Refueling Property Credit Extended for 2015 and 2016: The credit is 30% of the cost of installing non-hydrogen alternative vehicle refueling property – up to a set dollar maximum. An example would be the cost of installing the special 240-volt outlet that quickly charges a Tesla. If the outlet is installed in your home's garage, the credit is capped at $1,000. If installed at your office, it is capped at $30,000. The PATH Act did not modify the ongoing up-to-$7,500 federal income tax credit for the purchase of an electric or hybrid vehicle. For a list of vehicles that qualify for the credit, visit www.fueleconomy.gov/feg/taxevb.shtml.

Enhanced Child Tax Credit Made Permanent: This allows low income earners to claim a $1,000 tax credit for each child under age 17 that they can claim as a dependent. If the credit exceeds the taxpayer's income tax liability, the taxpayer will receive a "refund" from the U.S treasury equal to 15% of earned income in excess of $3,000. You might have a relative who can qualify.

Enhanced American Opportunity Tax Credit Made Permanent: The AOTC is a $2,500 tax credit for four years of post-secondary education. The credit phases out once income exceeds $80,000 (for singles) and $160,000 (for marrieds). Many readers will not qualify because of these income phase-outs. However, children earning a salary from their parents' practice and using that money to pay their tuition will be under the income thresholds and will qualify for the tax credit, essentially eliminating their tax liability.

Up-to-$4,000 Deduction for Higher Education Expenses Extended Through 2016: Up until 2014, a taxpayer could deduct up to $4,000 of tuition and related expenses for himself, his spouse and dependents. The $4,000 deduction phases down to $2,000 as the taxpayer's gross income rises from $130,000 to $160,000 ($65,000 to $80,000 for singles).

Enhanced Earned Income Tax Credit Made Permanent: Low income taxpayers will continue to be eligible for a refundable tax credit which increases with the number of children. The amount of the credit depends on whether you are married or single, your earned income and how many children you have. Generally, a family with three children and earned income up to $50,000 will qualify for a credit. Check with your CPA. Only 80% of people eligible for the EITC end up claiming it.

Deduction for Educator Expenses Made Permanent: Elementary and secondary school teachers can continue to claim a $250 deduction for out-of-pocket purchases of books, supplies, etc. This will be indexed for inflation, and starting in 2016, expenses for professional development will be deductible. This is an above the line deduction and not subject to the 2% of AGI limit for unreimbursed business expenses.

Increase in Excluded Employer-Provided Mass Transit and Parking Benefits Made Permanent: The tax laws had a preference for employer-provided parking benefits by permitting a tax-free fringe benefit of $250 per month. Employer-provided tax free transit passes (subway, buses, van pools, etc.) were limited to only $130 per month. The favoritism has been eliminated, and starting in 2015 the $250 limit now applies equally to transit passes.

Finally, please accept our wishes for a happy, healthy and prosperous new year!

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