Individual income tax planning

While opening the door to income tax planning is an important step to take throughout your life, many individuals see the myriad of taxes and the complicated rules behind them as a barrier to planning. We encourage you to not let this be the case for you. Your overall tax burden undoubtedly consumes a large percentage of your income. We believe that investing the time to understand the character of income that your activities and investments produce and the different taxes associated with those activities will lead you down the path to realizing a more tax-efficient result.

Today's increased tax rate environment
Individual income tax rates by type of income
Self-employment tax
Alternative minimum tax (AMT)
Health care taxes
State and foreign taxes
Year-round personalized planning
Resources

Today's increased tax rate environment

Before we discuss tax rates, it is important to briefly discuss how complex tax policy has evolved in recent years and led us to today's increased tax rate environment. We will discuss how we arrived at our current graduated income tax rate structure and also some of the additional taxes that may be assessed on your income.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) brought sweeping changes to the tax landscape in the early days of President George W. Bush's first term. The changes generally brought a reduction in tax rates that were to be phased in over nine years. Subsequently, the Jobs and Growth Tax Relief Reconciliation Act of 2003 accelerated the phase-in of those reductions. However, an original "sunset" provision of EGTRRA provided that the reduced rates would end on January 1, 2011, and revert back to their pre-EGTRRA levels. The sunset was included to ensure the legislation complied with certain parliamentary rules governing the budget reconciliation process under which EGTRRA was passed, specifically a rule that prevented the bill from increasing the deficit beyond the ten-year budget window.

The potential for the expiration of the reduced rates, as well as the reintroduction of various phase-outs that were gradually repealed under EGTRRA (*e.g.*, the "Pease" limitation on itemized deductions and the Personal Exemption Phase-out or "PEP"), loomed for years. This environment caused uncertainty for long-term income tax planning.

In 2010, Congress passed, and President Obama signed, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which extended the fully phased-in EGTRRA rate reductions and repealed phase-out provisions for two additional years, through 2012. Finally, in early January of 2013, Congress settled the issue by passing the American Taxpayer Relief Act of 2012 (ATRA). ATRA permanently extended the reduced tax rates for lower-and-middle-income taxpayers, but allowed the top tax rates to increase and return to pre-EGTRRA levels for upper-income taxpayers. ATRA also brought back, in permanent form, the Pease and PEP limitations for single taxpayers with adjusted gross income (AGI) over $250,000, or $300,000 for married filing jointly (MFJ) filers.

After periods of significant uncertainty and change, the individual income tax rates have remained static post-ATRA. However, the price of stability is today's increased tax rate environment.

Today's increased tax rate environment
Individual income tax rates by type of income
Self-employment tax
Alternative minimum tax (AMT)
Health care taxes
State and foreign taxes
Year-round personalized planning
Resources

Individual income tax planning

Today's increased tax rate environment

2016 and 2017 federal income tax brackets

Single

Tax rate on ordinary income	2016 over	2016 to	2017 over	2017 to	Tax rate on qualified dividends and long-term capital gains
10%	$0	$9,275	$0	$9,325	0%
15%	$9,275	$37,650	$9,325	$37,950	0%
25%	$37,650	$91,150	$37,950	$91,900	15%
28%	$91,150	$190,150	$91,900	$191,650	15%
33%	$190,150	$413,350	$191,650	$416,700	15%
35%	$413,350	$415,050	$416,700	$418,400	15%
39.6%	$415,050		$418,400		20%

MFJ/Qualifying widow or widower

Tax rate on ordinary income	2016 over	2016 to	2017 over	2017 to	Tax rate on qualified dividends and long-term capital gains
10%	$0	$18,550	$0	$18,650	0%
15%	$18,550	$75,300	$18,650	$75,900	0%
25%	$75,300	$151,900	$75,900	$153,100	15%
28%	$151,900	$231,450	$153,100	$233,350	15%
33%	$231,450	$413,350	$233,350	$416,700	15%
35%	$413,350	$466,950	$416,700	$470,700	15%
39.6%	$466,950		$470,700		20%

Today's increased tax rate environment

Individual income tax rates by type of income

Self-employment tax

Alternative minimum tax (AMT)

Health care taxes

State and foreign taxes

Year-round personalized planning

Resources

Today's increased tax rate environment

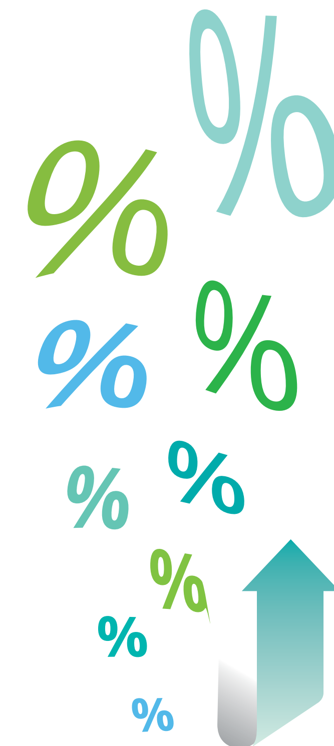
While relative stability was created for income tax rates, the Patient Protection and Affordable Care Act (PPACA), enacted in 2010, created two additional taxes to be assessed on individuals. The PPACA imposed the following taxes, effective as of January 1, 2013:

(1) A 3.8 percent net investment income tax (NIIT) on the net investment income of individuals, estates, and trusts, and

(2) A Federal Insurance Contributions Act Hospital Insurance (commonly known as Medicare Hospital Insurance or FICA-HI) tax that increased the employee share of Medicare taxes by 0.9 percent from 1.45 percent to 2.35 percent for wages received.

These additional taxes created great complexity and uncertainty. Although the law was passed in 2010, the Treasury Department did not issue proposed regulations until late 2012 and did not finalize those regulations until late in 2013. Given the issuance of the regulations, over time the application of these complicated statutory and regulatory provisions has become clearer, thus allowing individuals to better plan for these new taxes.

Despite potential changes or uncertainty in tax policy, we believe you should always be aware of and carefully analyze tax planning considerations. However, to the extent that change and uncertainty were an impediment to planning, now is the time to move forward given that we are in the midst of a relatively stable tax environment that may not last indefinitely. Presidential or Congressional changes could again create a period of uncertainty in the short or long term. We encourage you to take advantage of today's period of calm before that potential storm arrives by committing to thoughtful tax planning now.



Today's increased tax rate environment

Individual income tax rates by type of income

Self-employment tax

Alternative minimum tax (AMT)

Health care taxes

State and foreign taxes

Year-round personalized planning

Resources

Individual income tax rates by type of income

Categories of income	Categories of tax
Ordinary income	Income tax
Qualified dividends	Self-employment
Capital gains	Alternative Minimum Tax (AMT)
	Health care taxes
	State and foreign taxes

Ordinary income tax rates. If your primary source of income comes from employment, then you will generate ordinary income in the form of wages, salaries, tips, commissions, bonuses, and other types of compensation. Other investments may also generate ordinary income in the form of interest, nonqualified dividends, net income from a sole proprietorship, partnership or limited liability company (LLC), rents, royalties, or gambling winnings. For 2016 (and 2017), the top marginal ordinary income tax rate is 39.6 percent for single taxpayers with income more than $415,050 ($418,400) and married taxpayers with income more than $466,950 ($470,700). Ordinary tax rates continue to range from 10 percent to 39.6 percent and will remain in place permanently until further reform.

Tax rates on qualified dividends. We will refer to qualified dividend income as tax preferential income since the top qualified dividend rate is 20 percent for taxpayers in the top 39.6 percent bracket. This contrasts to the 39.6 percent top rate assessed on ordinary income. For taxpayers in the 25 percent through 35 percent ordinary income tax brackets, the top rate on their qualified dividend income is 15 percent, and for those taxpayers in the two lowest ordinary income tax brackets, their qualified dividend rate is zero percent. Note that in addition to these rates, qualified dividends may also be subject to the 3.8 percent NIIT.

Long-term capital gains tax rates. If you have invested in a capital asset, then the gain on the sale or exchange of such an asset results in capital gain. The long-term capital gains tax rate, assessed on capital assets held for greater than one year, is 20 percent for taxpayers in the top 39.6 percent tax bracket, 15 percent for taxpayers in the 25 percent through 35 percent tax brackets, and zero percent for those taxpayers in the two lowest tax brackets. Given the reduced rates on long-term capital gains, we will also refer to this income as tax preferential income.

2016 (and 2017) long-term capital gains rates

Taxable income less than threshold
$37,650 ($37,950) single;
$75,300 ($75,900) for MFJ

Taxable income
Over $37,650 ($37,950), but less than $415,050 ($418,400) single;
over $75,300 ($75,900), but less than $466,950 ($470,700) for MFJ

Taxable income greater than or equal to threshold
$415,050 ($418,400) single;
$466,950 ($470,700) for MFJ

Today's increased tax rate environment
Individual income tax rates by type of income
Self-employment tax
Alternative minimum tax (AMT)
Health care taxes
State and foreign taxes
Year-round personalized planning
Resources

Individual income tax rates by type of income

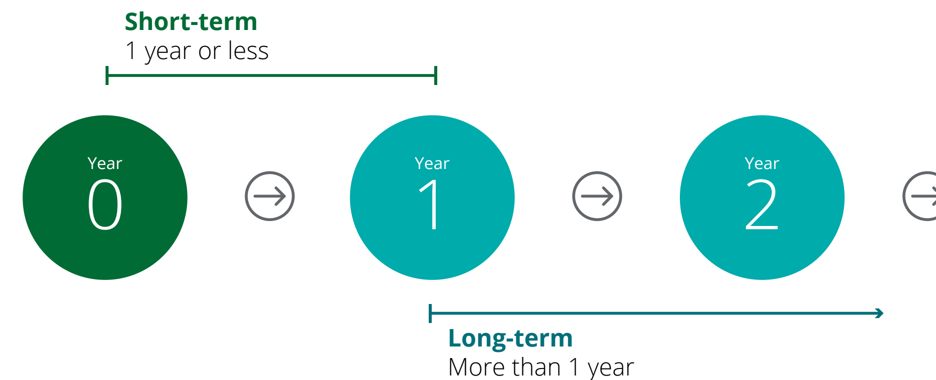
Given the tax preferential nature of long-term capital gain income, special attention should be given to the holding period of an asset to take full advantage of the long-term capital gain rates.

Certain sales of capital assets do not qualify for the lower capital gains rate. A "short-term capital gain"—or gain on the sale of an asset held for one year or less—is still a capital gain, but is taxed at ordinary income tax rates. Although short-term capital gains are taxed at the same rate as ordinary income, a benefit to short-term capital gains is that they can be offset with capital losses since an individual will net his or her capital gains and losses in arriving at their total capital gain income. Note that if capital losses exceed capital gains, a taxpayer can only deduct up to $3,000 of net capital losses against other income—the balance of their net capital loss is to be carried forward to future years.

Gains from installment sales are taxed at the rate in effect on the date an installment payment is received. Collectibles remain subject to a 28 percent maximum rate.

It is important to remember that more than one type of tax may apply to the same character of income. Therefore, we will now discuss additional taxes that may apply, including employment taxes, AMT, and NIIT.

Holding period



Today's increased tax rate environment
Individual income tax rates by type of income
Self-employment tax
Alternative minimum tax (AMT)
Health care taxes
State and foreign taxes
Year-round personalized planning
Resources

Self-employment tax

If your income is generated by operating a business as a sole proprietor, a partner in a partnership, or a member of a multi-member LLC, you usually are also subject to self-employment tax in addition to your ordinary income tax. The self-employment tax rate is 12.4 percent for social security tax on self-employment income up to $118,500 for 2016 ($127,200 for 2017) and 2.9 percent for Medicare taxes on all self-employment income. These taxes are in addition to the FICA-HI tax. Once self-employment tax has been calculated, then half of that amount is deductible when calculating overall AGI for that year.

FICA taxes

FICA	2016 base	2017 base	Employee rate	Employer rate	Total
Social Security	$118,500	$127,200	6.20%	6.20%	12.40%
Medicare	**Unlimited**	**Unlimited**	**1.45%**	**1.45%**	**2.90%**
FICA-HI	$200,000 Single $250,000 MFJ	$200,000 Single $250,000 MFJ	0.90%	N/A	0.90%
Total			8.55%	7.65%	16.20%

Today's increased tax rate environment

Individual income tax rates by type of income

Self-employment tax

Alternative minimum tax (AMT)

Health care taxes

State and foreign taxes

Year-round personalized planning

Resources

Alternative minimum tax (AMT)

The AMT has evolved into an unwieldy system that continues to ensnare millions of unsuspecting taxpayers. AMT is imposed at a nearly flat rate on an adjusted amount of taxable income above a certain threshold, which is also known as an exemption. The exemption is substantially higher than the exemption from regular income tax. The AMT exemption is indexed for inflation and phased out as taxpayers reach higher levels of AMT income. For 2016 (and 2017), the AMT exemption amount for single filers is $53,900 ($54,300) and begins to phase out at $119,700 ($120,700) . It is $83,800 ($84,500) for MFJ filers, for whom the exemption begins to phase out at $159,700 ($160,900).

The ability to apply most nonrefundable personal credits (including the Dependent Care Credit, the credit for the elderly and disabled, the credit for interest on certain home mortgages, and the Hope Education Credit) against the AMT expired at the end of 2011, but was reinstated again on a permanent basis as part of ATRA.

Now that the difference between the highest ordinary income tax rate and the highest AMT rate has increased, as has the AMT exemption, it is likely that fewer taxpayers will be subject to AMT going forward. Still, in order to navigate the AMT, taxpayers must be especially mindful of year-end cash payments, such as fourth quarter state income taxes (especially in states with high rates), prepayment of investment and tax advisor fees, and charitable contributions. Falling victim to AMT has many possible causes, but you may be particularly prone to AMT if you have any of the following circumstances:

- Large state and/or local income, sales tax or property tax deductions
- Large long-term capital gains or qualified dividends
- Large deductions for accelerated depreciation
- Large miscellaneous itemized deductions
- Mineral investments generating percentage depletion and intangible drilling costs
- Research and development expenses in activities in which you do not materially participate
- An exercise of incentive stock options
- Large amounts of tax-exempt income that is not exempt for state tax purposes
- A large number of dependents
- Tax-exempt income from private activity bonds

Current-year planning around timing of the payment of expenses that constitute itemized deductions not deductible under the AMT system is certainly important, but it may not be enough. In addition, projecting taxable income from hedge and private equity funds, as well as managing private activity bonds, are among activities that take on special significance. More than ever, meaningful AMT planning requires examining multi-year scenarios.

Today's increased tax rate environment
Individual income tax rates by type of income
Self-employment tax
Alternative minimum tax (AMT)
Health care taxes
State and foreign taxes
Year-round personalized planning
Resources

Health care taxes

As we have previously discussed the creation of the heath care taxes, it is now important to put the taxes in the context of how they apply to particular types of income. Note that each of these taxes are in addition to other taxes that are assessed on these types of income.

NIIT. An additional 3.8 percent NIIT is imposed on unearned income (income not earned from a trade or business and income subject to the passive activity rules), such as interest, dividends, capital gains, annuities, royalties, rents, and income from businesses in which the taxpayer does not actively participate. Because the tax applies to "gross income" from these sources, income that is excluded from gross income, such as tax-exempt interest, will not be taxed. The tax is applied against the lesser of the taxpayer's net investment income (after investment-related and allowable deductions) or modified AGI in excess of the threshold amounts. These thresholds are set at $200,000 for single filers and $250,000 for MFJ filers. Some types of income are exempt from the tax, including income from businesses in which the taxpayer actively participates, gains from the disposition of certain active partnerships and S corporations, distributions from qualified plans and individual retirement accounts, wages, and any item taken into account in determining self-employment income.

NIIT

A **3.8%** tax levied on certain unearned income of individuals with AGI over $200,000 ($250,000 for MFJ filers).

Net investment income

means the excess of the sum of gross income from the following over allowable deductions:

- Interest
- Dividends
- Capital gains
- Annuities
- Rents and royalties
- Passive activities and trading partnerships

Does **NOT** apply to:

- Wages
- Self-employment income
- Distributions from qualified plans
- Income that is derived in the ordinary course of a trade or business and not treated as a passive activity

FICA-HI tax. An additional 0.9 percent FICA-HI tax applies to earnings of self-employed individuals or wages of an employee received in excess of $200,000 ($250,000 if MFJ). Self-employed individuals will not be permitted to deduct any portion of the additional tax. If a self-employed individual also has wage income, then the threshold above which the additional tax is imposed will be reduced by the amount of wages taken into account in determining the taxpayer's liability.

FICA-HI Tax

Employee share increases by **0.9%** (2.35%, up from 1.45%) for individual's wages, compensation, or self-employment income that exceeds threshold amount for filing status:

MFJ	Married filing separately	Single
$250,000	**$125,000**	**$200,000**

Self-employed individuals are not permitted to deduct any portion of the additional tax.

This change does not change the employer hospital insurance contribution.

Today's increased tax rate environment

Individual income tax rates by type of income

Self-employment tax

Alternative minimum tax (AMT)

Health care taxes

State and foreign taxes

Year-round personalized planning

Resources

Individual income tax planning

State and foreign taxes

Now having worked our way through the various federal taxes that can be assessed, there are still income taxes from other jurisdictions to be addressed. While a thorough discussion of all possible taxes imposed by states or foreign countries is not the purpose here, no income tax planning exercise is complete without considering the potential for taxes from all possible jurisdictions.

States such as Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not have individual income taxes, but most states do—with California having the highest rate of more than 13 percent. If an individual is subject to income taxes in multiple states, it may be possible to generate a state tax credit in the resident state to reduce the overall tax burden.

Individual consumers may also be subject to sales and use taxes. When the governing body collects the tax at the point of purchase, it is called a sales tax. Alternatively, when a tax on goods or services is paid to a governing body directly by a consumer, it is usually called a use tax. The imposition of these taxes may be an important consideration when an investment is a commodity, such as an airplane or art.

Finally, if income is earned in a foreign jurisdiction, then it may be subject to foreign taxes. Similar to the state tax credit, a foreign tax credit may be available when income is subject to tax in multiple jurisdictions.

Today's increased tax rate environment
Individual income tax rates by type of income
Self-employment tax
Alternative minimum tax (AMT)
Health care taxes
State and foreign taxes
Year-round personalized planning
Resources

Year-round personalized planning

With a solid understanding of the various taxes that may be assessed on your income and an understanding of the importance of planning for this meaningful liability, you are now equipped to consider the issues that are presented to you based on your personal tax situation. When we say considerations, we like to think of those as levers that you can engage.

What lever can you pull that may position you for a potentially more tax-efficient result?

Maybe your lever is to take steps to defer income to a subsequent year, or maybe it is to accelerate a deduction or expense into the current year. Either way, think of these levers as tools within your control that you can use to affect your tax result. By implementing a long-term commitment to holistic tax planning, you likely will identify many different levers to consider each year and position yourself to navigate today's increased tax rate environment more efficiently.

To be more effective in your efforts, it is best to not think of your tax situation based on the income you expect to realize or the deductions you expect to incur. To only think of income planning approaches or deduction planning strategies is to think in a vacuum. That is not the way that it works when you file your taxes—everything is taken into consideration when calculating your tax bill. So we encourage you to think of planning here as a year-round process, taking into consideration all the levers you can pull, be they income or deduction decisions—to create a more efficient tax result.

As you think about this, keep in mind that the levers you will consider will be different than levers someone else would consider because each of us has a unique tax posture and different goals and objectives.

There is no one-size-fits-all approach that applies to everybody. You should focus on your planning based on your own specific fact pattern and objectives. Even if your income posture is identical to someone else's, maybe you are charitably inclined and they are not. Perhaps both of you are charitably inclined, but you plan to fund your charitable donations soon whereas the other person plans to fund his or her donations as part of an estate plan. So your levers become very specific and unique to you based on your tax posture and your personal goals and objectives. Understanding this is critical in tax planning because it shines a direct light on specific considerations for tax efficiencies for you and facilitates the pursuit of your goals and objectives.

As part of your long-term commitment to holistic tax planning, recognize that each year may present different issues based on that specific year's activity. For example, maybe this year you have a significant ordinary income event, but you expect a significant long-term capital gain event next year. Maybe this year you expect an operating loss from your business enterprise, but next year you project the business to turn around and be highly profitable. The likelihood of anticipated legislative changes will also need to be

Today's increased tax rate environment

Individual income tax rates by type of income

Self-employment tax

Alternative minimum tax (AMT)

Health care taxes

State and foreign taxes

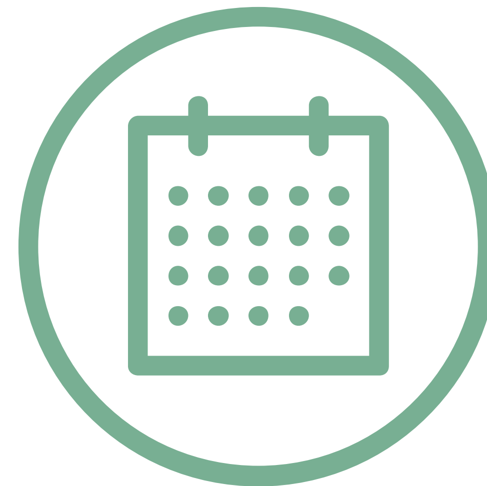
Year-round personalized planning

Resources

Year-round personalized planning

considered. As a result, steps you would take in one year compared to the next year to create an efficient tax result may vary greatly. For example, the levers you will consider in years with large amounts of tax preferential, low-rate income will likely need to be vastly different than the levers you would consider in years where you expect significant levels of high-rate ordinary income. Similarly, the levers you will pull if you expect tax rates to increase or decrease in future years will cause you to consider pulling levers that you will not otherwise consider.

To start to think about this in more detail, we encourage you to consider the character and the timing of your income and your deductions, as not all items of income or deductions are equal. As reviewed earlier, some income is subject to ordinary tax rates as high as 39.6 percent, like wages, whereas some income, like long-term capital gains or qualified dividend income, is subject to tax preferential rates that only go as high



as 20 percent. Some items of income are more easily controllable when you recognize the income event, for example, when to realize the long-term capital gain that is currently in your portfolio. Other items of income may be less controllable by you, such as the amount and timing of your company bonus.

The issue is even more complex for your deductions. Some deductions are easily controllable in terms of their timing, like your charitable contributions, but may still carry an array of tax issues, such as the funding of that charitable donation (cash versus stock versus other assets), let alone the optimal year to fund the donation. Some deductions are less controllable, like interest expense and real estate taxes, as you generally pay those when they become due. If that is not enough, consider that some deductions may provide significant value if you are not subject to the AMT, but those same deductions may provide no benefit if you are subject to AMT. Just because you are in AMT this year does not mean you will be in next year. Your deduction may reduce your taxes by 39.6 percent if it offsets ordinary income, only 20 percent if it offsets long-term capital gains, or absolutely zero percent if you are in AMT. As you digest this, you can begin to see that controllability is a significant lever for you to consider for both income and deduction items.

Today's increased tax rate environment
Individual income tax rates by type of income
Self-employment tax
Alternative minimum tax (AMT)
Health care taxes
State and foreign taxes
Year-round personalized planning
Resources

Year-round personalized planning

Putting all of this into perspective may be easier when you consider these important points:

1. Items that are controllable provide flexibility for determining the more optimal time for tax recognition of that item. This is equally applicable to items of income as it is to items of deduction.

2. Some items are automatically going to occur—you will pay your real estate taxes when they are due (or face a penalty for not doing so), and you will earn your wages when they are earned. Often these automatic events lay the foundation of your planning. In essence, enhance the efficiency you can gain from your controllable events against the backdrop of your noncontrollable events.

3. Controllable deductions may be one of your biggest levers. Again, an example would be when and how do you want to fund your charitable gifts. Will you use securities or an alternative asset? Recognizing that there are more efficient ways to fund these deductions—both in terms of the when and the how—allows you to reach a greater level of tax efficiency.

4. Your personal tax situation will afford you some additional considerations today, in future years, and in some instances, even prior years. Making sure you review it holistically and commit to thoughtful tax planning is likely to position you to realize a greater degree of tax efficiency than you otherwise might expect.

5. Do not lose sight of the fact that if you are an owner of, or invest in, passthrough entities, the more thoughtful planning that you may need to undertake to position yourself for an efficient tax result may be planning within those entities as opposed to planning by you directly. Failing to coordinate tax planning between a flow-through entity and the owners of that flow-through entity will likely undercut tax efficiency.

6. Before acquiring new investments, take time to understand the character of the income that will be generated by the investment as well as when you will recognize the income. Furthermore, analyze whether you will benefit from the expenses and losses allocated to you. The deduction for some expenses may be limited by the itemized deduction phaseout provisions or added back under the AMT regime. Furthermore, losses may be disallowed in the current year if you are subject to the passive loss rules. Failing to understand the character of income and expenses that the passthrough entity will pass through to you may lead to unwelcome surprises when you receive the final tax information.

This guide is meant to help you apply these considerations to your unique goals and objectives and open the door to tax-efficient planning with your advisor.

Resources

Private wealth	Private Wealth: Sustain, enhance and protect your wealth
Tax policy and elections	Tax News and Views
Individual income tax planning	Private wealth tax controversies: Deep experience navigating interactions with taxing authorities US Estate and gift tax rules for resident and nonresident aliens
Wealth transfer planning	Wealth Planning: securing your legacy Private Foundations: Establishing a vehicle for your charitable vision
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