2016 Year-End Tax Reminders

November 2016

Income Tax Rates

1. The following federal tax rates now apply to most types of capital gains for taxpayers in the highest tax brackets: 39.6% (short-term), 28% (collectibles) and 20% (long-term), plus 3.8% Net Investment Income Tax (discussed below). When harvesting losses and triggering gains, gains and losses are netted within each rate group. If there is a net loss in any group, net losses are applied to net gains taxable at the highest rates first. Any remaining net gain will be taxed at the applicable tax rate. Any remaining net loss may only be taken against ordinary income up to $3,000, and thereafter may be carried forward to future tax years.

   • As a result of the Affordable Care Act, an additional tax of 3.8% is imposed on the “Net Investment Income” (generally, interest, dividends and capital gains); effectively raising the above-mentioned three rates to 43.4% (short-term), 31.8% (collectibles) and 23.8% (long-term) for high income earners (in 2016 $250,000 for a married couple filing jointly). A 0.9% Additional Medicare Tax will be applied to the earned income that exceeds the stated thresholds (e.g. a married couple with $300,000 of earned income would pay the additional 0.9% tax on $50,000).

   • In 2016, taxpayers in the two lowest tax brackets – the 10% or 15% tax brackets – pay a capital gains rate of 0%. In appropriate circumstances, parents considering gifts to children should consider transferring low-basis assets to take advantage of the 0% tax bracket, being cognizant of the “kiddie tax” (discussed in more detail below) applicable to children under age 19, or under age 24 if the child is a full-time student who remains dependent.

   • The 15% tax bracket tops out at $37,650 of AGI for single taxpayers or $75,300 of AGI for married taxpayers.

2. The long-term capital gains rate applies to capital assets held for more than one year. The holding period generally begins the day after purchase and includes the day of sale. Purchase and sale dates are based on trade dates, not settlement dates.

3. Exchange Traded Funds (ETFs) that hold physical gold are considered to hold “collectibles” for capital gains purposes and, as such, their long-term capital gains rate is 31.8% (28% + 3.8%), not 23.8% (20% + 3.8%). Inverse ETFs focused on metals generally own futures and, therefore, are not considered collectibles. For ETFs invested in futures, there is generally a split of appreciation 60% long-term capital gain and 40% short-term capital gain. However, there are different practices in the case of inverse Exchange Traded Notes (ETNs), depending on the structure of the note: one approach is to treat ETN appreciation as long-term capital gain (23.8% rate) but another approach is to treat the appreciation as split 60% long-term capital gain and 40% short-term capital gain.

4. When a stock has been purchased over time in different lots, investors are generally deemed to sell the shares on a FIFO (first-in, first-out) basis. The seller can, however, elect to specifically identify other shares as being sold first. Typically, married filing joint taxpayers earning more than $466,950 (which places them in the 20% long-term capital gains bracket) would likely select the highest basis lots as the first to be sold in order to defer a capital gains tax payment. Married filing joint taxpayers earning less than $466,950 might consider accelerating some gain recognition to take advantage of the lower 15% long-term capital gains rate.

5. When harvesting losses, beware the wash sale rule. If a security is sold at a loss and a substantially identical security is acquired within 30 days before or after the sale (i.e. a 61-day period), the “wash sale” rule results in a deferral of the loss until the replacement securities are sold. Whether securities are substantially identical depends on the facts and circumstances of each case.

   • November 29, 2016 is the last day on which one can sell a position at loss and still be able to avoid wash sale rule by buying replacement securities on December 30, 2016.

6. Per the “Pease” limitation, for taxpayers with income meeting certain thresholds, itemized deductions (including those for charitable contributions) are reduced. The current threshold is $259,400 for taxpayers filing individually and $311,300 for those married filing jointly. The reduction amount is the lesser of: (a) 3% of the excess of adjusted gross income over the threshold, or (b) 80% of the total of
the deductions. The “Pease” limitation does not apply to 
deductions for Alternative Minimum Tax (AMT) purposes 
or does it apply to deductions for medical expenses, 
investment interest or casualty, wagering or theft losses. 
However, the limitation does apply to the charitable 
deduction.

An example of the application of this concept can be found 
in the white paper entitled “Application of Existing Tax 
Laws”.

7. Regarding cost basis of gifted property, when a donor 
makes a lifetime gift to a beneficiary (“at transfer”), the 
beneficiary takes the donor’s basis (and holding period), 
subject to upward adjustment for any gift tax paid and 
attributable to appreciation. However, where the fair market 
value (FMV) of the gifted asset is below the donor’s basis, 
the beneficiary must track a different basis for a subsequent 
sale at a gain or at a loss.

- On a subsequent sale, the basis for determining loss is the 
  FMV of the asset at transfer and the basis for determining 
gain is the donor’s cost basis.
- For example, gifted securities have a cost basis of 
  $10,000 and a FMV of $9,000 at transfer. They are later 
sold for $9,500. This results in neither gain nor loss as the 
  basis for figuring loss is $9,000 (resulting in a gain, not a 
  loss) and the basis for determining gain is $10,000 
  (resulting in a loss, not a gain).

If the subsequent sale of gifted property (when the donor’s 
basis in the property exceeded his or her FMV at transfer) 
takes place at a price point:

- The excess above the cost basis is a gain to the 
  beneficiary.
- Between the FMV at transfer and the donor’s cost basis, 
  there will be no gain or loss.
- Below FMV at transfer, the difference between such 
  FMV and the sales price is a loss to the beneficiary.

AMT
The Alternative Minimum Tax (AMT) was created to ensure 
that some taxpayers do not benefit disproportionately from 
tax-advantaged items. The AMT rate is generally 26% or 
28%, depending on income level and filing. The starting point 
for the AMT is regular taxable income, increased by certain 
adjustments including state and local income and property 
taxes and miscellaneous itemized deductions; tax-exempt 
interest on private activity bonds; and the difference between 
the FMV of stock and the option price on the date of the 
exercise of Incentive Stock Options (“ISOs”).

ISOs
When an employee exercises an ISO, the spread between 
the FMV of the stock at the time of exercise and the strike price is 
not subject to ordinary income tax; however, the spread is an 
adjustment item (i.e. treated as income) for purposes of 
calculating the AMT.

- If the ISO stock has depreciated significantly since an 
  exercise in 2016, the taxpayer may wish to make a taxable 
  sale of the stock, making a “disqualifying disposition”. The 
  disqualifying disposition must take place in the same 
taxable year as the exercise. It takes advantage of a special 
rule which recasts the ISO as a nonqualified stock option, 
avoids the AMT impact of the original exercise, and limits 
the compensation income recognized to the difference 
between the sales price of the stock and the exercise price of 
the option.

A Hedging Reminder
A short against the box that one entered into in 2016 as a 
short-term hedge under the safe harbor of IRC 1259 must be 
closed out by January 30, 2017 and the position must be held 
unhedged for 60 days following the close of the short 
transaction.

Qualified Dividends
Under current law, qualified dividends are taxed at a reduced 
tax rate of 20% (plus potentially 3.8%). To qualify, generally 
shareholders must hold the common stock on which the 
dividend is paid for more than 60 days during the 121-day 
period beginning 60 days before the ex-dividend date. Certain 
preferred shares can also qualify for the reduced rate; the 
holding period is extended to at least 91 days in the 181-day 
period beginning 90 days prior to the ex-dividend date.

- The taxpayer’s holding period is suspended for any period 
  for which the taxpayer (i) has an option to sell, is under a 
  contractual obligation to sell, or has an open short sale of 
  substantially identical stock; (ii) is the grantor of an option 
  to buy substantially identical stock; or (iii) has diminished 
  risk of loss by holding one or more positions with respect to 
  “substantially similar or related property.”

IRAs
The maximum IRA contribution limit for 2016 is $5,500. It is 
increased by $1,000 as a “catch-up” contribution for taxpayers 
50 and over. However, if the taxpayer’s total earned income 
was less than $5,500, the IRA contribution limit is equal to the 
taxpayer’s total earned income. Contributions may be made by 
the due date of filing tax returns, ignoring extensions, i.e. 
April 17, 2017.

The owner of an IRA must start receiving required minimum 
distributions (“RMDs”) by April 1 of the year following the 
year in which the owner reaches age 70 ½. All following 
RMDs must be taken by December 31 of each year including 
the year of the first RMD. In other words, if the owner of the 
IRA delays taking his or her first RMD until April 1 of the 
year after the year he or she reaches age 70 ½, he or she must 
take two RMDs in one tax year. If a RMD is not taken or if 
the amount taken is less than the RMD, an excise tax is
imposed equal to 50% of the RMD amount not taken; however, part or all of the excise tax may be waived by the IRS if the failure to take the RMD was due to reasonable error and the RMD is taken as soon as possible after the error is discovered.

IRA participants of age 70 ½ or older may make a direct distribution of up to $100,000 from their IRA to a qualifying public charity without including the distribution amount in income, subject to certain conditions.

**Roth IRAs**

Since 2010, virtually all taxpayers may convert a traditional IRA to a Roth IRA. However, limitations based on modified Adjusted Gross Income prevent certain taxpayers from contributing directly to a Roth IRA.

There are significant differences between a traditional IRA and a Roth IRA:

- Traditional IRA assets grow on a tax-deferred basis until they are taxed as ordinary income on distribution. As discussed above, in the case of a traditional IRA, required minimum distributions must be taken by April 1 of the year after the IRA owner turns 70½ and must continue to be taken on an annual basis by December 31 going forward.

- Roth IRAs, in contrast, are funded with after-tax dollars, grow on a tax-deferred basis, and provide income tax-free distributions if certain conditions are met. Roth IRAs are not subject to the RMD rules during the life of the Roth IRA owner, but are subject to the post-death RMD rules, meaning the beneficiary(ies) who inherits the Roth IRA must commence taking RMDs no later than December 31 of the year following the year of the owner’s death.

The conversion from a traditional IRA to a Roth IRA results in the recognition of taxable income of all of the pre-tax contributions and tax-deferred gains in the IRA at the time of conversion (or deemed distribution). If any of the traditional IRA balance is withdrawn but not converted into a Roth IRA (for example, if some of the traditional IRA account is used to pay the income tax liability incurred because of the conversion) while the taxpayer is under 59 ½ years old, the 10% early withdrawal penalty tax will apply to the taxable amount withdrawn but not converted.

**Gifts**

Regarding a gift to an individual, the annual exclusion for 2016 is $14,000 per donee (or $28,000 for a married couple splitting a gift, in which case the gift must be reported on a gift tax return filed with the IRS). The annual exclusion will remain $14,000 per donor/per donee for 2017. In addition to the annual exclusion, individuals have a $5.45MM credit against the gift tax. Gifts in excess of such amounts result in the payment of federal tax and in some cases (e.g. Connecticut) state gift tax. *The top federal gift tax rate this year is 40%. Additionally, on January 1, 2017, the estate tax exemption amount is expected to rise due to inflation adjustment from the current $5.45MM to $5.49MM.*

- Note that the annual exclusion for a transfer to a non-U.S. citizen spouse is $148,000 for 2016 (indexed annually).

- Note also that contributions to a 529 college savings plan can be “frontloaded” with five years’ worth of annual exclusion gifts, which is $70,000 per donee, added to the plan free of gift tax in the first year.

Regarding a gift to charity, a gift of cash or other property to a charity is deductible in the year the investor makes the gift.

- Gifts of stock traded on an exchange are valued at the mean between the highest and lowest quoted selling prices on the date of the gift.

- Depending on the circumstances, a gift of a security may be completed when the security is transferred by the investor’s agent or when the security is transferred on the books of the corporation (which may be later).

  - This rule may impact the timing of gifts of restricted stock.

**Charitable Deductions**

Regarding charitable deductions, either the cost basis or the FMV of property given to a U.S. charity may be deducted for income tax purposes. The amount deductible in any one year is subject to a limitation based on a percentage of the donor’s AGI.

The percentage limitation and cost basis or fair market valuation are a function of the type of property given (e.g. cash or ordinary income property or long-term capital gain property) and the classification of the charitable organization as a public charity or private foundation. Deductions for gifts in excess of the limitations can be carried forward five years. The table on this page provides a summary of the deductibility limits. Note that short-term capital gain property and gifts to private foundations that are not “Qualified Appreciated Securities” (i.e. generally public stock) are deducted at the lower of cost basis or FMV.

A private foundation must on average each year distribute to qualified charitable organizations at least 5% of the aggregate fair market value of its assets (and if it fails to do so it will be subject to significant excise taxes on the undistributed amount).

A 2% excise tax (which can be reduced to 1% if sufficient distributions are made) is imposed on the net investment income of a foundation.

In computation of the excise tax, capital losses can only be utilized in the year realized and do not carry forward for use in future years or carry back to prior years (i.e. use them or lose them).

**Kiddie Tax**
The Small Business and Work Opportunity Tax Act of 2007 raised the applicable age for the “kiddie tax” on which the child’s interest, dividends, and other unearned income above $2,100 in 2016 is taxed at the parent’s rate. The kiddie tax is applicable to children under age 19, or under age 24 if the child is a full-time student who remains dependent.

Parents may elect to include in their gross income the unearned income that is in excess of $1,050 but less than $10,500 of a child who is subject to the kiddie tax in 2016.

### Charitable Contribution Deductibility Limits

<table>
<thead>
<tr>
<th></th>
<th>Public Charity Amount of Deduction</th>
<th>AGI Limitation</th>
<th>Private Foundation Amount of Deduction</th>
<th>AGI Limitation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Fair Market Value</td>
<td>50%</td>
<td>Cost</td>
<td>30%</td>
</tr>
<tr>
<td>Short-Term Capital Gain</td>
<td>Lower of Cost or Fair Market Value</td>
<td>50%</td>
<td>Lower of Cost or Fair Market Value</td>
<td>30%</td>
</tr>
<tr>
<td>Property</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-Term Capital Gain</td>
<td>Fair Market Value</td>
<td>30%</td>
<td>Lower of Cost or Fair Market Value</td>
<td>20%</td>
</tr>
<tr>
<td>Property</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**IMPORTANT DISCLOSURES**

This material has been prepared for informational purposes only and is subject to change at any time without further notice. Information contained herein is based on data from multiple sources and Morgan Stanley Smith Barney LLC (“Morgan Stanley”) makes no representation as to the accuracy or completeness of data from sources outside of Morgan Stanley Smith Barney LLC. It does not provide individually tailored investment advice. Be aware that the particular legal, accounting and tax restrictions, margin requirements, commissions and transaction costs applicable to any given client may affect the consequences described, and these analyses will not be suitable to discuss with every client. The appropriateness of a particular investment or strategy will depend on an investor’s individual circumstances and objectives.

Tax laws are complex and subject to change. This information is based on current federal tax laws in effect at the time this was written. Morgan Stanley Smith Barney LLC, its affiliates, Financial Advisors or Private Wealth Advisors do not provide tax or legal advice. Clients should consult their tax advisor for matters involving taxation and tax planning and their attorney for matters involving trust and estate planning and other legal matters.

© 2016 Morgan Stanley Private Wealth Management, a division of Morgan Stanley Smith Barney LLC. Member SIPC.