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IRS releases 2016 inflation-adjusted numbers

On October 21st, the IRS released its 2016 inflation-adjusted numbers (see Revenue Procedure 2015-53 and IR-2015-118). Because inflation is low, some numbers haven't budged from last year, and others show only slight increases. Here is a selected run-down of these figures, along with other points to keep in mind:

Income tax – top brackets. The top two rate brackets ***for individuals*** are 35% and 39.6%, which will apply to taxable income that exceeds the following amounts:

	35%	39.6%
Married filing jointly, surviving spouses	$413,350	$466,950
Heads of households	$413,350	$441,000
Single taxpayers	$413,350	$415,050
Married filing separately	$206,675	$233,475

The income ranges for the 10%, 15%, 28% and 33% rate brackets all differ (and yes, there really is only a $1,700 difference between the 35% and 39.6% rate for single taxpayers).

Trusts and estates have extremely compressed rate brackets, and are not eligible for the 35% rate; they hit the 33% and 39.6% rates if their taxable income exceeds the following amounts:

33%:	$ 9,050 (same as 2015)
39.6%:	$12,400

"Kiddie tax." The "kiddie tax" applies to: a) children under age 18, and b) children who don't earn more than half of their own support and are i) age 18 or ii) full time students, ages 19-23. This means that if these children have more than $2,100 of unearned income (the same as in 2015), it will effectively be taxed at their parent's top rate. ("Unearned income" refers to items such as interest, dividends and capital gains.) Note that if parents elect to report their child's unearned income on their own income tax return, that income will factor into the parents' calculation for the 3.8% tax on net investment income (see below); if the child is married and files a joint return, the kiddie tax does not apply.

AMT Exemption. The alternative minimum tax (AMT) is a parallel tax system that originally targeted a relative handful of wealthy taxpayers, but now reaches deep into the middle class. Taxpayers especially vulnerable to the AMT are those who live in high-tax states and have large itemized deductions for state and local taxes, or those with large families and numerous personal exemptions for their dependents (but see the personal exemption phase out below). The AMT exemption is now permanently indexed for inflation; the 2016 exemption amounts are as follows:

Married filing jointly:	$83,800
Heads of households & single taxpayers:	$53,900
Married filing separately:	$41,900
Estates and trusts:	$23,900

AMT brackets. The 26% AMT rate applies to alternative minimum taxable income (AMTI) up to the threshold amounts below; the 28% rate applies to AMTI above these amounts:

Married filing jointly, single taxpayers, estates & trusts:	$186,300
Married filing separately:	$ 93,150

Standard deduction. The standard deduction reduces a taxpayer's taxable income, and is used when a taxpayer does not "itemize" deductions for payments such as state and local income taxes and mortgage interest, and charitable contributions. As with many itemized deductions, the standard deduction does not count against the AMT. The 2016 standard deduction is as follows:

Married filing jointly & surviving spouses	$12,600 (same as 2015)
Heads of households	$ 9,300
Single taxpayers & married filing separately	$ 6,300 (same as 2015)

Personal exemption and phase-out. Taxpayers get a personal exemption for themselves and for each of their dependents (usually, their children). Regardless of filing status, the 2016 personal exemption is $4,050. Yet taxpayers whose adjusted gross income (AGI) exceeds a threshold amount will see those exemptions phased out – and disappear completely – if they have "too much" AGI (the phase-out is 2% for every $2500 of AGI over the threshold amount; AGI refers to total income minus certain "above-the-line" deductions, such as those for alimony paid or one-half of the self-employment tax). **PEP** (the personal exemption phase-out) will apply as follows in 2016:

	AGI Threshold: Phase-out Begins	AGI: Exemptions Fully Eliminated
Married filing jointly, surviving spouses	$311,300	$433,800
Heads of households	$285,350	$407,850
Single taxpayers	$259,400	$381,900
Married filing separately	$155,650	$216,900

"Pease limitation." Taxpayers with "too much" AGI can see most of their itemized deductions reduced by the lesser of 3% of AGI over the PEP threshold amounts listed above or 80% of those itemized deductions. This limitation applies to all itemized deductions *except* those for medical expenses, investment interest, and casualty, theft and wagering losses; in other words, "Pease deductions," such as those for state and local taxes, mortgage interest and charitable contributions may get a "haircut." Note, however, that unless a taxpayer's AGI is exponentially higher than her Pease deductions, that haircut will likely be limited to 3%.

Retirement accounts:

- **IRAs.** The contribution limit for IRAs will still be $5,500. Taxpayers who are ***at least 50*** can make ***"catch-up" contributions*** of $1,000 (this number is frozen and is not indexed for inflation).

- **Roth IRAs.** Roth IRAs are funded with after-tax dollars, and have the same contribution limits as the IRAs mentioned above. Taxpayers can't contribute to a Roth, however, if they have "too much" modified adjusted gross income (this is generally the same as adjusted gross income). In 2016, contributions will be phased-out at the following income levels:

Married filing jointly:	$184,000 to $194,000
Heads of households & single taxpayers:	$117,000 to $132,000
Married filing separately (not indexed):	$ 0 to $ 10,000

  Note: as of 2010, any taxpayer – regardless of income level and filing status – can convert a "traditional" IRA into a Roth, a move that may trigger significant current income tax.

- **401(k) contributions and other elective deferrals.** The contribution limit for deferred plans such as 401(k)s will still be $18,000, and ***catch-up contributions*** for taxpayers who are ***at least 50*** will still be $6,000.

Estate and gift taxes:

- **Basic exclusion amount.** The basic exclusion amount protects transfers from gift and estate taxes, and will rise to $5.45 million from $5.43 million (a $20,000 increase from 2015); this means that a married couple will be able to protect a total of $10.9 million from gift and estate taxes.

- **Generation-skipping transfer tax (GST) exemption.** The GST exemption protects transfers to people such as grandchildren from GST, an additional transfer tax. Because the GST exemption equals the basic exclusion amount, it too will rise to $5.45 million in 2016. This means that with proper planning, a married couple will be able to protect $10.9 million from GST in 2016.

- **Annual exclusion gifts.** These gifts will still be ***$14,000 per donee***, or $28,000 if the taxpayer's spouse joins in the gift. (Such gifts do not erode the basic exclusion amount.)

- **Annual exclusion gifts to non-citizen spouses.** These gifts rise to $148,000 (up from $147,000).

Social Security. The Social Security Administration recently announced that there will be no cost of living increase in Social Security benefits for 2016. While Social Security recipients may not be happy to hear this, wage earners may be pleased at what this means: in 2016, the amount of maximum taxable earnings subject to the 6.2% payroll tax will be the same as what it was in 2015: $118,500. (The 6.2% payroll tax represents the OASDI, or old age, survivors and disability insurance portion of FICA, the Federal Insurance Contributions Act.) The 1.45% Medicare hospital insurance portion of FICA applies to an unlimited amount of wages, and increases by another 0.90% (90 basis points) for wage income that exceeds $200,000 (single taxpayers), $250,000 (married filing jointly) and $125,000 (married filing separately) – bringing the total Medicare tax for wage income above those amounts to 2.35%. Once a wage-earner's income exceeds $200,000, the employer is required to withhold additional Medicare tax, regardless of the wage-earner's filing status. (These income thresholds are NOT indexed for inflation.)

3.8% tax on net investment income. Like the additional 0.90% Medicare tax on wage income above certain thresholds (see above), the 3.8% tax on net investment income took effect in 2013; both were part of the Affordable Care Act, or "Obamacare," as many refer to it. Net investment income refers to items such as interest, dividends, capital gains and royalties. The 3.8% tax can apply if the taxpayer's modified adjusted gross income (AGI plus otherwise excluded foreign income) exceeds the same $250,000 / $200,000 / $125,000 threshold amounts that apply to the 0.90% Medicare tax – again, thresholds that are *not* indexed for inflation. Unlike the 0.90% additional Medicare tax, there is no automatic withholding for the 3.8% tax, a factor to consider in being "current" with tax payments (see below).

Other points:

- **Charitable IRA rollovers.** Congress has not yet acted on an "extenders" bill to continue some 50+ temporary tax benefits that expired at the end of 2014, including charitable IRA rollovers. This provision has allowed taxpayers who are at least 70½ to give up to $100,000 from their IRA directly to a public charity, provided that certain requirements are met. (The distribution counts towards the taxpayer's "required minimum distribution" for the year, is not included in taxable income, and is not eligible for a charitable deduction.) Although extenders legislation is on Congress's "to do" list, it is unclear when this legislation may pass, even though it has bipartisan support.

- **Being "current" with tax payments.** To avoid interest and penalties on underpayments of income tax, taxpayers must be current with their tax obligations. This means that taxpayers must either pay in 90% of their current year's liability (through a combination of withholding and quarterly estimated tax payments) OR avail themselves of the so-called "safe harbor": paying in 100% of their prior year's income tax liability (or 110% if their prior year's adjusted gross income exceeded $150,000 (or $75,000 if they are married filing separately)).

- **Same-sex married couples.** On June 26, 2013, the Supreme Court decided *Windsor*, which held that Section 3 of the Defense of Marriage Act was unconstitutional by defining marriage as only between a man and a woman. The IRS followed up on *Windsor* with Revenue Ruling 2013-17, which provided that effective September 16, 2013, same-sex married couples would be treated as married for *all* federal tax purposes. That meant that married same-sex couples who were used to filing as single taxpayers (or as head of household if one partner had a child) began filing as married (jointly or separately); whether that filing status carried through to the state level, however, depended on whether the couple's state of residence recognized their marriage. On June 26, 2015, the Supreme Court decided *Obergefell*, which held that states must issue licenses for same-sex marriages and must recognize same-sex marriages that were lawfully performed in another state. Thus, same-sex married couples who have had a mismatch between their filing status for federal and state purposes should now find that they are treated as married for state purposes as well.

- **"Married" versus "single" filing status.** The "marriage bonus" may reduce a married couple's federal taxes if the spouses have a significant income disparity, but the "marriage penalty" could significantly increase the couple's taxes if they have similar amounts of income; in addition, a married couple is more likely to be caught by the 3.8% tax on net investment income. That is because an unmarried couple can have household income of $400,000 ($200,000 each) and not be subject to the net investment income tax; a married couple, however, can be subject to the 3.8% tax at $250,000 of household income – (see above). (Note that individuals in a civil union or a registered domestic partnership are treated as single taxpayers for federal tax purposes.)

- **Avoid the wash sale rule.** The end of the year is often when taxpayers look carefully at their investment portfolios and "harvest losses" to offset realized gains. So if Mom, for example, is selling stock or securities that are worth less than her "adjusted basis" (generally, what she paid for the asset), she'll be caught by the wash sale rule if she repurchases those same assets within 30 days before or after the sale (even if she repurchases them in her IRA). If the wash sale rule applies, Mom can't take the current loss – it's added to the cost basis of the repurchased stock or security and is thereby deferred (there's no problem if Mom is merely selling winners and "harvesting gains").

Things to remember for year-end gifts:

- **Gifts to individuals.** Time is running out for 2015 annual exclusion gifts of $14,000 to family and friends ($28,000 for a married donor whose spouse agrees to the gift). Cash gifts may be given up to 11:59 p.m. on December 31st and still count as a 2015 gift. Checks, however, must be cashed *before* January 1, 2016 to count as 2015 gifts (p.s.: the generous donor must also stay alive until the bank makes good on the check).

  In addition to annual exclusion gifts, generous donors can make direct payments for tuition, medical expenses and health insurance premiums – none of which count against the donor's $5.43 million basic exclusion amount.

- **Gifts to charities.** For last-minute gifts to charities to qualify as a 2015 deduction, the check must be sent *before* January 1, 2016 (it need not be cashed before then, however).

No more closing letters – unless requested

This past June, the IRS quietly announced on its online "Frequently Asked Questions on Estate Taxes" that it will no longer issue closing letters for estate tax returns filed on or after June 1, 2015 unless the executor requests one (a closing letter means that the IRS has either accepted the return as filed, or that the return was audited and proposed adjustments have been agreed to). To request a closing letter, the executor should a) wait at least four months after filing the return and b) call the toll-free number listed on the website and provide the decedent's name, date of death and Social Security number. (No address is provided for making a written request.) Since this announcement, a Treasury Department official has stated that information will soon be forthcoming as to how executors can instead request a coded transcript of the estate tax return (this is supposed to offer the same finality as a closing letter), and that executors should please think hard about whether they really need that closing letter.

The IRS presumably made this change because a) budget and staffing cuts have taken their toll, and b) many of the estate tax returns they now receive are well under the current $5.43 million filing threshold: such returns are being filed for "portability" purposes, which allows a deceased spouse's unused exclusion – up to

$5.43 million in 2015 – to carry over to the surviving spouse. Considering that such estates offer no prospect of current revenue, why squander precious resources on a closing letter?

The bottom line is that executors of estates over the filing threshold will presumably still want a closing letter, and have one more item to put on their administration checklist. Good luck getting through on that toll-free number, however!

November 7520 rate

The IRS has issued the November 2015 applicable federal rates: the November 7520 rate remains at 2.0%, where it was in October. The November mid-term rates are: 1.59% (annual), 1.58% (semiannual and quarterly) and 1.57% (monthly). The October mid-term rates were: 1.67% (annual), 1.66% (semiannual and quarterly) and 1.65% (monthly).

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