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CERTIFIED PUBLIC ACCOUNTANTS

2020 Tax Considerations

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INDIVIDUAL INCOME TAX PROVISIONS

Individual Tax Changes

New income tax rates and brackets.

For tax years beginning after December 31, 2017 and before January 1, 2026, seven tax rates apply for individuals: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. The Act also provides four tax rates for estates and trusts: 10%, 24%, 35%, and 37%.

Standard Deduction Increased

For tax years beginning after December 31, 2017 and before January 1, 2026, the standard deduction is increased to $24,000 for married individuals filing a joint return, $18,000 for head-of-household filers, and $12,000 for all other taxpayers, adjusted for inflation in tax years beginning after 2018 ($24,800, $18,650, and $12,400, respectively for 2020) ($25,100, $18,800, and $12,550, respectfully for 2021).

Personal Exemptions Suspended

For tax years beginning after December 31, 2017 and before January 1, 2026, the deduction for personal exemptions is effectively suspended by reducing the exemption amount to zero.

Kiddie Tax

For tax years beginning after December 31, 2017, the taxable income of a child attributable to earned income is taxed under the rates for single individuals, and taxable income of a child attributable to net unearned income is taxed according to the brackets applicable to trusts and estates. This rule applies to the child's ordinary income and his or her income taxed at preferential rates. The exemption from the kiddie tax will be $2,200 for 2020 ($2,200 for 2021). A parent will be able to elect to include a child's income on the parent's return if the child's income is more than $1,100 and less than $11,000 for 2020 (more than $1,100 and less than $11,000 for 2021).

Capital Gains Provisions Conformed

The Act generally retains present-law maximum rates on net capital gains and qualified dividends. It retains the breakpoints that exist under pre-Act law, but indexes them for inflation using C-CPI-U in tax years after December 31, 2017.

For 2020, the 15% breakpoint is: $80,000 ($80,800 for 2021) for joint returns and surviving spouses (half this amount for married taxpayers filing separately), $53,600 ($54,100 for 2021) for heads of household, $2,650 ($2,700 for 2021) for trusts and estates, and $40,000 ($40,400 for 2021) for other unmarried individuals. The 20% breakpoint is $496,600 ($501,600 for 2021) for joint returns and surviving spouses (half this amount for married taxpayers filing separately), $469,050 ($473,750 for 2021) for heads of household, $13,150 ($13,250 for 2021) for estates and trusts, and $441,450 ($445,850 for 2021) for other unmarried individuals.

Carried Interest

Effective for tax years beginning after December 31, 2017, the Act effectively imposes a 3-year holding period requirement in order for certain partnership interests received in connection with the performance of services to be taxed as long-term capital gain. "Partnership Interests Held in Connection with Performance of Services." If the 3-year holding period is not met with respect to an applicable partnership interest held by the taxpayer, the taxpayer's gain will be treated as short-term gain taxed at ordinary income rates.

Deduction for Personal Casualty and Theft Losses Suspended

For tax years beginning after December 31, 2017 and before January 1, 2026, the personal casualty and theft loss deduction is suspended, except for personal losses incurred in a Federally-declared disaster. However, where a taxpayer has personal casualty gains, the loss suspension does not apply to the extent that such loss does not exceed the gain.

Gambling Loss Limitation Modified

For tax years beginning after December 31, 2017 and before January 1, 2026, the limitation on wagering losses under Code Sec. 165(d) is modified to provide that *all* deductions for expenses incurred in carrying out wagering transactions, and not just gambling losses are, limited to the extent of gambling winnings. (Code Sec. 165(d), as amended by Act Sec. 11050)

Child Tax Credit Increased

For tax years beginning after December 31, 2017 and before January 1, 2026, the child tax credit is increased to $2,000, and other changes are made to phase-outs and refundability during this same period, as outlined below.

- The income levels at which the credit phases out are increased to $400,000 for married taxpayers filing jointly ($200,000 for all other taxpayers) (not indexed for inflation).
- In addition, a $500 nonrefundable credit is provided for certain non-child dependents.
- The amount of the credit that is refundable is increased to $1,400 per qualifying child, and this amount is indexed for inflation, up to the $2,000 base credit amount. The earned income threshold for the refundable portion of the credit is decreased from $3,000 to $2,500.
- No credit will be allowed to a taxpayer with respect to any qualifying child unless the taxpayer provides the child's social security number.

State and Local Tax Deduction Limited

For tax years beginning after December 31, 2017 and before January 1, 2026, subject to the exception described below, State, local, and foreign property taxes, and State and local sales taxes, are deductible only when paid or accrued in carrying on a trade or business or an activity described in Code Sec. 212 (generally, for the production of income). State and local income, war profits, and excess profits are not allowable as a deduction.

However, a taxpayer may claim an itemized deduction of up to $10,000 ($5,000 for a married taxpayer filing a separate return) for the *aggregate* of (i) State and local property taxes *not* paid or accrued in carrying on a trade or business or activity described in Code Sec. 212; and (ii) State and local income, war profits, and excess profits taxes (or sale taxes in lieu of income, etc. taxes) paid or accrued in the tax year. Foreign real property taxes many not be deducted.

Mortgage and Home Equity Indebtedness Interest Deduction Limited

For tax years beginning after December 31, 2017 and before January 1, 2026, the deduction for interest on home equity indebtedness is suspended, and the deduction for mortgage interest is limited to underlying indebtedness of up to $750,000 ($375,000 for married taxpayers filing separately). For tax years after December 31, 2025, the prior $1,000,000/$500,000 limitations are restored, and a taxpayer may treat up to these amounts as acquisition indebtedness regardless of when the indebtedness was incurred. The suspension for home equity indebtedness also ends for tax years beginning after December 31, 2025.

The new lower limit does not apply to any acquisition indebtedness incurred before December 15, 2017.

A taxpayer who has entered into a binding written contract before December 15, 2017 to close on the purchase of a principal residence before January 1, 2018, and who purchases such residence before April 1, 2018, shall be considered to incur acquisition indebtedness prior to December 15, 2017.

The $1,000,000/$500,000 limitations continue to apply to taxpayers who refinance existing qualified residence indebtedness that was incurred before December 15, 2017, so long as the indebtedness resulting from the refinancing does not exceed the amount of the refinanced indebtedness.

Medical Expense Deduction Threshold Temporarily Reduced

For tax years beginning after December 31, 2016 and ending before January 1, 2019, the threshold on medical expense deductions is reduced to 7.5% for all taxpayers.

In addition, the rule limiting the medical expense deduction for AMT purposes to 10% of AGI does not apply to tax years beginning after December 31, 2016 and ending January 1, 2019.

Charitable Contribution Deduction Limitation Increased

For contributions made in tax years beginning after December 31, 2017 and before January 1, 2026, the 50% limitation under Code Sec. 170(b) for cash contributions to public charities and certain private foundations in increased to 60%. Contributions exceeding the 60% limitation are generally allowed to be carried forward and deducted for up to five years, subject to the later year's ceiling.

No Deduction for Amounts Paid for College Athletic Seating Rights

For contributions made in tax years beginning after December 31, 2017, no charitable deduction is allowed for any payment to an institution of higher education in exchange for which the payor receives the right to purchase tickets or seating at an athletic event.

Alimony Deduction by Payor/Inclusion by Payee Suspended

For any divorce or separation agreement executed after December 31, 2018, or executed before the date but modified after it (if the modification expressly provides that the new amendments apply), alimony and separate maintenance payments are not deductible by the payor spouse and are not included in the income of the payee spouse. Rather, income used for alimony is taxed at the rates applicable to the payor spouse.

Miscellaneous Itemized Deductions Suspended

For tax years beginning after December 31, 2017 and before January 1, 2026, the deduction for miscellaneous itemized deductions that are subject to the 2% floor is suspended.

Overall Limitation on Itemized Deductions Suspended

For tax years beginning after December 31, 2017 and before January 1, 2026, the "Pease limitation" on itemized deductions is suspended.

Exclusion for Moving Expense Reimbursements Suspended

For tax years beginning after December 31, 2017 and before January 1, 2026, the exclusion for qualified moving expense reimbursements is suspended, except for members of the Armed Forces on active duty (and their spouses and dependents) who move pursuant to a military order and incident to a permanent change of station.

Moving Expenses Deduction Suspended

For tax years beginning after December 31, 2017 and before January 1, 2026, the deduction for moving expenses is suspended, except for members of the Armed Forces on active duty who move pursuant to a military order and incident to a permanent change of station.

Deduction for Living Expenses of Members of Congress Eliminated

For tax years beginning after the enactment date, members of Congress cannot deduct living expenses when they are away from home.

Repeal of Obamacare Individual Mandate

Under pre-Act law, the Affordable Care Act (also called the ACA or Obamacare) required that individuals who were not covered by a health plan that provided at least minimum essential coverage were required to pay a "shared responsibility payment" (also referred to as a penalty) with their federal tax return. Unless an exception applied, the tax was imposed for any month that an individual did not have minimum essential coverage.

For tax years beginning after December 31, 2018, the amount of the individual shared responsibility payment is reduced to zero. (Code Sec. 5000A(c), amended by Act Sec. 11081) This repeal is permanent.

Alternative Minimum Tax (AMT)

For tax years beginning after December 31, 2017 and before January 1, 2026, the Act increases the AMT exemption amounts for individuals, for 2020 are as follows:

- For joint returns and surviving spouses, $113,400 ($114,600 for 2021).
- For single taxpayers, $72,900 ($73,600 for 2021).
- For marrieds filing separately, $56,700 ($57,300 for 2021).

Under the Act, the above exemption amounts are reduced (not below zero) to an amount equal to 25% of the amount by which the alternative taxable income of the taxpayer exceeds the phase-out amounts for 2019, and increased as follows:

- For joint returns and surviving spouses, $1,036,800 ($1,047,200 for 2021).
- For all other taxpayers (other than estates and trusts), $518,400 ($523,600 for 2021).
- For estates and trusts, $84,800 ($85,700 for 2021).

ABLE Account Changes

ABLE Accounts under Code Sec. 529A provide individuals with disabilities and their families the ability to fund a tax preferred savings account to pay for "qualified" disability related expenses. Contributions may be made by the person with a disability (the "designated beneficiary"), parents, family members or others. Under pre-Act law, the annual limitation on contributions is the amount of the annual gift-tax exemption ($15,000 in 2020 and 2021).

Effective for tax years beginning after the enactment date and before January 1, 2026, the contribution limitation to ABLE accounts with respect to contributions made by the designated beneficiary is increased, and other changes are in effect as described below. After the overall limitation on contributions is reached (i.e., the annual gift tax exemption amount; for 2020, $15,000), an ABLE account's designated beneficiary can contribute an additional amount, up to the lesser of (a) the Federal poverty line for a one-person household; or (b) the individual's compensation for the tax year.

Additionally, the designated beneficiary of an ABLE account can claim the saver's credit under Code Sec. 25B for contributions made to his or her ABLE account.

The Act also requires that a designated beneficiary (or person acting on the beneficiary's behalf) maintain adequate records for ensuring compliance with the above limitations.

For distributions after the date of enactment, amounts from qualified tuition programs (QTPs, also known as 529 accounts; see below) are allowed to be rolled over to an ABLE account without penalty, provided that the ABLE account is owned by the designated beneficiary of that 529 account, or a member of such designated beneficiary's family. Such rolled-over amounts are counted towards the overall limitation on amounts that can be contributed to an ABLE account within a tax year, and any amount rolled over in excess of this limitation is includible in the gross income of the distributee.

Expanded Use of 529 Account Funds

Under pre-Act law, funds in a Code Sec. 529 college savings account could only be used for qualified higher education expenses. If funds were withdrawn from the account for other purposes, each withdrawal was treated as containing a pro-rata portion of earnings and principal. The earnings portion of a nonqualified withdrawal was taxable as ordinary income and subject to a 10% additional tax unless an exception applied.

"Qualified higher education expenses" including tuition, fees, books, supplies, and required equipment, as well as reasonable room and board if the student was enrolled at least half-time. Eligible schools included colleges, universities, vocational schools, or other postsecondary schools eligible to participate in a student aid program of the Department of Education. This included nearly all accredited public, nonprofit, and proprietary (for-profit) postsecondary institutions.

For distributions after December 31, 2017, "qualified higher education expenses" include tuition at an elementary or secondary public, private, or religious school.

Student Loan Discharged on Death or Disability

Gross income generally includes the discharge of indebtedness of the taxpayer. Under an exception to this general rule, gross income does not include any amount from the forgiveness (in whole or in part) of certain student loans, if the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers.

For discharges of indebtedness after December 31, 2017 and before January 1, 2026, certain student loans that are discharged on account of death or total and permanent disability of the students are also excluded from gross income.

Deferred Compensation

Code Sec. 83 governs the amount and timing of income inclusion for property, including employer stock, transferred to an employee in connection with the performance of services.

Under Code Sec. 83(a), an employee must generally recognize income for the tax year in which the employee's right to the stock is transferable or is not subject to a substantial risk of forfeiture. The amount includible in income is the excess of the stock's fair market value at the time of substantial vesting over the amount, if any, paid by the employee for the stock.

Generally effective with respect to stock attributable to options exercised or restricted stock units (RSUs) settled after December 31, 2017 (subject to a transition rule; see below), a qualified employee can elect to defer, for income tax purposes, recognition of the amount of income attributable to qualified stock transferred to the employee by the employer. The election applies only for income tax purposes; the application of FICA and FUTA is not affected.

The election must be made no later than 30 days after the first time the employee's right to the stock is substantially vested or is transferable, whichever occurs earlier. If the election is made, the income has to be included in the employee's income for the tax year that includes the earliest of:

1) The first date the qualified stock becomes transferable, including, solely for this purpose, transferable to the employer;
2) The date the employee first becomes an "excluded employee" (i.e., an individual: (a) who is one-percent owner of the corporation at any time during the 10 preceding calendar years; (b) who is, or has been at any prior time, the chief executive office or chief financial officer of the corporation or an individual acting in either capacity; (c) who is a family member of an individual described in (a) or (b); or (d) who has been one of the four highest compensated officers of the corporation for any of the 10 preceding tax years;
3) The first date on which any stock of the employer becomes readily tradable on an established securities market;
4) The date five years after the first date the employee's right to the stock becomes substantially vested; or
5) The date on which the employee revokes his or her election.

The election is available for "qualified stock" attributable to a statutory option. In such a case, the option is not treated as a statutory option, and the rules relating to statutory options and related stock do not apply. In addition, an arrangement under which an employee may receive qualified stock is not treated as a nonqualified deferred compensation plan solely because of an employee's inclusion deferral election or ability to make the election.

Deferred income inclusion also applies for purposes of the employer's deduction of the amount of income attributable to the qualified stock. That is, if an employee makes the election, the employer's deduction is deferred until the employer's tax year in which or with which ends the tax year of the employee for which the amount is included in the employee's income.

The new election applies for qualified stock of an eligible corporation. A corporation is treated as such for a tax year if: (1) no stock of the employer corporation (or any predecessor) is readily tradable on an established securities market during any preceding calendar year, and (2) the corporation has a written plan under which, in the calendar year, not less than 80% of all employees who provide services to the corporation in the United States (or any U.S. possession) are granted stock options, or restricted stock units (RSUs), with the same rights and privileges to receive qualified stock.

Detailed employer notice, withholding, and reporting requirements also apply with regard to the election.

As noted above, the income deferral election generally applies with respect to stock attributable to options exercised or RSUs settled after December 31, 2017. However, under a transition rule, until IRS issues regs or other guidance implementing the 80% and the employer notice requirements under the provision, a corporation will be treated as complying with those requirements if it complies with a reasonable good faith interpretation of them. The penalty for a failure to provide the notice required under the provision applies to failures after December 31, 2017.

Disaster Relief Provisions

Effective for tax years beginning after December 31, 2017, and before January 1, 2026, if an individual has a net disaster loss for any tax year beginning after December 31, 2017, and before January 1, 2026, the standard deduction is increased by the net disaster loss.

The Act also provides that, if any individual has a net disaster loss for any tax year beginning after December 31, 2017 and before January 1, 2026, the AMT adjustment for the standard deduction does not apply to the increase in the standard deduction that is attributable to the net disaster loss.

A net disaster loss is the excess of (i) qualified disaster-related personal casualty losses, over (ii) personal casualty gains. "Qualified disaster-related personal casualty losses" are those described in Code Sec. 165(c)(3) that arise in a 2016 disaster area (below).

The Act provides tax relief relating to any "2016 disaster area," which means any area with respect to which a major disaster was declared by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act during calendar year 2016.

The application of this provision might be limited as it applies to losses potentially deductible in the 2018 through 2025 tax years, but is limited to losses incurred in the 2016 disaster areas.

Health Savings Accounts

The rising cost of health care coverage has caused many individuals and employers to switch from traditional health insurance coverage to high-deductible health plans. Individuals or employees who were covered by a high-deductible health plan at any time during the year have a savings opportunity. They can contribute an amount equal to all or a part of their annual deductible to a Health Savings Account (HSA). Contributions by an individual to an HSA are deductible above-the-line in computing Adjusted Gross Income (AGI).

Any "eligible individual" can set up an HSA. An eligible individual is a person who:

- is covered under a high-deductible health plan (HDHP) on the first day of the month,
- is not covered by any other health plan that is not a HDHP (with certain exceptions for plans providing limited types of coverage),
- is not entitled to Medicare benefits (generally, has not yet reached age 65), and
- may not be claimed as a dependent on another person's tax return.

For example, an individual may acquire high-deductible health coverage from an insurer and set up an HSA through the insurer or with a bank. Similarly, an employee who has qualifying high-deductible coverage through his employer can independently establish and fund an HSA.

For 2020, a high deductible health plan may be either an insured plan or an employer-sponsored self-insured medical reimbursement plan. In the case of individual self-only coverage, a plan must have an annual deductible of at least $1,400 ($1,400 for 2021) and an annual cap on out-of-pocket expenses (counting deductibles, copayments, and other amounts, but not premiums) of no more than $6,900 ($7,000 for 2021). For family coverage, the annual deductible must be at least $2,800 ($2,800 for 2021) and the annual out-of-pocket expense cap cannot exceed $13,800 ($14,000 for 2021). The plan must provide that no payments will be made until the family as a whole has incurred annual covered expenses in excess of the annual deductible.

The amount that can be contributed to an HSA depends on the type of coverage (i.e., self-only or family), the annual deductible, and the period of coverage during the year. The maximum annual contribution is the sum of limits determined separately for each month.

For 2020, the maximum monthly contribution for an individual with self-only coverage is 1/12 of the lesser of the annual deductible (minimum $1,400) or $3,550 ($3,600 for 2021). For family coverage, the maximum annual contribution is 1/12 of the lesser of the annual deductible (minimum $2,800) or $7,100 ($7,200 for 2021).

Individuals age 55 and older can make catch-up contributions in addition to their regular contributions for the year. For 2020, the catch-up contribution limit is $1,000. As with regular contributions, catch-up contributions are computed on a monthly basis.

Contributions, including catch-up contributions cannot be made to an individual's HSA after age 65.

Although the contribution limits are determined monthly, annual HSA contributions can be made in one or more payments at any time before the contribution deadline. The contribution deadline is the due date (without extensions) for filing the individual's return for the year of the contribution. Thus, for calendar year taxpayers, the deadline for making 2020 HSA contributions is April 15, 2021.

Distributions from an HSA are tax-free to the extent they are used to pay for qualified out-of-pocket medical expenses of the HSA account holder or the account holder's spouse or dependents. However, distributions qualify for tax-free treatment only if they are used to pay qualified medical expenses that were incurred after the HSA was established. Consequently, taxpayers who have not yet established an HSA will not be able to use their 2020 contributions to cover medical expenses incurred earlier in the year.

HSA funds that are not needed for medical expenses can serve as a tax-deferred savings for retirement. A distribution that is not used to pay qualified medical expenses is includible in the gross income of the account holder. In addition, such a distribution generally is subject to an additional 10% tax. However, the 10% penalty tax does not apply to distributions made on account of death or disability or after the account holder reaches age 65.

Reduced Home Sale Exclusion for Some Sellers

Most homeowners are aware of the home sale exclusion, a provision of the tax laws which provides that homeowners who sell their principal residence typically do not need to pay taxes on as much as $500,000 of their gain if they meet certain conditions. (The $500,000 exemption is the maximum exclusion for a married couple filing jointly; taxpayers filing individually get an exemption of up to $250,000.) To be eligible for the full exclusion, a taxpayer must have owned the home – and lived in it as his or her principal residence – for at least two of the five years prior to the sale. Because of the "principal residence" requirement, vacation or second homes normally do not qualify for the exclusion. However, in what some saw as a loophole, the law permitted taxpayers to convert their second home to their principal residence, live in it for two years, sell it, and take the full $250,000/$500,000 exclusion available for principal residences, even though portions of their gains were attributable to periods when the property was used as a vacation or second home, not a principal residence.

The new law closes that "loophole" by requiring homeowners to pay taxes on gains made from the sale of a second home to reflect the portion of time the home was not used as a principal residence (e.g., vacation or rental property). The amount taxed will be based on the portion of the time during which the taxpayer owned the home that the house was used as a vacation home or rented out. The rest of the gain remains eligible for the up-to-$500,000 exclusion, as long as the two-out-of-five year usage and ownership tests are met. The new law in effect reduces the exclusion based on the ratio of years of use as a principal residence to the total time of ownership. For example, if a taxpayer owned a vacation home for ten years, but lived in it as a principal residence only for the final two years prior to sale, the maximum available exclusion would be reduced by four-fifths. Accordingly, a $400,000 gain on the sale that would be eligible for the full exclusion under pre-Act law would be reduced by four-fifths, to $80,000.

The good news for current owners of second homes is that the new law is not retroactive. The tightening applies only to sales after 2008. Plus, any periods of personal or rental use before 2009 are ignored for purposes of the provision. Also, the new law does not change the rule that allows homeowners to take advantage of the home sale exclusion every two years. Taxpayers can still "home hop" with full tax exclusion if they only own one home at a time. Moreover, the taxpayer still qualifies for capital gain treatment on the amount of gain that cannot be excluded.

For purposes of the allocation of gain to periods of nonqualified use, a "period of nonqualified use" is any period (other than the portion of any period preceding January 1, 2009) during which the property is not used as the principal residence of the taxpayer or the taxpayer's spouse or former spouse.

Since the definition of a period of nonqualified use doesn't include any period preceding January 1, 2009, a taxpayer can avoid the application of Code Sec. 121 (b)(4) if he moves into his vacation home (or any other residence owned by the taxpayer) and makes it his principal residence before January 1, 2009.

Exceptions to the Definition of a Period of Nonqualified Use

A period of nonqualified use will *not* include any portion of the five-year testing period which is after the last date that the property is used as the principal residence of the taxpayer or the taxpayer's spouse. Thus, any period after the last date the property was used as the principal residence of the taxpayer or his spouse (regardless of use during that period) is not taken into account in determining periods of nonqualified use.

Z, an individual, buys a principal residence on January 1, Year 9 (a year beginning after December 31, 2008), for $400,000, and moves out on January 1, Year 19. On December 1, Year 21 (more than two years after it was last used as Z's principal residence), Z sells the property for $600,000. The entire $200,000 gain will be excluded from gross income, as under pre-2008 Housing Act law.

Since the period that Z did not use the residence as a principal residence occurred after the last date that Z had used the property as a principal residence during the five-year testing period, that period will not be considered to be a period of nonqualified use under the exception. Thus, even if Z had rented the residence (his former principal residence) during Years 19 and 20, that period will not be considered to be a period of nonqualified use.

Since the exception provided above will only apply to any portion of the five-year testing period which is after the last date that the property is used as the principal residence of the taxpayer or the taxpayer's spouse, the exception will not apply to periods of nonqualified use that occurred before the five-year testing period. If a taxpayer uses the property as his principal residence in more than one period of time during the ownership period, the exception will only apply to the period after the last date that the property was used a principal residence by the taxpayer or his spouse. Any other periods that he did not use the property as his principal residence presumably will be considered to be periods of nonqualified use. Unless one of the other exceptions (such as the temporary absence exception or the exception for taxpayers serving on qualified official extended duty, both described below) apply, those periods of nonqualified use will be included in the numerator of the ratio (used to determine the amount of gain allocated to nonqualified use as part of the aggregate periods of nonqualified use during the period the taxpayer owned the property.

C, an individual, buys a principal residence on January 1, Year 1 (a year beginning after December 31, 2008), for $400,000, and lives in it as his principal residence for five years (i.e., until December 31, Year 5). Due to a change in his employment, C moves away and does not use the property as his principal residence for the next five years (January 1, Year 6 to December 31, Year 10). On January 1, Year 11, C moves back in the house and uses it as his principal residence. On December 31, Year 20, C sells the property for $800,000 and realizes a gain of $400,000.

The five-year period from January 1, Year 6 to December 31, Year 10 will not qualify for the exception and thus, is a period of nonqualified use. That period of nonqualified use was not a portion of the five-year testing period which was after the last date that the property was used as a principal residence.

Thus, 25% of the gain [5 years (the aggregate period of nonqualified use during the taxpayer's ownership of the property) ÷ 20 years (the period of the taxpayer's ownership of the property)] will be gain allocated to periods of nonqualified use and the Code Sec. 121 exclusion will not apply to $100,000 (25% of $400,000). Of the remaining $300,000 of gain, the maximum amount of gain that qualifies for the Code Sec. 121 exclusion will be $250,000.

In Summary, C's taxable gain from the sale will include: $100,000 of gain allocated to periods of nonqualified use, and $50,000 of gain in excess of C's Code Sec. 121 exclusion ($300,000 - $250,000).

C's absence from the residence (January 1, Year 6 to December 31, Year 10) will not qualify for the temporary absence exception to the definition of a period of nonqualified use because the absence exceeded an aggregate period of two years.

Temporary Absence – Exception to the Definition of a Period of Nonqualified Use

A period of nonqualified use will not include any other period of temporary absence (not to exceed an aggregate period of two years) due to change of employment, health conditions, or any other unforeseen circumstances as may be specified by IRS.

Taxpayers Serving on Qualified Official Extended Duty – Exception to the Definition of a Period of Nonqualified Use

A period of nonqualified use will *not* include any period (not to exceed an aggregate period of ten years) during which the taxpayer or the taxpayer's spouse is serving on qualified official extended duty as a member of the uniformed services, a member of the Foreign Service, or an employee of the intelligence community.

The suspension election for members of the uniformed services, members of the Foreign Service, and employees of the intelligence community is the same as it was under pre-2008 Housing Act law.

If any gain was attributable to post May 6, 1997 depreciation, the exclusion will not apply to that amount of gain as under pre-2008 Housing Act law.

The above is effective for sales and exchanges after December 31, 2008.

Converting a Residence to Rental Property

A taxpayer may decide to permanently convert a personal residence to rental property. This decision is often made as a result of the taxpayer's inability to sell the property at a gain, or a desire to retain the property for future personal use.

The decision whether to convert a personal residence to rental property may be based on several non-tax factors. If selling a personal residence would result in a nondeductible loss, the taxpayer should consider converting the residence to rental property since any loss realized while the home is a personal residence is never deductible. While tax savings opportunities are generally limited for residential rental conversions primarily because of the passive activity loss rules, converting a personal residence into rental property may allow the taxpayer to eventually recognize a loss on the property's subsequent sale if it continues to decline in value.

When a principal residence is converted to business use (or for use in the production of income), its starting point for basis for depreciation is the lower of (1) the adjusted basis on the date of conversion, or (2) the property's fair market value at the time of conversion.

Taxpayer purchased a home in Chicago in 2004 for $250,000, of which $50,000 represented the cost of the land. Taxpayer lived in the home until 2008, when he moved to New York. Rather than sell the house, he converted it to a rental property. The property's FMV, excluding the land, on its conversion to rental property was $185,000. Taxpayer's basis for depreciation is $185,000, the FMV at the time of conversion, since it was less than the adjusted basis. (Adjusted basis is generally the cost of the property plus amounts paid for capital improvements less any depreciation claimed for tax purposes).

Property converted from residential to rental use must be depreciated using the method and recovery period in effect in the year of conversion.

If the taxpayer intends to incur major renovation or remodeling costs, the costs should be incurred after the property has been placed into service (offered for rent). This may allow for a higher depreciable basis of the property and turn repairs into deductions.

Taxpayers may need the equity in cash from their current residence for a down payment on a new residence. Yet, for non-economic reasons they may want to retain the old residence. In this situation, they should consider selling the home to a newly formed controlled entity (for example, a wholly owned S Corporation) at fair market value for a mortgage note. The residence can then be rented inside the S Corporation and depreciated at the stepped-up FMV basis. The residence is effectively retained with no current tax cost because the gain on the sale is excluded under Sec. 121 (provided the requirements of Sec. 121 are met).

The IRS has ruled that the sale of a residence to a taxpayer's wholly owned corporation qualified for the former Sec. 1034 Gain Deferral. In that ruling, the IRS stated that there was no prohibition in the Sec. 1034 rules against selling the residence to a related party and excluding the gain. Many tax practitioners believe this same rationale can apply to the Sec. 121 Gain Exclusion rules.

Taxpayers own a house that they have lived in for 20 years. The house has a tax basis of $75,000 and a FMV of $275,000. They have decided to relocate in order to live closer to their family. They need the value in cash from their old residence for a down payment on their new residence. However, because they hope to move back in a few years, they would prefer not to sell the old residence. They like the idea of renting the old house in order to retain it and still provide some tax benefits and possibly some cash flow.

Taxpayers can form a wholly owned S Corporation and have the S Corporation buy the residence for its value ($275,000) on a third-party mortgage note. Taxpayers would receive cash of $275,000, and the $200,000 gain ($275,000-$75,000) is excluded under Sec. 121. Therefore, this is accomplished at no current tax cost.

The S Corporation can begin to rent the house and take depreciation deductions on the portion of the $275,000 cost allocated to the building. The rental activity inside the S Corporation will generate either passive activity gains or losses.

If gain from the sale of the residence to the controlled entity exceeds the maximum Sec. 121 exclusion, the excess is taxable as ordinary income (rather than capital gain) because the controlled entity (related-party) purchaser will depreciate the property (Sec. 1239 (a)).

If the S Corporation ultimately sells the residence, any gain would be taxed at capital gains rates (currently 15%), subject to a 25% rate for unrecaptured Sec. 1250 gain (i.e. gain attributable to depreciation allowed on the residence for periods after May 6, 1997).

If a residence converted to rental property is later sold at a gain, the basis in the converted property is the original cost or other basis plus amounts paid for capital improvements, less any depreciation taken. If the sale results in a loss, however, the starting point for basis is the lower of the property's adjusted cost basis or FMV when it was converted from personal to rental property. This rule is designed to ensure that any decline in value occurring while the property was held as a personal residence does not later become deductible on the sale of the rental property.

Taxpayer converted their personal residence to income-producing property in 2000. The house had a $50,000 original cost, and the property's FMV was $45,000 when it was converted to rental use. Over the eight year rental period, a total of $8,000 in depreciation was taken. In 2008, taxpayer sold the property for $40,000.

1)	*Original Cost*	*$ 50,000*
2)	*Conversion Value*	*45,000*
3)	*Depreciation Taken*	*8,000*
4)	*Adjusted Basis for Determining Gain (1– 3)*	*42,000*
5)	*Adjusted Basis for Determining Loss Lesser of (1) or (2 – 3)*	*37,000*
6)	*Sales Price*	*40,000*
7)	*Recognize Gain (6 – 4) but not less than 0*	*- 0 -*
8)	*Recognize Loss(6 – 5) but not more than 0*	*- 0 -*

No reportable gain or loss occurs because (1) no gain results when the original cost is used in the gain computation, and (2) no loss results when using the lower of cost or market basis for determining loss.

The fact that a residence is rented at the time of a sale does not automatically preclude gain attributable to such use from being excluded under Sec. 121. The taxpayer must still meet the ownership and use and the one-sale-in-two-years tests of Sec. 121 and gain cannot be excluded to the extent of depreciation adjustments to periods after May 6, 1997.

Safe Harbor for Exchanges of Vacation Homes

Until recently, taxpayers who own vacation and second homes have been in a quandary as to whether Section 1031 (Like-Kind Exchange) could apply to exchanges of those types of properties. In order to qualify for nonrecognition treatment under Section 1031 both the property relinquished and the property received must be deemed held for use in the taxpayer's trade or business or for investment.

One consequence of the held for requirement is that homes used purely for personal use do not qualify for exchange treatment. Nevertheless, taxpayers often purchase and own second homes with the duel intention of personal use and future appreciation. These taxpayers have wondered whether this type of ownership could be considered as "held for investment" so as to qualify the property for exchange treatment on sale.

In 2007, the tax court for the first time considered the application of Section 1031 to vacation homes. In Moore, TCM 2007 – 134, the court denied Section 1031 treatment on an exchange of vacation properties, which it deemed were not held primarily for trade or business or for investment by the taxpayers. The facts in Moore illustrate a fairly common scenario associated with recreational vacation properties. In 1988 the Moore's purchased two contiguous parcels of lakefront real property, along with a mobile home located on one of those parcels (the Clark Hill property). The Moore's and their children used the Clark Hill property two or three weekends a month during the summers. They also made various improvements to the property. They never advertised the Clark Hill property for sale and never rented or attempted to rent the property to others. They did not claim deductions for investment interest or for maintenance and repair costs. Several years later, the Moore's moved their principal residence and decided to sell the Clark Hill property and purchase another piece of improved lakefront property closer to their new residence (the Lake Lanier property). In 1999 they bought a 75% interest in the Lake Lanier property and an escrow agent bought a 25% interest, which the Moore's later acquired after the sold the Clark Hill property, treating the 25% Investment in the Lake Lanier property as replacement property in a Section 1031 exchange for the Clark Hill property. They and their children used the Lake Lanier property similarly to the Clark Hill property. They never rented or attempted to rent the Lake Lanier property. The Moore's asserted that one of their principal reasons for holding both the Clark Hill property and the Lake Lanier property was the investment potential of these assets. The tax court dismissed this rationale, holding that in order to qualify for Section 1031 treatment on the exchange the Moore's had to prove that they held both properties primarily for investment. This conclusion is the critical holding in the case.

The court specifically held that it was not sufficient to show that expectation of appreciation in value was one of the motives for holding the property, but that investment must be the principal or primary intent. It further relied on a line of cases that rejected taxpayer attempts to convert primary residences to investment property be moving out prior to placing the property on the market for sale. The court concluded, based on the Moore's use of the homes, the lack of rental activity, and their failure to hold the homes primarily for sale at a profit, that they did not hold the homes primarily for investment. Accordingly, Section 1031 treatment was denied.

A government report stated that there is a lack of IRS guidance as to whether vacation and second homes qualify under Section 1031. The report urged the IRS to issue clear guidance in this area.

In March 2008, the IRS issued Rev. Proc. 2008-16. The procedure provides a safe harbor under which the service will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment under Section 1031. The safe harbor is effective for exchanges occurring after March 9, 2008.

Under Rev. Proc. 2008-16, a dwelling unit passes the held for test with respect to its personal use as relinquished property in a like-kind exchange if it is owned by the taxpayer for at least 24 months immediately before the exchange and in each of the two 12-month periods immediately preceding the start of the exchange:

- The taxpayer rents the property to another person at a fair rental for 14 days or more, and
- The taxpayer's personal property does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the property is rented at a fair rental.

Similarly, a dwelling unit passes the held for test with respect to its personal use as replacement property in an exchange if it is owned by the taxpayer for at least 24 months immediately after the exchange and in each of the two 12-month periods immediately after the exchange:

- The taxpayer rents the property to another person at a fair rental for 14 days or more, and
- The taxpayer's personal use of the property does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

Steve has a summer cottage in Fort Wayne that he purchased in 2006. Steve lives full time in Indianapolis. For the first several years of ownership, Steve used the cottage himself during the summer. Steve did not attempt to rent the cottage to third parties. In 2007 and 2008, Steve rented the cottage to a family at fair rental value for 175 days during the summer and fall. In each of those two years, Steve used the cottage himself for 16 days during the spring. In December 2008, Steve exchanges the cottage for a larger house in Pompano Beach, Florida. Steve rents that house to third-party tenants a total of 200 days during 2009 and just 14 days during 2010. Steve uses the home himself for 19 days during 2009 and for no days during 2010.

Steve meets the safe harbor described by Rev. Proc. 2008-16. As such, he may properly report his exchange of the Fort Wayne cottage for the Pompano Beach house as a valid Section 1031 exchange on his 2008 federal income tax return, provided that all other requirements of Section 1031 are met.

The post-exchange replacement property use requirements applicable to Steve extends well beyond the time he is required to file his tax return for the year of the exchange. What if planned rental usage does not materialize or a taxpayer's personal use of the property exceeds the allowable limits? Rev. Proc. 2008-16 provides for this by stating that if a taxpayer reports a transaction as an exchange on the taxpayer's federal return expecting that the replacement property will meet the Revenue Procedure's qualifying use standards but this does not occur, the taxpayer, if necessary, should file an amended return and not report the transaction as an exchange.

Accordingly, if Steve ends up using the Pompano House primarily for his own personal use and does not rent it out for the two 12-month periods following its exchange, he may be required to amend his 2008 return and report a taxable sale of the Fort Wayne cottage unless he can establish that the personal use was not his primary purpose for ownership of the cottage.

Rev. Proc. 2008-16 offers a fairly clear, albeit limited, set of parameters for determining whether vacation property held for personal use as well as future appreciation qualifies under Section 1031. It is important to remember, however, that as a safe harbor it neither establishes substantive law nor affects any requirement of Section 1031 other than the question of whether personal use of a residence prevents it from being deemed to be held primarily for use in a trade or business or for investment.

To qualify for the safe harbor for property being sold, a taxpayer must rent out the property for the two years prior to an exchange, and during that period engage in limited personal use. To avoid potential IRS challenge on the held for issue with respect to vacation property being acquired in an exchange, the taxpayer must rent out that property and also limit personal use for the two years following the exchange. There is clearly no requirement that both sides of an exchange satisfy these requirements; because all real estate is generally considered like-kind, a taxpayer can exchange a vacation property for an office, commercial, or other type of rental property or vice versa.

While it clearly does not resolve the issue of when vacation homes may be the subject of like-kind exchanges, Rev. Proc. 2008-16 provides welcome guidance to taxpayers seeking to exchange vacation properties and second homes. The safe harbor will allow taxpayers that buy and hold such properties with true investment intent to structure valid Section 1031 exchanges despite limited amounts of personal use. It also should reduce the time to audit and review such transactions. Nevertheless, Rev. Proc. 2008-16 is just a safe harbor. Taxpayers can and should be able to structure exchanges of homes that fall outside its guidance.

Restrictions on Passive Activity Losses and Credits

Losses generated by passive activities may only be used to offset passive activity income. They cannot be offset against actively-earned income such as professional fees or salary, or portfolio income such as dividends or interest. Passive activity credits may be used only to offset tax on income from passive activities, with a carryover of any unused credits.

Passive activities generally include any trade, business or investment activity in which the taxpayer does not materially participate. Losses and credits attributable to rental activities are generally treated as passive without regard to whether the owner materially participates. However, passive activities do not include rental realty activities in which real estate professionals materially participate. Limited partnership interests are treated as passive activities except as regs otherwise provide. But directly-owned oil and gas working interests and such interests owned through a general partnership interest are treated as nonpassive even if the owner does not materially participate in them. And a taxpayer can deduct up to $25,000 a year of losses from rental real estate activities if a more lenient "active participation" standard is met, and the "deduction equivalent" in credits also is available to eligible taxpayers.

Publicly Traded Partnerships

The passive activity limitations apply separately to each "publicly traded partnership." As a result, net income or loss from such an organization cannot be offset against income or loss from any other passive activity interest held by the taxpayer.

Step Up Level of Involvement to Satisfy Material Participation Standard Before End of Year
A taxpayer can satisfy the material participation test by:

- Participating in an activity more than 500 hours during the tax year.
- Participating more than 100 hours if no one else does more.
- Participating more than 500 hours in all his "significant participation activities." A "significant participation activity" is one in which the taxpayer participates for more than 100 hours and in which he does not materially participate under any other rule.

Consider Sale of Passive Activity
One way to deal with passive activity losses may be to sell the activity generating them. If a taxpayer disposes of his entire interest in such an activity in a fully-taxable transaction, then any loss from the activity for the tax year of disposition (including losses carried over from earlier years), over any net income or gain for the tax year from all other passive activities (including carryover losses from earlier years), is treated as a loss that is not from a passive activity. (However, suspended passive activity credits are not freed up when the activity that generated them is sold, but the taxpayer may elect to increase his basis by the amount of the unused credits.)

A taxpayer may, for the tax year in which there is a disposition of substantially all of an activity, treat the part disposed of as a separate activity, but only if the taxpayer can establish with reasonable certainty (1) the amount of deductions and credits allocable to the part of the activity for the tax year with respect to carryover of disallowed deductions and credits, and (2) the amount of gross income and of any other deductions and credits allocable to that part of the activity for the tax year.

Real Estate Professionals Can Deduct Some Rental Realty Losses
An "eligible" taxpayer's losses and credits from rental real estate activities in which he materially participates will not be treated as passive and may be used to offset nonpassive activity income.

An individual taxpayer is "eligible" if (1) more than half of the personal services that he performs are performed in real property trades or businesses in which he materially participates, and (2) he performs more than 750 hours of services during the tax year in real property trades or businesses in which he materially participates. A closely held C corporation is eligible if more than 50% of its gross receipts for the tax year are derived from real property trades or businesses in which it materially participates.

Limits on Deductions for Investment and Personal Interest

Investment Interest
Investment interest generally defined as interest used to buy or carry investment property-is deductible by noncorporate taxpayers only to the extent of net investment income. Investment income includes income such as dividends, interest, and certain gain on the sale of investment property but, for purposes of the investment interest deduction, generally does not include net capital gain from disposing of investment property (including capital gain distributions from mutual funds) or qualified dividend income. Net capital gain is the excess of net long-term capital gain for the year over the net short-term capital loss for the year. Qualified dividend income is income from dividends that qualify to be taxed at the net capital gain tax rates. However, a taxpayer can choose to include part or all of net capital gain and qualified dividend income in investment income.

Investment interest not allowed as a deduction for a tax year because of the investment interest limit is treated as interest paid or accrued in the following year and may eventually become deductible, either in the following tax year or in some later year.

Election to Include Net Capital Gain and Qualified Dividend Income in Investment Income
A taxpayer may elect to include all or part of his net capital gain and qualified dividend income in investment income. However, any amount that the taxpayer elects to include in investment income does not qualify for the favorable tax rates that apply to net capital gain and qualified dividend income. That is, net capital gain and qualified dividend income is reduced (but not below zero) by the amount the taxpayer elects to take into account as investment income to permit investment interest deductions.

Personal interest

Personal interest is not deductible. This includes all interest except (1) interest connected with a trade or business, (2) investment interest, (3) passive activity interest, (4) qualified residence interest, (5) interest on qualifying higher-education loans, and (6) otherwise deductible interest on deferred estate tax payments.

Interest May Also be Subject to Passive Activity Loss Rules

The passive activity loss and investment interest rules dovetail in such a way that any interest, other than personal interest, qualified residence interest, estate tax interest, or interest relating to a trade or business in which the taxpayer materially participates, is subject to one of the two rules. The application of the investment interest limitation is described above. Interest that relates to a passive activity is subject to the passive activity rules.

Qualified Residence Interest

Qualified residence interest (QRI) is deductible. QRI is interest on acquisition debt with the respect to any qualified residence of the taxpayer. Acquisition indebtedness is debt that is incurred in acquiring, constructing or substantially improving the taxpayer's qualified residence (or adjoining land) and is secured by that qualified residence. A qualified residence is a taxpayer's principal residence and/or any other residence (second residence) the taxpayer properly elects to treat as qualified for the tax year. If the taxpayer has a principal residence and two or more other residences, he can choose each year which of the other homes qualifies as his second residence.

Under the Tax Cuts and Jobs Act (TCJA), for tax years beginning after December 31, 2017, and before January 1, 2026, the maximum amount that is treated as acquisition debt is $750,000 ($375,000 for a married taxpayer filing separately). The $1 million, pre-TCJA limit applies to acquisition debt incurred before December 15, 2017, and to debt arising from refinancing pre-December 15, 2017 acquisition debt, to the extent the debt resulting from the refinancing does not exceed the original debt amount. Thus, taxpayers can refinance up to $1 million of pre-December 15, 2017 acquisition debt, and that refinanced debt amount will not be subject to the reduced limitation.

For tax years beginning after December 31, 2017, and before January 1, 2026, taxpayers may not claim a deduction for interest on home equity debt. However, IRS has clarified that for those years, the fact that a loan is labelled a home equity loan, home equity line of credit or second mortgage does not prevent the loan from being acquisition debt, if the loan is used to buy, build or substantially improve the taxpayer's home that secures the loan-to the extent the dollar limitation on acquisition debt is not exceeded.

Year-End Planning for the Alternative Minimum Tax

While the TCJA significantly raised the alternative minimum tax (AMT) amounts thus subjecting far fewer individual taxpayers to the AMT for 2018 and later tax years, the AMT can affect the year-end planning of high income taxpayers with large amounts of preference items. If the AMT applies, and the taxpayer's regular taxable income is relatively small, year-end tax planning may have to be geared more to reducing the AMT than the regular tax.

The amount of AMT an individual taxpayer must pay is the excess of his "tentative" minimum tax over his regular income tax. "Tentative" minimum tax, generally speaking, is 26% of the taxpayer's AMT "taxable excess." A taxpayer's AMT "taxable excess" is his alternative minimum taxable income (i.e., his regular taxable income modified by certain preferences and adjustments) reduced by an exemption amount that is adjusted annually for inflation. To the extent that the taxpayer's AMT taxable excess exceeds $98,950 ($99,950 in 2021) for married persons filing separately, and $197,900 ($199,900 in 2021) for joint returns, for unmarried individuals and estates and trusts, the AMT rate is 28%.

The following are the 2020 exemption amounts for individuals:

- Married individuals filing jointly and surviving spouses: $113,400 in 2020, less 25% of AMTI exceeding $1,036,800;
- Unmarried individuals: $72,900 in 2020, less 25% of AMTI exceeding $518,400; and
- Married individuals filing separately: $56,700 in 2020, less 25% of AMTI exceeding $518,400.

AMT Credit

In general, to the extent that an individual taxpayer's AMT is based on deferral preferences and adjustments (and not exclusion preferences and adjustments) and does not exceed the excess of his tentative AMT over his regular income tax, it may be carried forward as a credit against his regular income tax in later years. The amount of AMT attributable to deferral preferences is the taxpayer's total AMT reduced by the amount of AMT he would have to pay if he had only exclusion preferences and no deferral preferences.

Exclusions preferences are preferences that permanently avoid the payment of taxes. Exclusion preferences include, among other things, certain tax exempt interest, state and local income taxes, percentage depletion in excess of basis, and part of the gain excluded on the disposition of certain qualified small business stock.

Deferral preferences are those that merely delay the payment of taxes. Deferral preferences include for example, certain accelerated depreciation, excess intangible drilling costs and certain tax shelter farm losses.

Effect of Nonrefundable Personal Credits

Personal nonrefundable credits may offset AMT as well as regular tax.

How to Cope with the AMT

Assuming the AMT continues in its present form, one strategy for a taxpayer who is consistently subject to the AMT year after year is to spread out preferences over two or more years rather than compressing them into one. This takes maximum advantage of the alternative minimum tax exemption amounts, the levels at which the exemption phase-out begins and the "taxable excess" level at which the 28% rate begins to apply. For example, joint return filers who have large amounts of AMT income year after year should try to spread their AMT preferences and adjustments in such a way as to eliminate or at least reduce the amount of the exemption that is phased out.

Since the AMT is only paid when the tentative minimum tax exceeds the regular tax, a taxpayer's anticipated 2020 and 2021 regular tax must be considered in determining how much of his 2020 preferences and adjustments should be shifted into 2021 or vice versa.

To shift preferences from 2020 to 2021 or the reverse, defer or accelerate the item from one year to the other. For instance, put off or speed up the payment of state and local taxes, or the exercise of an incentive stock option.

Charitable Contribution Deduction or No Charitable Contribution Deduction

The Tax Cuts and Jobs Act (TCJA) nearly doubled the standard deduction for 2018 and later years. For 2020, it is $12,400 ($12,550 for 2021) for individuals, and $24,800 ($25,100 for 2021) for joint filers younger than age 65. Taxpayers who are age 65 or over, blind or disabled add an additional $1,350 ($1,700 for unmarried taxpayers). In addition, TCJA capped or eliminated several itemized deductions. As a result, many taxpayers who have itemized in the past will not itemize in 2018 and later years. And, since a charitable contribution deduction is only available as an itemized deduction, many more taxpayers will get no tax benefit for making a charitable contribution.

One result is that some taxpayers who have always itemized need to come to the realization that making charitable contributions will be more costly to them in 2018 and later years because they will get no tax benefit for them. Conceivably, they need to reconsider their charitable contribution budget.

Taxpayers who, at first glance, might believe that they can never again get a tax deduction for their charitable contributions, can take steps to get such a tax deduction for 2018 and later years.

One strategy is a variation on the time-honored strategy of "bunching." In pre-TCJA years, a common strategy, for taxpayers whose itemized deductions normally would be less than the standard deduction, would be to pay two years' worth of one or more itemized deduction items in one year, then skip paying that item in the next year.

One way to do this is to make several years worth of charitable contributions in a single year, then skipping making charitable contributions in other years. For example, instead of giving $10,000 per year over five years to a charity, a taxpayer would give $50,000 in one year; doing so would take him above the standard deduction and thus provide a tax benefit for his contribution.

Because the bunching strategy is one designed to increase *all* itemized deductions so that they exceed the standard deduction, that strategy should be one that considers all itemized deductions, not just charitable deductions. Thus, for example, one might pay medical bills at the end of 2019 rather than in 2020 as well as making extra charitable contributions in 2019.

Also note, when calculating the tax benefit of employing bunching, that no tax benefit is gained with respect to some of the amounts expended. That is, there is no tax benefit for the amounts expended that bring the total itemized deductions for the bunched year to be equal to the standard deduction for that year.

A donor-advised fund is an investment account held for charitable purposes. Donors take tax deductions when they put money in, then recommend grants to charities over time. Using such a fund allows the taxpayer to gain the benefit of bunching while allowing him to postpone making decisions as to which charities he will contribute to.

Donor-advised funds are available through financial-services firms, independent groups, community foundations, hospitals, universities and religious organizations. Note that these funds often have a series of constraints and rules.

A taxpayer who controls a C corporation and whose standard deduction is higher than his itemized deductions can get a tax benefit by having his corporation make the charitable contributions that he would otherwise make personally. Whereas the deduction for corporate charitable contributions is limited to 10% of modified taxable income any excess over that limit may be carried forward for up to five years.

Individuals Who Have Reached Age 70 ½ Should Consider Making Charitable Contribution from IRA

An annual exclusion from gross income (not to exceed $100,000) is available for otherwise taxable IRA distributions that are qualified charitable distributions as defined below. Such distributions from an IRA are not subject to the 30%-60% percentage limitations on making contributions since they will neither be included in gross income nor claimed as a deduction on the taxpayer's return. Since such a distribution is not includible in gross income, it will not increase adjusted gross income (AGI) for purposes of the phaseout of any deduction, exclusion, or tax credit that is limited or lost completely when AGI reaches certain specified levels.

To constitute a qualified charitable distribution, the distribution must be made after the IRA owner attains age 70½; and must be made directly by the IRA trustee to a Code Sec. 170(b)(1)(A) charitable organization (other than a Code Sec. 509(a)(3) organization or a donor advised fund (as defined in Code Sec. 4966(d)(2)). Also, to be excludible from gross income, the distribution must otherwise be entirely deductible as a charitable contribution deduction under Code Sec. 170 without regard to the charitable deduction percentage limits discussed above. Thus, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available for any part of the IRA distribution.

A taxpayer who claims the standard deduction instead of itemized deductions in computing his income tax will also benefit from having charitable contributions made directly from his IRA to a public charity instead of taking a distribution from his IRA and then contributing the amount of the distribution to the charity.

Where Taxpayer Made Nondeductible Contributions to His IRA(s)

If the IRA owner has any nondeductible contributions in any of his IRAs, the following rules apply to charitable contributions made from his IRAs: The IRA distribution is treated as consisting of income first, up to the aggregate amount that would be includible in gross income if the aggregate balance of all IRAs having the same owner were distributed during the same year. The annuity rules of Code Sec. 72 under which a pro rata part of the distribution would be treated as made out of nondeductible contributions do not apply. However, proper adjustments must be made in applying the Code Sec. 72 annuity rules to other distributions made in the tax year and later tax years to reflect the amount treated as a qualified charitable distribution under this special rule.

If a substantial part of the amount contributed from an IRA will consist of nondeductible contributions, then the owner may be better off taking a distribution from the IRA and then contributing the full amount to charity. He will get a deduction for the amount contributed, but only the part includible in his income will increase his AGI.

Even though a direct distribution from an IRA to a charity is not included in the taxpayer's gross income, it is taken into account in determining the owner's required minimum distribution (RMD) for the year. Thus, if the amount distributed directly from the IRA to an eligible charity during 2019 at least equals the amount of the owner's RMD for the tax year, he will not be required to take any other distribution from the IRA for that tax year.

A taxpayer who is younger than age 70½ at the end of 2020, who anticipates that in the year that he turns 70½ and/or in later years he will not itemize his deductions, and who does not have any traditional IRAs, should establish and contribute as much as he can to one or more traditional IRAs in 2020. If the immediately previous sentence applies to a taxpayer, except that he already has one or more traditional IRAs, he should make maximum contributions to one or more traditional IRAs in 2020. Then, when he reaches age 70½, he should make qualified charitable distributions. Doing all of this will allow him to, in effect, convert nondeductible charitable contributions that he makes in the year he turns 70½ and later years, into deductible-in-2020 IRA contributions and reductions of gross income from his age 70½ and later year distributions from the IRAs.

Itemized Deductions

For tax years beginning after December 31, 2017 and before January 1, 2026, the Tax Cuts and Jobs Act (TCJA) eliminated or limited a number of traditional itemized deductions. In addition, the TCJA doubled the standard deduction. And it suspended the overall limitation on itemized deductions that formerly applied to taxpayers whose adjusted gross income exceeded specified thresholds.

Among the changes to specific itemized deductions made by the TCJA were:

- Miscellaneous itemized deductions are no longer deductible.
- The itemized deduction for casualty and theft losses has been suspended except for losses incurred in a federally declared disaster.
- The deduction for job-related moving expenses has been eliminated, except for certain military personnel. (The exclusion for moving expense reimbursements has also been suspended.)
- The itemized deduction for state and local income and property taxes is limited to a total of $10,000 starting in 2018.
- The itemized deduction for mortgage interest on loans used to acquire a principal residence and a second home is only deductible on debt up to $750,000 (down from the prior $1 million), starting with loans taken out in 2018. And there is no longer any deduction for interest on home equity loans, unless they are used to buy, build or substantially improve the taxpayer's home that secures the loan.
- For 2017 and 2018, the itemized deduction for medical expenses applies to the extent those expenses exceed 7.5% of adjusted gross income (down from the prior 10%).

As noted above “miscellaneous itemized deductions” are no longer deductible for 2018. This category included:

- Unreimbursed employee business expenses such as expenses for transportation and lodging while away from home, business meals and entertainment, continuing education courses, subscriptions to professional journals, union and professional dues, professional uniforms, job hunting, and the business use of the employee’s home;
- Unreimbursed vehicle expenses of rural mail carriers;
- Investment advisory fees, subscriptions to investment advisory publications, certain attorneys’ fees, and cost of safe deposit boxes;
- Tax return preparation costs;
- Expenses allowed under the “hobby loss” rules of Code Sec. 183.

In considering the bar on “miscellaneous itemized deductions,” taxpayers should remember that certain other miscellaneous deductions are not “miscellaneous itemized deductions” and so remain deductible. These include amortizable bond premium, estate tax on income in respect of a decedent (IRD), impairment-related work expenses, and repayments of more than $3,000 under a claim of right.

EDUCATION

American Opportunity Tax Credit

The American Opportunity Tax Credit is a credit for qualified education expenses paid for an eligible student for the first four years of higher education. You can get a maximum annual credit of $2,500 per eligible student. If the credit brings the amount of tax you owe to $0, you can have 40% of any remaining amount of the credit (up to $1,000) refunded to you.

The amount of the credit is 100% of the first $2,000 of qualified education expenses you paid for each eligible student and 25% of the next $2,000 of qualified education expenses you paid for that student.

To claim the full credit, your modified adjusted gross income must be $80,000 or less ($160,000 or less for married filing jointly). You cannot claim the credit if your modified adjusted gross income is over $90,000 ($180,000 for joint filers).

Lifetime Learning Credit

The lifetime learning credit helps parents and students pay for post-secondary education.

For the tax year, you may be able to claim a lifetime learning credit of up to $2,000 for qualified education expenses paid for all students enrolled in eligible educational institutions. There is no limit on the number of years the lifetime learning credit can be claimed for each student. However, a taxpayer cannot claim both the American opportunity credit and lifetime learning credits for the same student in one year. Thus, the lifetime learning credit may be particularly helpful to graduate students, students who are only taking one course and those who are not pursuing a degree.

Generally, you can claim the lifetime learning credit if all three of the following requirements are met:

- You pay qualified education expenses of higher education.
- You pay the education expenses for an eligible student.
- The eligible student is either yourself, your spouse or a dependent for whom you claim an exemption on your tax return.

If you're eligible to claim the lifetime learning credit and are also eligible to claim the American opportunity credit for the same student in the same year, you can choose to claim either credit, but not both.

If you pay qualified education expenses for more than one student in the same year, you can choose to take credits on a per-student, per-year basis. This means that, for example, you can claim the American opportunity credit for one student and the lifetime learning credit for another student in the same year. The 2020 income phaseout begins at $59,000 ($59,000 for 2021) for single taxpayers and at $118,000 ($119,000 for 2021) for married filing jointly.

EGTRRA Changes to Student Loan Deduction Rules are Made Permanent

Individuals can deduct a maximum of $2,500 annually for interest paid on qualified higher education loans. The deduction is claimed as an adjustment to gross income to arrive at adjusted gross income (AGI). For 2020 the deduction phases out ratably for single taxpayers with modified AGI between $70,000 and $85,000 (between $70,000 and $85,000 for 2021) and between $140,000 and $170,000 (between $140,000 and $170,000 for 2021) for married filing jointly. The phaseout amounts and ranges are indexed for inflation.

The Economic Growth and Tax Relief Reconciliation Act amended the rules for deducting interest on student loans, effective generally for tax years beginning after 2001, by:

- eliminating the 60-month limit on the deduction for interest paid on a qualified education loan, and
- increasing the pre-2001 EGTRRA AGI phaseout ranges ($70,000 to $85,000 for taxpayers other than joint filers; $140,000 to $170,000 for a married couple filing jointly) applicable to the student loan interest deduction. The phaseout ranges, as amended by 2001 EGTRRA, were indexed for inflation.

Increased $2,000 Contribution Limit and Other EGTRRA Enhancements to Coverdell ESAs are Made Permanent

An individual can make a nondeductible cash contribution to a Coverdell education savings account ("Coverdell ESA", or "CESA", formerly called an "education IRA") for qualified education expenses of a beneficiary under the age of 18. A specified aggregate amount can be contributed each year by all contributors for one beneficiary. The amount an individual contributor can contribute is phased out as the contributor's modified adjusted gross income (MAGI) exceeds specified levels. A 6% excise tax applies to excess contributions.

Earnings on the contributions made to a CESA are subject to tax when withdrawn. But distributions from a CESA are excludible from the distributee's (i.e., the student's) gross income to the extent the distributions do not exceed the qualified education expenses incurred by the beneficiary during the tax year the distributions are made. The earnings portion of a CESA distribution not used to pay qualified education expense is includible in a distributee's income, and that amount is subject to a 10% tax that applies in addition to the regular tax.

Tax-free (including free of the 10% tax described above) transfers or rollovers of CESA account balances from a CESA benefiting one beneficiary to a CESA benefitting another beneficiary (and resignations of named beneficiaries) are permitted if the new beneficiary is a family member of the previous beneficiary and is under age 30. Generally, a balance remaining in a CESA is deemed to be distributed within 30 days after the beneficiary turns 30.

Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the CESA rules were modified to:

- increase the limit on CESA aggregate annual contributions (from $500) to $2,000 per beneficiary;
- permit corporations and other entities (in addition to individuals) to make contributions to a CESA, regardless of the corporation's or entity's income;
- increase the MAGI phaseout range for joint filers (from $150,000 - $160,000) to $190,000 - $220,000 to equal twice the range for single filers (i.e., $95,000 - $110,000), and so eliminate any "marriage penalty;"
- permit contributions to a CESA for a tax year to be made until April 15th of the following year;
- modify the definition of excess contribution to a CESA for purposes of the 6% excise tax on excess contributions to reflect various other EGTRRA changes;
- extend the time (to before June 1st of the following tax year) for taxpayers to withdraw excess contributions (and the earnings on them) to avoid imposition of the 6% excise tax;
- expand the definition of education expenses that can be paid by CESAs to include elementary and secondary school expenses (in addition to qualified higher education expenses);
- provide for coordination of the Hope and Lifetime Learning credits with the CESA rules to permit a Hope or Lifetime Learning credit to be taken in the same year as a tax-free distribution is taken from a CESA for a designated beneficiary (but for different expenses);
- provide rules coordinating distributions from both a qualified tuition program (QTP, or "529 plan") and a CESA for the same beneficiary for the same tax year (but for different expenses);
- eliminate the age limitations described above for acceptance of CESA contributions, deemed balance distributions, tax-free rollovers to other family-member-beneficiaries, and tax-free change of beneficiaries, for "special needs beneficiaries;"
- provide that the 10% additional tax on taxable distributions from a CESA does not apply to distributions of contributions to a CESA made by June 1st of the tax year following the tax year in which the contribution was made.

Specifically, as a result of the above extension, the following rules apply on a permanent basis:

- the limit on CESA aggregate annual contributions is $2,000 per beneficiary (and is not decreased to $500 per beneficiary);
- corporations and other entities (not just individuals) can make contributions to a CESA, and the corporations and other entities can do so regardless of their income;
- the MAGI phaseout range for joint filers is $190,000 - $220,000 (and does not decrease to $150,000 - $160,000);
- CESA contributions for a tax year can be made until April 15th of the following year;
- the definition of CESA excess contribution reflects the various other EGTRRA changes to the CESA rules;

- taxpayers have until June 1st of the following tax year to withdraw excess contributions (and the earnings on them) to avoid imposition of the 6% excise tax;
- education expenses that can be paid by CESAs include elementary and secondary school expenses and qualified higher education expenses (rather than only qualified higher education expenses);
- a Hope or Lifetime Learning credit can be taken in the same year as a tax-free distribution is taken from a CESA for a designated beneficiary (but for different expenses);
- the rule coordinating distributions being made from both a QTP and a CESA for the same beneficiary for the same tax year (but for different expenses) applies;
- special needs beneficiaries are exempted from the age limitations for a CESA's acceptance of contributions, deemed balance distributions, tax-free rollovers to other family-member-beneficiaries, and tax-free change of beneficiaries; and
- the 10% additional tax on taxable distributions from a CESA is inapplicable to distributions of contributions to a CESA made by June 1st of the tax year following the tax year in which the contribution was made.

Exclusion for Employer-Provided Educational Assistance, and Restoration of the Exclusion for Graduate-Level Courses, Made Permanent

Under Code Sec. 127, an employee's gross income does not include amounts paid or expenses incurred (up to $5,250 annually) by the employer in providing educational assistance to employees under an educational assistance program. An educational assistance program is a separate written plan of the employer for the exclusive benefit of its employees, having the purpose of providing the employees with educational assistance. The courses taken need not be related to the employee's job for the exclusion to apply. To be qualified, the program must not discriminate in favor of highly compensated employees, nor may more than 5% of the amounts paid or incurred by the employer for educational assistance during the year be provided for individuals (and their spouses and dependents) owning more than 5% of the employer. Further, the program cannot provide employees with a choice between educational assistance and other remuneration that would be includible in their gross income. Finally, reasonable notification of the program's availability and terms must be provided to employees.

Before the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA), Congress had periodically waited until the educational assistance exclusion was set to expire before renewing it, and had sometimes allowed it to expire, and then extended it retroactively. The exclusion was set to expire for courses beginning after December 31, 2001. Under EGTRRA, the exclusion was extended "permanently" subject to the EGTRRA sunset.

Also, EGTRRA restored the exclusion for graduate level courses, which had earlier been eliminated. This was also subject to the EGTRRA sunset.

Income Exclusion for Awards Under the National Health Service Corps and Armed Forces Health Professions Programs Made Permanent

Gross income does not include (i) any amount received as a "qualified scholarship" by an individual who is a candidate for a degree at a primary, secondary, or post-secondary educational institution, or (ii) qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of those educational institutions. But these exclusions do not apply to any amount that a student receives that represents payment for teaching, research, or other services provided by the student, required as a condition for receiving the scholarship or tuition reduction.

Thus, before enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, there was no exclusion from gross income for health profession scholarship programs which required scholarship recipients to provide medical services as a condition for their awards.

EGTRRA provided that education awards received under specified health scholarship programs may be tax-free qualified scholarships, without regard to any service obligation on the part of the recipient. Specifically, the rule that the exclusions for qualified scholarships and qualified tuition do not apply to amounts received which represent compensation does not apply to any amount received by an individual under the following programs:

- The National Health Service Corps Scholarship Program (the "NHSC Scholarship Program," under Sec. 338A(g)(1)(A) of the Public Health Services Act), and
- The F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance program (the "Armed Forces Scholarship Program," under Subchapter 1 of Chapter 105 of Title 10 of the United States Code).

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- The F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance program (the "Armed Forces Scholarship Program," under Subchapter 1 of Chapter 105 of Title 10 of the United States Code).

Interest Exclusion for Higher Education

The interest on U.S. Savings Bonds redeemed to pay qualified higher education expenses may be tax-free. The exclusion is phased out at certain income levels, which are adjusted annually for cost-of-living increases. The phaseout for 2020 will begin at modified adjusted gross income above $82,350 ($83,200 for 2021) for single taxpayers, and $123,550 ($124,800 for 2021) for joint filers.

Scholarships and Fellowships

A scholarship is generally an amount paid or allowed to, or for the benefit of, a student at an educational institution to aid in the pursuit of studies. The student may be either an undergraduate or a graduate. A fellowship is generally an amount paid for the benefit of an individual to aid in the pursuit of study or research. Generally, whether the amount is tax free or taxable depends on the expense paid with the amount and whether you are a degree candidate.

A scholarship or fellowship is tax free only if you meet the following conditions:

- You are a candidate for a degree at an eligible educational institution.
- You use the scholarship or fellowship to pay qualified education expenses.

Qualified Education Expenses

For purpose of tax-free scholarships and fellowships, these are expenses for:

- Tuition and fees required to enroll at or attend an eligible educational institution.
- Course-related expenses, such as fees, books, supplies, and equipment that are required for the courses at the eligible educational institution. These items must be required of all students in your course of instruction.

However, in order for these to be qualified education expenses, the terms of the scholarship or fellowship cannot require that it be used for other purposes, such as room and board, or specify that it cannot be used for tuition or course-related expenses.

Expenses that Do Not Qualify

Qualified education expenses do not include the cost of:

- Room and board.
- Travel.
- Research.
- Clerical help.
- Equipment and other expenses that are not required for enrollment in or attendance at an eligible educational institution.

This is true even if the fee must be paid to the institution as a condition of enrollment or attendance. Scholarship or fellowship amounts used to pay these costs are taxable.

Illinois "Bright Start" College Savings Plan

The Illinois "Bright Start" college savings plan is being offered under provisions of Section 529 of the Internal Revenue code. Bright Start works by investing in mutual funds. Illinois has contracted with Oppenheimer Funds to manage the investment trust. Portfolios are managed by OFI Private Investments, Inc., a subsidiary of Oppenheimer Funds, Inc. and Illinois Investments managed by Oppenheimer Funds, Inc. and its affiliates, as well as the Vanguard Group and American Century Investments.

Illinois also has "College Illinois" which has been around for a few years. Prepaid tuition through the college Illinois plan is a less aggressive investment, a defined benefit plan that acts as a hedge against tuition inflation by allowing parents and grandparents to lock in current tuition rates for state schools.

Section 529 college savings plans offer contribution advantages over another option called Coverdell Education Savings Accounts with their low annual deposit limits of $2,000.

Contributions of up to $15,000 a year and $450,000 over the life of the account are permitted in Bright Start.

Provisions for lump sum contributions as large as $75,000 ($150,000 for married couples) without gift tax penalties are also included in the tax code, in case grandma and grandpa want some of their nest egg to go toward educating their grandchildren.

Private institutions may be sponsors of prepaid tuition programs. The definition of a "Qualified Tuition Program" will include certain prepaid tuition programs established and maintained by eligible educational institutions (including private institutions) that satisfy the requirements under code section 529.

Exclusion for qualifying payouts. Distributions will be excluded from gross income to the extent they are used to pay for qualified higher education expenses. The exclusion will apply to payouts from qualified state tuition programs, and to payouts from qualified tuition programs established and maintained by entities other than a state. Starting January 1, 2018, the definition of qualified higher education expenses is expanded to include tuition for K-12 schools, as a result of the 2017 Tax Cuts and Jobs Act. However, the new law limits qualified 529 withdrawals for eligible K-12 tuition to $10,000 per beneficiary per year.

Qualified higher education expenses will include special needs services for special needs beneficiaries.

For the exclusion for distributions from qualified tuition plans to pay for qualified higher educational expenses, including room and board, the maximum room and board allowance will be the actual amount charged by the educational institution for room and board.

During the same tax year, taxpayers will be able to claim the American Opportunity Credit or Lifetime Learning Credit and exclude amounts distributed from a qualified tuition program for the same student as long as the distribution is not used for the same expenses as which a credit will be claimed.

The definition of a family member for purposes of beneficiary changes and rollovers will include first cousins of the original beneficiary.

Coverdell ESAs and Qualified Tuition Programs offer essentially the same income tax benefit, namely tax-free earnings if payouts are made for qualified educational purposes. However, each offers a unique combination of benefits and limitations. For example, a Coverdell ESA can be used for elementary and secondary school expenses or college costs, but annual contributions are limited $2,000 per beneficiary and an individual's contributions are subject to AGI phase outs. The qualified tuition program, on the other hand, does not restrict contributions, but must be used for higher education. The best savings vehicle ultimately will depend on the needs of the donor and the beneficiary who will receive the education.

Unlike custodial mutual funds in his name that become his property at age 18, college savings plans like Bright Start remain in the name of the adult who opened the account. The beneficiary may be changed to another family member, including adults who may want to pursue an advanced degree.

The account is also not included as part of the owner's taxable estate.

However, withdrawals for nonqualified education expenses incur a federally mandated 10% penalty on top of the income being taxed at the owner's higher rate.

Most Section 529 savings plans offered by other states are open to out-of-state residents.

Bright Start applications and other information are available at 877-43-BRIGHT or online at www.brightstartsavings.com.

TRUST AND ESTATE INCOME TAX

On December 22, 2017, the president signed into law P.L. 115-97, known as the Tax Cuts and Jobs Act which provides the following tax brackets for tax years 2018 through 2025 for trusts' and estates' income tax at 10%, 24%, 35% and 37% marginal tax rates.

2021 Rate Schedule for Trusts and Estates:

If taxable income is:	The tax would be:
Not over $2,650	10% of taxable income
Over $2,650 but not over $9,550	$265 plus 24% of the excess over $2,650
Over $9,550 but not over $13,050	$1,921 plus 35% of the excess over $9,550
Over $13,050	$3,146 plus 37% of the excess over $13,050

2020 Rate Schedule for Trusts and Estates:

If taxable income is:	The tax would be:
Not over $2,600	10% of taxable income
Over $2,600 but not over $9,450	$260 plus 24% of the excess over $2,600
Over $9,450 but not over $12,950	$1,904 plus 35% of the excess over $9,450
Over $12,950	$3,129 plus 37% of the excess over $12,950

ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAXES

Estate Tax

The Estate Tax is a tax on your right to transfer property at your death. It consists of an accounting of everything you own or have certain interests in at the date of death. The fair market value of these items is used, not necessarily what you paid for them or what their values were when you acquired them. The total of all of these items is your "Gross Estate." The includible property may consist of cash and securities, real estate, insurance, trusts, annuities, business interests and other assets.

Once you have accounted for the Gross Estate, certain deductions (and in special circumstances, reductions to value) are allowed in arriving at your "Taxable Estate." These deductions may include mortgages and other debts, estate administration expenses, property that passes to surviving spouses and qualified charities. The value of some operating business interests or farms may be reduced for estates that qualify.

After the net amount is computed, the value of lifetime taxable gifts (beginning with gifts made in 1977) is added to this number and the tax is computed. The tax is then reduced by the available unified credit.

Most relatively simple estates (cash, publicly traded securities, small amounts of other easily valued assets, and no special deductions or elections, or jointly held property) do not require the filing of an estate tax return. A filing is required for estates with combined gross assets and prior taxable gifts exceeding $5,450,000 in 2016, $5,490,000 in 2017, $11,180,000 in 2018, $11,400,000 in 2019, $11,580,000 in 2020, and $11,700,000 in 2021.

Beginning January 1, 2011, estates of decedents survived by a spouse may elect to pass any of the decedent's unused exemption to the surviving spouse. This election is made on a timely filed estate tax return for the decedent with a surviving spouse. Note that simplified valuation provisions apply for those estates without a filing requirement absent the portability election.

2020 Estate Tax Rates

If taxable income is:	The tax would be:
$500,000 to $750,000	$155,800 plus 37% of the excess over $500,000
$750,000 to $1,000,000	$248,300 plus 39% of the excess over $750,000
Over $1,000,000	$345,800 plus 40% of the excess over $1,000,000

The Tax Cuts and Jobs Act (TCJA) made changes that taxpayers should consider when making or reviewing their estate plans. For example:

- The TCJA doubled the estate and gift tax exemption; it will be $11,180,000 in 2018. However, this doubling only applies for 2018 through the end of 2025. The doubling and its temporary nature both provide a motivation to draft documents that refer to general terms—like "the federal estate tax exemption in effect at the time of death"—as opposed to specific dollar amounts.
- Consider the possibility that a reference to the exemption amount in an estate planning document that was drafted before the enactment of the TCJA doubled exemption could create an undesirable result.

A will drafted before enactment of the TCJA provides that a trust receive the "unused portion of the federal estate tax exemption," that the beneficiaries of that trust are the decedent's children and not his spouse, and that the spouse receives the residue of the estate. It may not be the wish of the decedent to fund that trust with the new $11 million-plus exemption. If, for example, the estate is only worth $13 million, the residue will be less than $2 million, rather than the over-$7 million amount that would have been the residue under pre-TCJA law.

The doubling of the basic exclusion amount will cause many estates to no longer be subject to federal estate taxation. Before adjusting a client's estate planning, however, consider whether the client will be subject to state estate tax. Illinois, for example, has a $4 million per person exemption, and while such a tax is deductible against the federal estate tax, if no federal estate tax is due the state estate tax is effectively increased.

Unified Estate and Gift Tax Exclusion Amount

For gifts made and estates of decedents dying in 2020, the exclusion amount will be $11,580,000 ($11,700,000 for 2021).

Generation-Skipping Transfer (GST) Tax Exemption

The exemption from GST tax will be $11,580,000 for transfers in 2020 ($11,700,000 for 2021).

Gift Tax Annual Exclusion

For gifts made in 2020, the gift tax annual exclusion will be $15,000 (no change for 2021).

Special Use Valuation Reduction Limit

For estates of decedents dying in 2020, the limit on the decrease in value that can result from the use of special valuation will be $1,180,000 ($1,190,000 for 2021).

Determining 2% Portion for Interest on Deferred Estate Tax

In determining the part of the estate tax that is deferred on a farm or closely-held business that is subject to interest at a rate of 2% a year, for decedents dying in 2020, the tentative tax will be computed on $1,570,000 ($1,590,000 for 2021) plus the applicable exclusion amount.

Annual Exclusion for Gifts to Noncitizen Spouses

For gifts made in 2020, the annual exclusion for gifts to noncitizen spouses will be $157,000 ($159,000 for 2021).

PENSION AND IRA PROVISIONS

Plan Benefit and Contribution Limits

Defined Benefit Plans
The maximum annual benefit payable at retirement under a defined benefit plan is generally the lesser of 100% of average compensation or a statutory amount, $230,000 for 2020 ($230,000 for 2021).

Defined Contribution Plans
The qualification rules for defined contribution plans limits the annual additions for each plan participant to the lesser of 25% of compensation or a statutory amount $57,000 for 2020 ($58,000 for 2021).

Compensation Limit
The annual compensation of each participant that can be taken into account for purposes of determining contributions and benefits under a plan is limited to a statutory amount, $285,000 for 2020 ($290,000 for 2021).

Elective Deferral Limitations
The limit on the deductible amount of elective deferrals to 401(k) plans and 403(b) annuities may not exceed the "applicable dollar amount." The applicable dollar amount for these plans will be $19,500 for 2020 ($19,500 for 2021).

The deductible amount of elective deferrals to SIMPLE plans will be limited to another "applicable dollar amount." The applicable dollar amount for SIMPLE plans will be $13,500 for 2020 ($13,500 for 2021).

Section 457 Plans
The limit on the deductible amount of elective deferrals to a Section 457 plan is also an applicable dollar amount. The maximum annual deferral will be $19,500 for 2020 ($19,500 for 2021).

Under the special catch-up rule, the limit is twice the otherwise applicable dollar amount in the three years before retirement.

For Individuals Over Age 50, Additional Elective Deferrals in Excess of Otherwise Applicable Limits

The otherwise applicable dollar limit on elective deferrals under a Section 401(k) plan, Section 403(b) annuity, Simplified Employee Pension (SEP), or SIMPLE, or deferrals under a government Section 457 plan is increased for individuals who have attained age 50 by the end of the year. The additional amount of contributions that may be made is the lesser of (1) a specified dollar amount or (2) the participant's compensation for the year reduced by his or her other elective deferrals for the year. The dollar amount under a Section 401(k) plan, Section 403(b) annuity, SEP, or Section 457 plan is $6,500 for 2020 ($6,500 for 2021).

The dollar amount under a SIMPLE plan is $3,000 for 2020 (no change for 2021).

Higher IRA Contribution Limits

An individual may make annual deductible contributions to a traditional IRA if neither the individual nor his spouse is an active participant in an employer-sponsored retirement plan. For a married couple, deductible IRA contributions can be made for each spouse (including, for example, a homemaker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount. If the individual is an active participant in an employer-sponsored retirement plan, the deduction limit is phased - out if Adjusted Gross Income exceeds certain levels for the tax year. For example, for 2020, the IRA deduction for single taxpayers phased out over $65,000 to $75,000 ($66,000 to $76,000 in 2021) of Adjusted Gross Income, $104,000 to $124,000 ($105,000 to $125,000 in 2021) for married taxpayers filing jointly. For a nonactive participant who had an active-participant spouse, the IRA deduction phaseout begins at $196,000 of Adjusted Gross Income in 2020 ($206,000 in 2021).

Contributions to Roth IRAs are subject to income limits. For 2020, the maximum yearly contribution that can be made to a Roth IRA is phased out for a single individual with an Adjusted Gross Income between $124,000 and $139,000 (between $125,000 and $140,000 for 2021) and for joint filers with Adjusted Gross Income between $196,000 and $206,000 (between $198,000 and $208,000 for 2021).

The maximum annual dollar contribution limit for IRA contributions will increase to the following levels:

Tax Years Beginning in	Maximum Deductible IRA Amount
2020 and 2021	$6,000

Individuals who attain age 50 before the close of the tax year will be able to make additional catch-up IRA contributions. The otherwise allowable maximum contribution limit (before applying the Adjusted Gross Income phaseout limits) for these individuals will be $1,000 for 2006 and later years.

401(k) and 403(b) Plans May Treat Post-2005 Elective Deferrals as After-Tax Roth IRA Type Contributions

For tax years beginning after 2005, a 401(k) plan or 403(b) annuity will be allowed to include a "qualified Roth contribution program" that allows participants to elect to have all or part of their elective deferrals treated as Roth contributions. These deferrals will not be excludable from gross income. The annual dollar limit on a participant's Roth contribution will be the then-applicable Code Section 402(g) limitation on elective deferrals (e.g., $19,500 in 2020). This new option for elective deferrals will allow taxpayers to make larger annual Roth IRA contributions than they can make with regular Roth IRAs.

Tax Credit to Help Lower-Income Taxpayers Save for Retirement

Eligible lower-income taxpayers can claim a nonrefundable tax credit for contributions to certain qualified plans. The maximum annual contribution eligible for the credit is $2,000.

The credit will be in addition to any deduction or exclusion that would otherwise apply for a contribution. Only an individual who is 18 or over (other than a full-time student or an individual allowed as a dependent on another taxpayer's return) will be eligible for the credit.

The credit will be available for elective contributions to 401(k) plans, 403(b) annuities, Section 457 plans, SIMPLE or SEP plans, traditional or Roth IRAs, and voluntary after-tax employee contributions to a qualified retirement plan. The amount of any credit-eligible contribution will be reduced by taxable distributions received by the taxpayer.

The credit rate (50%, 20%, or 10%) depends on the taxpayer's filing status and modified Adjusted Gross Income. For 2021, the rates are as follows:

Modified Adjusted Gross Income						Applicable Percentage
Joint Return		*Head of Household*		*All Other Cases*		
Over	Not Over	Over	Not Over	Over	Not Over	
$ - 0 -	$39,500	$ - 0 -	$29,625	$ - 0 -	$19,750	50%
$39,500	$43,001	$29,625	$32,250	$19,750	$21,500	20%
$43,020	$66,000	$32,250	$49,500	$21,500	$33,000	10%
$66,000		$49,500		$33,000		0%

The maximum credit allowed to an individual will be $1,000 ($2,000 x 50%) on joint returns with modified Adjusted Gross Income not over $39,000.

Roth IRA Conversion

All taxpayers, regardless of their modified adjusted gross income (AGI), may convert amounts in a traditional IRA to amounts in a Roth IRA. Marrieds filing separately also are eligible. Before 2010, only taxpayers with modified AGI of $100,000 or less could make such conversion, and marrieds filing separately were not eligible regardless of modified AGI.

Amounts from a SEP-IRA or a SIMPLE IRA also may be converted to a Roth IRA, but a conversion from a SIMPLE IRA may be made only after the 2-year period beginning on the date on which the taxpayer first participated in any SIMPLE IRA maintained by the taxpayer's employer.

A conversion from a regular IRA to a Roth IRA generally is subject to tax as if it were distributed from the traditional IRA and not recontributed to another IRA, but is not subject to the 10% premature distribution tax.

Roth IRAs have two major advantages over regular IRAs:

- Distributions from regular IRAs are taxed as ordinary income (except to the extent they represent nondeductible contributions). By contrast, Roth IRA distributions are tax-free if they are "qualified distributions," that is, if they are made after the 5-tax-year period that begins with the first tax year for which the taxpayer made a contribution to a Roth IRA, and when the account owner is 59 ½ years of age or older, or on account of death, disability, or the purchase of a home by a qualified first-time homebuyer (limited to $10,000).
- Regular IRAs are subject to the lifetime required minimum distribution (RMD) rules that generally require minimum annual distributions to be made commencing in the year following the year in which the IRA owner attains age 70 ½. By contrast, Roth IRAs aren't subject to the lifetime RMD rules that apply to regular IRAs (as well as individual account qualified plans).

The consensus view is that the conversion route should be considered by taxpayers who:

- Have a number of years to go before retirement (and are therefore able to recoup the dollars that are lost to taxes on account of the conversion),
- Anticipate being taxed in a higher bracket in the future than they are now, and
- Can pay the tax on the conversion from non-retirement-account assets (otherwise, there will be a smaller buildup of tax-free earnings in the depleted retirement account.

Roth IRA Contributions

Individuals may make nondeductible contributions to a Roth IRA, subject to the overall limit on IRA contributions. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with MAGI over certain levels for the tax year. For taxpayers filing joint returns, the otherwise allowable contributions to a Roth IRA will be phased out ratably in 2020 for MAGI between $196,000 and $206,000 (between $198,000 and $208,000 for 2021). For single taxpayers and heads of household it will be phased out ratably for MAGI between $124,000 and $139,000 (between $125,000 and $140,000 for 2021). For married taxpayers filing separate returns, the otherwise allowable contribution will continue to be phased out ratably for MAGI between $0 and $10,000 (no change for 2021).

Distributions from Elective Deferral Plans May be Rolled Over to Designated Roth Accounts

The new law allows 401(k), 403(b), and governmental 457(b) plans to permit participants to roll over their pre-tax account balances into a designated Roth account. The amount of the rollover will be includible in taxable income except to the extent it is the return of after-tax contributions.

To be eligible for rollover to a designated Roth account, a distribution must be (i) an eligible rollover distribution, (ii) otherwise allowed under the plan, and (iii) allowable in the amount and form elected. For example, an amount in a 401(k) plan account that is subject to distribution restrictions (e.g., because the participant has not reached age 59 ½) cannot be rolled over to a designated Roth account under the new rollover rules. However, an employer may expand its distribution options beyond those currently allowed by the plan (e.g., by adding in-service distributions before normal retirement age) in order to allow employees to make rollover contributions to a designated Roth account through a direct rollover to the designated Roth account within that plan.

If a plan allows rollover contributions to a designated Roth account, the plan must be amended to reflect this plan feature.

Although there are many similarities between the treatment of Roth IRAs and designated Roth accounts, one difference is that, in determining the taxation of Roth IRA distributions that are not qualified distributions, after-tax contributions are considered recovered before income. This basis-first recovery rule for Roth IRAs does not apply to distributions from designated Roth accounts. Another difference is that a first-time homebuyer expense can be a qualified distribution from a Roth IRA (even without the occurrence of another event, such as the individual reaching age 59 ½), but cannot by itself be qualified distribution from a designated Roth account.

A taxpayer who can rollover an amount from an applicable employer plan to either a Roth IRA or a designated Roth account, might consider whether taking withdrawals from the Roth account or Roth IRA within the five-tax-year holding period for qualified distributions would result in additional tax on a distribution from a designated Roth account (because for the unavailability of the basis-first recovery rule). Also, a taxpayer who is contemplating a withdrawal from the Roth account or Roth IRA to purchase a home as a first-time homebuyer, but who has not yet reached age 59 ½, should consider that such a withdrawal can be qualified distribution from a Roth IRA, but not from a designated Roth account, if the taxpayer has not reached age 59 ½.

Under the 2010 Small Business Act, the tax-free treatment of rollovers that ordinarily applies (under Code Sec. 402(c) for qualified plans, under Code Sec. 403(b)(8) for 403(b) annuities and under Code Sec. 457(e)(16) for governmental section 457 plans) does not apply for distributions rolled over from an applicable retirement plan to a designated Roth account (as described above). Rather, the amount that an individual receives in a distribution from an applicable retirement plan that would be includible in gross income if it were not part of qualified rollover distribution, must be included in his gross income.

If a direct rollover is made by a transfer of property to a designated Roth account, then the amount of the distribution is the fair market value of the property on the date of the transfer.

Multiemployer Pension Reform

The consolidated and further appropriations Act of 2015 contains a significant 160 page amendment on multiemployer pension reform. This legislation is designed to give multiemployer pension plans the tools they need to remain viable. One of the new provisions allow trustees of severely underfunded plans to adjust vested benefits without violating the Code Sec. 411(d)(6) anti-cutback rule, which may enable deeply troubled plans to survive without a federal bailout.

Repeal of the Rule Allowing Recharacterization of IRA Contributions

Under pre-Act law, if an individual makes a contribution to an IRA (traditional or Roth) for a tax year, the individual is allowed to recharacterize the contribution as a contribution to the other type of IRA (traditional or Roth) by making a trustee-to-trustee transfer to the other type of IRA before the due date for the individual's income tax return for that year. In the case of a recharacterization, the contribution will be treated as having been made to the transferee IRA (and not the original, transferor IRA) as of the date of the original contribution. Both regular contributions and conversion contributions to a Roth IRA can be recharacterized as having been made to a traditional IRA.

For tax years beginning after December 31, 2017, the rule that allows a contribution to one type of IRA to be recharacterized as a contribution to the other type of IRA does not apply to a conversion contribution to a Roth IRA. Thus, recharacterization cannot be used to unwind a Roth conversion.

Extended Rollover Period for Rollover of Plan Loan Offset Amounts

If an employee stops making payments on a retirement plan loan before the loan is repaid, a deemed distribution of the outstanding loan balance generally occurs. Such a distribution is generally taxed as though an actual distribution occurred, including being subject to a 10% early distribution tax, if applicable. A deemed distribution is not eligible for rollover to another eligible retirement plan.

Under pre-Act law, a plan may also provide that, in certain circumstances (for example, if an employee terminates employment), an employee's obligation to repay a loan is accelerated and, if the loan is not repaid, the loan is cancelled and the employee's account balance is offset by the amount of the unpaid loan balance, referred to as a loan offset. A loan offset is treated as an actual distribution from the plan equal to the unpaid loan balance (rather than a deemed distribution), and (unlike a deemed distribution) the amount of the distribution is eligible for tax free rollover to another eligible retirement plan within 60 days. However, the plan is not required to offer a direct rollover with respect to a plan loan offset amount that is an eligible rollover distribution, and the plan loan offset amount is generally not subject to 20% income tax withholding.

For plan loan offset amounts which are treated as distributed in tax years beginning after December 31, 2017, the Act provides that the period during which a qualified plan loan offset amount may be contributed to an eligible retirement plan as a rollover contribution would be extended from 60 days after the date of the offset to the due date (including extensions) for filing the Federal income tax return for the tax year in which the plan loan offset occurs – that is, the tax year in which the amount is treated as distributed from the plan. A qualified plan loan offset amount is a plan loan offset amount that is treated as distributed from a qualified retirement plan, a Code Sec. 403(b) plan, or a governmental Code Sec. 457(b) plan solely by reason of the termination of the plan or the failure to meet the repayment terms of the loan because of the employee's separation from service, whether due to layoff, cessation of business, termination of employment, or otherwise. A loan offset amount under the Act (as before) is the amount by which an employee's account balance under the plan is reduced to repay a loan from the plan.

BUSINESS PROVISIONS

Corporate Tax Rates Reduced

Under pre-Act law, corporations are subject to graduated tax rates of 15% (for taxable income of $0-$50,000), 25% (for taxable income of $50,001-$75,000), 34% (for taxable income of $75,001-$10,000,000), and 35% (for taxable income over $10,000,000). Personal service corporations pay tax on their entire taxable income at the rate of 35%.

For tax years beginning after December 31, 2017, the corporate tax rate is a flat 21% rate.

Dividends-Received Deduction Percentages Reduced

Under pre-Act law, corporations that receive dividends from other corporations are entitled to a deduction for dividends received. If the corporation owns at least 20% of the stock of another corporation, an 80% dividends received deduction is allowed. Otherwise, a 70% deduction is allowed.

For tax years beginning after December 31, 2017, the 80% dividends received deduction is reduced to 65%, and the 70% dividends received deduction is reduced to 50%.

Alternative Minimum Tax Repealed

Under pre-Act law, the corporate alternative minimum tax (AMT) is 20%, with an exemption amount of up to $40,000. Corporations with average gross receipts of less than $7.5 million for the preceding three tax years are exempt from the AMT. The exemption amount phases out starting at $150,000 of alternative minimum taxable income.

For tax years beginning after December 31, 2017, the corporate AMT is repealed.

Increased Code 179 Expensing

A taxpayer may, subject to limitations, elect under Code Sec. 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions. Under pre-Act law, the maximum amount a taxpayer could expense was $500,000 of the cost of qualifying property placed in service for the tax year. The $500,000 amount was reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the tax year exceeds $2 million. These amounts were indexed for inflation.

In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business, and includes off-the-shelf computer software and qualified real property (i.e., qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property).

Passenger automobiles subject to the Code Sec. 280F limitation are eligible for Code Sec. 179 expensing only to the extent of the Code Sec. 280F dollar limitations. For sport utility vehicles above the 6,000 pound weight rating and not more than the 14,000 pound weight rating, which are not subject to the Code Sec. 280F limitation, the maximum cost that may be expensed for any tax year under Code Sec. 179 is $25,900 for 2020 and $26,200 for 2021, respectively.

For property placed in service in tax years beginning after December 31, 2017, the maximum amount a taxpayer may expense under Code Sec. 179 is increased to $1,000,000, and the phase-out threshold amount is increased to $2,500,000 ($1,050,000 and $2,620,000 for 2021). For tax years beginning after 2018, these amounts (as well as the $25,000 sport utility vehicle limitation) are indexed for inflation. Property is not treated as acquired after the date on which a written binding contract is entered into for such acquisition.

The definition of Code Sec. 179 property is expanded to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging. ***The definition of qualified real property eligible for Code Sec. 179 expensing is also expanded to include the following improvements to nonresidential real property after the date such property was first placed in service: roofs; heating; ventilation and air-conditioning property; fire protection and alarm systems; and security systems.***

Temporary 100% Cost Recovery of Qualifying Business Assets

Under pre-Act law, an additional first-year bonus depreciation deduction was allowed equal to 50% of the adjusted basis of qualified property, the original use of which began with the taxpayer, placed in service before January 1, 2020 (January 1, 2021, for certain property with a longer production period). The 50% allowance was phased down for property placed in service after December 31, 2017. A first-year depreciation deduction is also electively available for certain plants bearing fruit or nuts planted or grafted after 2015 and before 2020. Film productions are not eligible for bonus depreciation.

A 100% first-year deduction for the adjusted basis is allowed for qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023 (after September 27, 2017, and before January 1, 2024, for certain property with longer production periods). Thus, the phase-down of the 50% allowance for property placed in service after December 31, 2017, and for specified plants planted or grafted after that date, is repealed. ***The additional first-year depreciation deduction is allowed for new and used property.***

In later years, the first-year bonus depreciation deduction phases down, as follows:

- 80% for property placed in service after December 31, 2022 and before January 1, 2024.
- 60% for property placed in service after December 31, 2023 and before January 1, 2025.
- 40% for property placed in service after December 31, 2024 and before January 1, 2026.
- 20% for property placed in service after December 31, 2025 and before January 1, 2027.

For certain property with longer production periods, the beginning and end dates in the list above are increased by one year. For example, bonus first-year depreciation is 80% for long-production-period property placed in service after December 31, 2023 and before January 1, 2025.

First-year depreciation sunsets after 2026.

For the first tax year ending after September 27, 2017, a taxpayer can elect to claim 50% bonus first-year depreciation (instead of claiming a 100% first-year depreciation allowance).

Luxury Automobile Depreciation Limits Increased

Code Sec. 280F limits the Code Sec. 179 expensing and cost recovery deduction with respect to certain passenger autos (the luxury auto depreciation limit). Under pre-Act law, for passenger autos placed in service in 2017, for which the additional first-year depreciation deduction under Code Sec. 168(k) is not claimed, the maximum amount of allowable depreciation deduction is $3,160 for the year in which the vehicle is placed in service, $5,100 for the second year, $3,050 for the third year, and $1,875 for the fourth and later years in the recovery period. This limitation is indexed for inflation.

For passenger automobiles eligible for the additional first-year depreciation allowance in 2017, the first-year limitation is increased by an additional $8,000. This amount is phased down from $8,000 by $1,600 per calendar year beginning in 2018. Thus, the Code Sec. 280F increase amount for property placed in service during 2018 is $6,400 ($4,800 for 2019).

Special rules also apply to listed property, such as any passenger auto; any other property used as a means of transportation; any property of a type generally used for purposed of entertainment, recreation, or amusement; and under pre-Act law, any computer or peripheral equipment.

For passenger automobiles placed in service after December 31, 2017, in tax years ending after that date, for which the additional first-year depreciation deduction under Code Sec. 168(k) is not claimed, the maximum amount of allowable depreciation is increased to:

$10,000 for the year in which the vehicle is placed in service, $16,000 for the second year, $9,600 for the third year, and $5,760 for the fourth and later years in the recovery period. For passenger automobiles placed in service after 2018, these dollar limits are indexed for inflation. For passenger autos eligible for bonus first-year depreciation, the maximum first –year depreciation allowance remains at $8,000.

In addition, computer or peripheral equipment is removed from the definition of listed property, and so is not subject to the heightened substantiation requirements that apply to listed property.

Limits on Deduction of Business Interest

Under pre-Act law, interest paid or accrued by a business generally is deductible in the computation of taxable income subject to a number of limitations. For a taxpayer other than a corporation, the deduction of interest on indebtedness that is allocable to property held for investment (investment interest) is limited to the taxpayer's net investment income for the tax year.

Code Sec. 163(j) may disallow a deduction for disqualified interest paid or accrued by a corporation in a tax year if: (1) the payor's debt-to-equity ratio exceeds 1.5 to 1.0 (the safe harbor ratio); and (2) the payor's net interest expense exceeds 50% of its adjusted taxable income (generally, taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under Code Sec. 199, depreciation, amortization, and depletion).

For tax years beginning after December 31, 2017, every business, regardless of its form, is generally subject to a disallowance of a deduction for net interest expense in excess of 30% of the business's adjusted taxable income. The net interest expense disallowance is determined at the tax filer level. However, a special rule applies to pass-through entities, which requires the determination to be made at the entity level, for example, at the partnership level instead of the partner level.

For tax years beginning after December 31, 2017 and before January 1, 2022, adjusted taxable income is computed without regard to deductions allowable for depreciation, amortization, or depletion and without the former Code Sec. 199 deduction (which is repealed effective December 31, 2017).

The amount of any business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding taxable year. Business interest may be carried forward indefinitely, subject to certain restrictions applicable to partnerships.

An exemption from these rules applies for taxpayers (other than tax shelters) with average annual gross receipts for the three-tax year period ending with the prior tax year that do not exceed $25 million ($26 million for 2021). The business-interest-limit provision does not apply to certain regulated public utilities and electric cooperatives. ***Real property trades or businesses can elect out of the provision if they use ADS to depreciate applicable real property used in a trade or business.***

The limit on the amount allowed as a deduction for business interest is increased by a partner's distributive share of the partnership's excess taxable income. The excess taxable income for any partnership is the amount which bears the same ratio to the partnership's adjusted taxable income as the excess (if any) of 30% of the adjusted taxable income of the partnership over the amount (if any) by which the business interest of the partnership, reduced by floor plan financing interest, exceeds the business interest income of the partnership bears to 30% of the adjusted taxable income of the partnership. As a result, a partner of a partnership can deduct additional interest expense the partner may have paid or incurred to the extent the partnership could have deducted more business interest. Excess taxable income is allocated in the same manner as non-separately stated income and loss. Similar to these rules also apply to S corporations.

In the case of a partnership, any business interest that is not allowed as a deduction to the partnership for the tax year is allocated to each partner in the same manner as non-separately stated taxable income or loss of the partnership. The partner may deduct its share of the partnership's excess business interest in any future year, but only against excess taxable income attributed to the partner by the partnership the activities of which gave rise to the excess business interest carryforward. Any such deduction requires a corresponding reduction in excess taxable income. In addition, when excess business interest is allocated to a partner, the partner's basis in its partnership interest is reduced (but not below zero) by the amount of such allocation, even though the carryforward does not give rise to a partner deduction in the year of the basis reduction. However, the partner's deduction in a future year for interest carried forward does not reduce the partner's basis in the partnership interest.

In the event the partner disposes of a partnership interest the basis of which has been so reduced, the partner's basis in such interest shall be increased, immediately before such disposition, by the amount that any such basis reductions exceed any amount of excess interest expense that has been treated as paid by the partner (i.e., excess interest expense that has been deducted by the partner against excess taxable income of the same partnership). The rule does not apply to S corporations and their shareholders.

Modification of Net Operating Loss Deduction

Under pre-Act law, a net operating loss (NOL) may generally be carried back two years and carried over 20 years to offset taxable income in such years. However, different carryback periods apply with respect to NOLs arising in different circumstances. For example, extended carryback periods are allowed for NOLs attributable to specified liability losses and certain casualty and disaster losses.

For NOLs arising in tax years ending after December 31, 2017, the two-year carryback and the special carryback provisions are repealed, but a two-year carryback applies in the case of certain losses incurred in the trade or business of farming.

For losses arising in tax years beginning after December 31, 2017, the NOL deduction is limited to 80% of taxable income (determined without regard to the deduction). Carryovers to other years are adjusted to take account of this limitation, and, NOLs can be carried forward indefinitely.

Like-Kind Exchange Treatment Limited

Under pre-Act law, the like-kind exchange rule provided that no gain or loss was recognized to the extent that property-which included a wide range of property from real estate to tangible personal property-held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged for property of a like-kind that also is held for productive use in a trade or business or for investment.

Generally effective for transfers after December 31, 2017, the rule allowing the deferral of gain on like-kind exchanges is modified to allow for like-kind exchanges only with respect to real property that is not held primarily for sale. However, under a transition rule, the pre-Act like-kind exchange rules apply to exchanges of personal property if the taxpayer has either disposed of the relinquished property or acquired the replacement property on or before December 31, 2017.

Employer's Deduction for Fringe Benefit Expenses Limited

Under current law, a taxpayer may deduct up to 50% of expenses relating to meals and entertainment. Housing and meals provided for the convenience of the employer on the business premises of the employer are excluded from the employee's gross income. Various other fringe benefits provided by employers are not included in an employee's gross income, such as qualified transportation fringe benefits.

For amounts incurred or paid after December 31, 2017, deductions for entertainment expenses are disallowed, eliminating the subjective determination of whether such expenses are sufficiently business related; the current 50% limit on the deductibility of business meals is expanded to meals provided through an in-house cafeteria or otherwise on the premises of the employer; and deductions for employee transportation fringe benefits (e.g., parking and mass transit) are denied, but the exclusion from income for such benefits received by an employee is retained. In addition, no deduction is allowed for transportation expenses that are the equivalent of commuting for employees (e.g., between the employee's home and the workplace), except as provided for the safety of the employee.

For tax years beginning after December 31, 2025, the Act will disallow an employer's deduction for expenses associated with meals provided for the convenience of the employer on the employer's business premises, or provided on or near the employer's business premises through an employer-operated facility that meets certain requirements.

Nondeductible Penalties and Fines

Under pre-Act law, no deduction is allowed for fines or penalties paid to a government for the violation of any law.

For amounts generally paid or incurred on or after the date of enactment, no deduction is allowed for any otherwise deductible amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or specified nongovernmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law. An exception applies to payments that the taxpayer establishes are either restitution (including remediation of property) or amounts required to come into compliance with any law that was violated or involved in the investigation or inquiry, that are identified in the court order or settlement agreement as restitution, remediation, or required to come into compliance. IRS remains free to challenge the characterization of an amount so identified; however, no deduction is allowed unless the identification is made.

An exception also applies to any amount paid or incurred as taxes due.

Restitution for failure to pay any tax, that is assessed as restitution under the Code is deductible only to the extent it would have been allowed as a deduction if it had been timely paid.

Government agencies (or entities treated as such) must report to IRS and to the taxpayer the amount of each settlement agreement or order entered into where the aggregate amount required to be paid or incurred to or at the direction of the government is at least $600 (or such other amount as may be specified by IRS). The report must separately identify any amounts that are for restitution or remediation of property, or correction of noncompliance. The report must be made at the time the agreement is entered into, as determined by IRS.

The provisions do not apply to amounts paid or incurred under any binding order or agreement entered into before the date of enactment. But this exception would not apply to an order or agreement requiring court approval unless the approval was obtained before the enactment date.

Employee Achievement Awards

Employee achievement award are excludable to the extent the employer can deduct the cost of the award – generally limited to $400 for any one employee, or $1,600 for a "qualified plan award." An employee achievement award is an item of tangible personal property given to an employee in recognition of either length of service or safety achievement and presented as part of a meaningful presentation.

For amounts paid or incurred after December 31, 2017, a definition of "tangible personal property" is provide. Tangible personal property does not include cash, cash equivalents, gift cards, gift coupons, gift certificates (other than where from the employer pre-selected or pre-approved a limited selection) vacations, meals, lodging, tickets for theatre or sporting events, stock, bonds or similar items, and other non-tangible personal property. No inference is intended that this is a change from present law and guidance.

Deduction for Local Lobbying Expenses Eliminated

Under current law, businesses generally may deduct ordinary and necessary expenses paid or incurred in connection with carrying on any trade or business. Under pre-Act law, an exception to the general rule, however, disallows deductions for lobbying and political expenditures with respect to legislation and candidates for office, except for lobbying expenses with respect to legislation before local government bodies.

For amounts paid or incurred on or after the date of enactment, the Code Sec. 162(e) deduction for lobbying expenses with respect to legislation before local government bodies is eliminated.

Rehabilitation Credit Limited

Under pre-Act law, a 20% credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure, i.e., any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district. A 10% credit is provided for qualified rehabilitation expenditures with respect to a qualified rehabilitated building, which generally means a building that was first placed in service before 1936. A building is treated as having met the substantial rehabilitation requirement under the 10% credit only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the tax year exceed the greater of (1) the adjusted basis of the building (and its structural components), or (2) $5,000.

Straight-line depreciation or the ADS must be used in order for rehabilitation expenditures to be treated as qualified for the credit.

For amounts paid or incurred after December 31, 2017, the 10% credit for qualified rehabilitation expenditures with respect to a pre-'36 building is repealed and a 20% credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure which can be claimed ratably over a 5-year period beginning in the tax year in which a qualified rehabilitated structure is placed in service.

A transition rule provides that for qualified rehabilitation expenditures (for either a certified historic structure or a pre-'36 building), for any building owned or leased (as provided under pre-Act law) by the taxpayer at all times on and after January 1, 2018, the 24-month period selected by the taxpayer, or the 60-month period selected by the taxpayer under the rule for phased rehabilitation, is to begin no later than the end of the 180-day period beginning on the date of the enactment, and apply to such expenditures paid or incurred after the end of the tax year in which such 24-or 60-month period ends.

New Credit for Employer-Paid Family and Medical Leave

Under pre-Act law, no credit is provided to employers for compensation paid to employees while on leave.

For wages paid in tax years beginning after December 31, 2017, but not beginning after December 31, 2019, the Act allows businesses to claim a general business credit equal to 12.5% of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave (FMLA) if the rate of payment is 50% of the wages normally paid to an employee. The credit is increased by 0.25 percentage points (but not above 25%) for each percentage point by which the rate of payment exceeds 50%. All qualifying full-time employees have to be given at least two weeks of annual paid family and medical leave (all less-than-full-time qualifying employees have to begiven a commensurate amount of leave on a pro rata basis).

Taxable Year of Inclusion

In general, for a cash basis taxpayer, an amount is included in income when actually or constructively received. For an accrual basis taxpayer, an amount is included in income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy (i.e., when the "all events test" is met), unless an exception permits deferral or exclusion. A number of exceptions that exist to permit deferral of income relate to advance payments. An advance payment is when a taxpayer receives payment before the taxpayer provides goods or services to its customer. The exceptions often allow tax deferral to mirror financial accounting deferral (e.g., income is recognized as the goods are provided or the services are performed).

Generally for tax years beginning after December 31, 2017, a taxpayer is required to recognize income no later than the tax year in which such income is taken into account as income on an applicable financial statement (AFS) or another financial statement under rules specified by IRS (subject to an exception for long-term contract income under Code Sec. 460).

The Act also codifies the current deferral method of accounting for advance payments for goods and services provided by Rev Proc 2004-34 to allow taxpayers to defer the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income also is deferred for financial statement purposes.

Cash Method of Accounting

Under pre-Act law, a corporation, or a partnership with a corporate partner, may generally only use the cash method of accounting if, for all earlier tax years beginning after December 31, 1985, the corporation or partnership met a gross receipts test – i.e., the average annual gross receipts the entity for the three-tax-year period ending with the earlier tax year does not exceed $5 million. Under current law, farm corporations and farm partnerships with a corporate partner may only use the cash method of accounting if their gross receipts do not exceed $1 million in any year. An exception allows certain family farm corporations to qualify if the corporation's gross receipts do not exceed $25 million ($26 million for 2020 and 2021). Qualified personal service corporations are allowed to use the cash method without regard to whether they meet the gross receipts test.

For tax year December 31, 2018, the cash method may be used by taxpayers (other than tax shelters) that satisfy a $25 million ($26 million for 2019 and 2020) gross receipts test, regardless of whether the purchase, production, or sale of merchandise is an income-producing factor. Under the gross receipts test, taxpayers with annual average gross receipts that do not exceed $25 million ($26 million for 2020 and 2021) (indexed for inflation for tax years beginning after December 31, 2018) for the three prior tax years are allowed to use the cash method.

The exceptions from the required use of the accrual method for qualified personal service corporations and taxpayers other than C corporations are retained. Accordingly, qualified personal service corporations, partnerships without C corporation partners, S corporations, and other pass-through entities are allowed to use the cash method without regard to whether they meet the $25 million ($26 million for 2020 and 2021) gross receipts test, so long as the use of the method clearly reflects income.

Use of this provision results in a change in the taxpayer's accounting method for purposes of Code Sec. 481.

Accounting for Inventories

Under pre-Act law, businesses that are required to use an inventory method must generally use the accrual accounting method. However, the cash method can be used for certain small businesses that meet a gross receipt test with average gross receipts of not more than $1 million ($10 million businesses in certain industries). These businesses account for inventory as non-incidental materials and supplies.

For tax year December 31, 2018, taxpayers that meet the $25 million ($26 million for 2020 and 2021) gross receipts test are not required to account for inventories under Code Sec. 471, but rather may use an accounting method for inventories that either (1) treats inventories as non-incidental materials and supplies, or (2) conforms to the taxpayer's financial accounting treatment of inventories.

Use of this provision results in a change in the taxpayer's accounting method for purposes of Code Sec. 481.

Capitalization and Inclusion of Certain Expenses in Inventory Costs

The uniform capitalization (UNICAP) rules generally require certain direct and indirect costs associated with real or tangible personal property manufactured by a business to be included in either inventory or capitalized into the basis of such property. However, under pre-Act law, a business with average annual gross receipts of $10 million or less in the preceding three years is not subject to the UNICAP rules for personal property acquired for resale. The exemption does not apply to real property (e.g., buildings) or personal property that is manufactured by the business.

For tax year December 31, 2018, any producer or re-seller that meets the $25 million ($26 million for 2020 and 2021) gross receipts test is exempted from the application of Code Sec. 263A. The exemptions from the UNICAP rules that are not based on a taxpayer's gross receipts are retained.

Use of this provision results in a change in the taxpayer's accounting method for purposes of Code Sec. 481.

Accounting for Long-Term Contracts

Under pre-Act law, an exception from the requirement to use the percentage-of-completion method (PCM) for long-term contracts was provided for construction companies with average annual gross receipts of $10 million or less in the preceding three years (i.e., small construction contracts) that met certain requirements. They were allowed to instead deduct costs associated with construction when they were paid and recognize income when the building was completed.

For contracts entered into after December 31, 2017, in tax years ending after that date, the exception for small construction contracts from the requirement to use the PCM is expanded to apply to contracts for the construction or improvement of real property if the contract: (1) is expected (at the time such contract is entered into) to be completed within two years of commencement of the contract and (2) is performed by a taxpayer that (for the tax year in which the contract was entered into) meets the $25 million ($26 million for 2020 and 2021) gross receipts test.

Use of this PCM exception for small construction contracts is applied on a cutoff basis for all similarly classified contracts (so there is no adjustment under Code Sec. 481(a) for contracts entered into before January 1, 2018).

"S" Corporation Shareholder Compensation

The IRS is on the lookout for S Corporations that fail to pay reasonable salaries to shareholders who perform services for the corporation. The failure to pay adequate salaries to shareholder-employees is a red flag for an audit.

The IRS can reclassify as salaries any distributions to the shareholders. Determining what a reasonable salary is may be more art than science, but the attempt must be made.

Because the IRS's goal is to collect FICA tax on the salaries, one solution is to pay the maximum amount of wages subject to FICA tax, assuming, of course this is a reasonable salary, based on the shareholder-employee's services actually rendered. A smaller salary may be justified for an executive in a startup or a relatively small corporation. The salary should also consider the shareholder-employee's experience and skill, the geographical region, customer base, number of employees, and time committed to the corporation. What is a reasonable salary depends on the facts of each case. No test is conclusive. It often becomes a judgment call by the IRS. Comparable salaries from industry data are usually appropriate.

The tax court in several instances allowed statistical data from an industry and region to be used as guidance for reasonable compensation. There is no IRS rule that insolates the S Corporation from an audit on this issue. A reasonable salary depends on all the facts and circumstances in each individual case. If the S Corporation is a personal service corporation with one employee, the shareholder-employee, then a case can be made that the entire net earnings of the corporation should be salary. At the other extreme, if the S Corporation is a construction company with large amounts of capital equipment, then a good deal of the corporate earnings are a return on this capital and a reasonable salary may be just a small percentage of corporate earnings.

The reclassification of a distribution to salary results in increased taxes to you in the form of payroll taxes.

The lost revenue is of great concern to the IRS. In May, 2005, the office of the Treasury Inspector General for the administration reported that in 2000 alone, more than 36,000 single-shareholder S Corporations with profits excess $100,000 paid no salaries or payroll taxes. Another 40,000 with profits between $50,000 and $100,000 did not pay any salaries.

We have seen an extreme increase in audits related to this issue. The IRS compares the officer compensation line item on the S Corporation return to the profit of the S Corporation and will typically audit those returns that show little if any officer compensation.

Shareholder Loans to "S" Corporations

On October 17, 2008 the IRS finalized regulations on the treatment of open account debt between S Corporations and their shareholders. If a shareholder's basis in S Corporation shareholder debt has been reduced by his or her share of the S Corporation losses and the S Corporation makes a distribution or pays off the debt with an amount in excess of the remaining basis, gain must be recognized.

A capital gain will result if the debt is evidenced by a written note. If the S Corporation repays the debt and the shareholder lends more money later in the year for purposes of avoiding the gain, each payment is treated as an individual transaction, and the two payments are not netted for purposes of determining basis in debt at the end of the year. When the debt of the S Corporation to the shareholder is paid off in installments, each installment is allocated between return of capital and gain based on the proportion of the shareholder's basis in the debt to its face amount. Under the final regulations, open account debt would be defined as shareholder advances not evidenced by separate written instruments for which the principal amount of the aggregate advances does not exceed $25,000 at the close of any day during the S Corporation's tax year. If the running balance exceeds $25,000, the entire principal amount of that debt would no longer be open account debt. The principal amount would be treated as debt evidenced by a written instrument.

Regulation 1.1367-2(a) states that generally, if shareholder advances are not evidenced be separate written instruments for which the principal amount of the aggregate advances does not exceed $25,000 and repayments on the advances, the debt is called open account debt and treated as a single debt. However, ordinary income results on the S Corporation's repayment of the open account debt.

Although ordinary income is a disadvantage of not evidencing loans, an advantage is that multiple loans and repayments made throughout the year are considered open account debt and are netted at the end of the year rather than gain occurring on repayment of each individual debt. The final regulations generally are proposed to apply to shareholder advances to S Corporations made on or after October 20, 2008.

If the indebtedness is evidenced by a note, the repayment is treated as a sale or exchange. Accordingly, if the note is a capital asset in the shareholder's hands the excess of the amount repaid over basis is taxed as capital gain. (Rev. Rul. 64-162, 1964-1 C.B. 304).

However, if the debt is not evidenced by a note, there is no sale or exchange when the debt is paid. Thus, a payment by an S Corporation of a debt to a shareholder that is carried on an open account, will be ordinary income to the extent of the amount paid over the applied basis (Rev. Rul. 68-537, 1968-2 C.B. 372).

If a shareholder's advances are not evidenced by a separate written instrument, net of repayments, exceed an aggregate outstanding principal amount of $25,000 at the close of the S Corporation's tax year, for any later tax year, the aggregate principal amount is treated as indebtedness evidenced by a separate written instrument, with the result that the indebtedness is not open account debt and is subject to all basis adjustment rules applicable to basis of indebtedness of an S Corporation to a shareholder. However, in this case the gain would be ordinary as there is no written note it is merely deemed a written note for purposes of the timing of taxability. Should you find yourself in this situation, you should draw up actual notes so that the gain would be capital gain.

Economic Substance Doctrine Clarified

Under pre-2010 Reconciliation Act law, courts denied claimed tax benefits under two closely related nonstatutory doctrines that evolved in judicial decisions. Under the "economic substance" doctrine, courts generally denied claimed tax benefits if the transaction that gave rise to those benefits lacked economic substance independent of tax considerations – even though the purported activity actually occurred. A common law doctrine that often was considered together with the economic substance doctrine was the business purpose doctrine. The business purpose doctrine involved a subjective inquiry into the taxpayer's motives, i.e., whether the taxpayer intended the transaction to serve some useful non-tax purpose.

There was a lack of uniformity as to the proper application of the economic substance doctrine. Some courts applied a conjunctive test that required a taxpayer to establish the presence of both economic substance (i.e. the objective component) and business purpose (i.e. the subjective component) for the transaction to be given effect. Under a narrower approach used by some courts either a business purpose or economic substance was sufficient to have the transaction respected. Under a third approach economic substance and business purpose were viewed as simply more precise factors to consider in determining if a transaction had any practical economic effects other than the creation of tax benefits. In 2006, the Federal Circuit Court stated that while the economic substance doctrine could well apply if the taxpayer's sole subjective motivation was tax avoidance, even if the transaction had economic substance, a lack of economic substance was sufficient to disqualify the transaction without proof that the taxpayer's sole motive was tax avoidance. In 2009, the 5th Circuit also adopted the view that a lack of economic substance alone was sufficient to disqualify the transaction without regard to the taxpayer's motive.

The 2010 Reconciliation Act provides statutory rules for applying the economic substance doctrine.

The 2010 Reconciliation Act also defines the economic substance doctrine as the common law doctrine under which the Federal income tax benefits of a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

Testing a Transaction Under the Codified Economic Substance Doctrine

Under the 2010 Reconciliation Act, a transaction to which the economic substance doctrine is relevant (see below) has economic substance only if:

- The transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
- The taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into the transaction. (This list is referred to as the economic substance test list.)

The determination of whether the economic substance doctrine is relevant to a transaction is made as if this provision was never enacted. Thus, the provision does not change current law standards in determining when to utilize an economic substance analysis.

SOLE PROPRIETORSHIPS, S CORPORATIONS & PARTNERSHIPS TAX CHANGES

New Deduction for Pass-Through Income

Under pre-Act law, the net income of these pass-through businesses – sole proprietorships, partnerships, limited liability companies (LLCs), and S corporations – was not subject to an entity-level tax and was instead reported by the owners or shareholders on their individual income tax returns. Thus, the income was effectively subject to individual income tax rates.

Generally for tax years beginning after December 31, 2017 and before January 1, 2026, the Act adds a new section, Code Sec. 199A, "Qualified Business Income," under which a non-corporate taxpayer, including a trust or estate, who has qualified business income (QBI) from a partnership, S corporation, or sole proprietorship is allowed to deduct:

1) The lesser of: (a) the "combined qualified business income amount" of the taxpayer, or (b) 20% of the excess, if any, of the taxable income of the taxpayer for the tax year over the sum of net capital gain and the aggregate amount of the qualified cooperative dividends of the taxpayer for the tax year; *plus*
2) The lesser of: (i) 20% of the aggregate amount of the qualified cooperative dividends of the taxpayer for the tax year, or (ii) taxable income (reduced by the net capital gain) of the taxpayer for the tax year.

The "combined qualified business income amount" means, for any tax year, an amount equal to: (i) the deductible amount for each qualified trade or business of the taxpayer (defined as 20% of the taxpayer's QBI subject to the W-2 wage limitation; see below); *plus* (ii) 20% of the aggregate amount of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership income of the taxpayer for the tax year.

QBI is generally defined as the net amount of "qualified items of income, gain, deduction, and loss" relating to any qualified trade or business of the taxpayer. For this purpose, qualified items of income, gain, deduction, and loss are items of income, gain, deduction, and loss to the extent these items are effectively connected with the conduct of a trade or business within the United States under Code Sec. 864(c) and included or allowed in determining taxable income for the year. If the net amount of qualified income, gain, deduction, and loss relating to qualified trade or businesses of the taxpayer for any tax year is less than zero, the amount is treated as a loss from a qualified trade or business in the succeeding tax year. QBI does *not* include: certain investment items; reasonable compensation paid to the taxpayer by any qualified trade or business for services rendered with respect to the trade or business; any guaranteed payment to a partner for services to the business under Code Sec. 707(c); or a payment under Code Sec. 707(a) to a partner for services rendered with respect to the trade or business.

The 20% deduction is not allowed in computing adjusted gross income (AGI), but rather is allowed as a deduction reducing *taxable* income.

For pass-through entities, other than sole proprietorships, the deduction cannot exceed the greater of:

1) 50% of the W-2 wages with respect to the qualified trade or business ("W-2 wage limit"), or
2) The sum of 25% of the W-2 wages paid with respect to the qualified trade or business *plus* 2.5% of the unadjusted basis, immediately after acquisition, of all "qualified property." Qualified property is defined in Code Sec. 199A(b)(6) as meaning tangible, depreciable property which is held by and available for use in the qualified trade or business at the close of the tax year, which is used at any point during the tax year in the production of qualified business income, and the depreciable period for which has not ended before the close of the tax year.

The second limitation, which was newly added to the bill during Conference, apparently allows pass-through businesses to be eligible for the deduction on the basis of owning property that qualifies under the provision (e.g., real estate).

For partnership or S corporation, each partner or shareholder is treated as having W-2 wages for the tax year in an amount equal to his or her allocable share of the W-2 wages of the entity for the tax year. A partner's or shareholder's allocable share of W-2 wages is determined in the same way as the partner's or shareholder's allocable share of wage expenses. For an S corporation, an allocable share is the shareholder's pro rata share of an item. However, the W-2 wage limit begins phasing out in the case of a taxpayer with taxable income exceeding $321,450 ($326,600 for 2020) for married individuals filing jointly, and $160,700 ($163,300 for 2020) for other individuals. The application of the W-2 wage limit is phased in for individuals with taxable income exceeding these thresholds, over the next $100,000 of taxable income for married individuals filing jointly ($50,000 for other individuals).

The deduction does not apply to specified service businesses (i.e., trades or businesses described in Code Sec. 1202(e)(3)(A), but excluding engineering and architecture; and trades or businesses that involve the performance of services that consist of investment-type activities). However, the service business limitation begins phasing out in the case of a taxpayer whose taxable income exceeds $321,450 ($326,600 for 2020) for married individuals filing jointly; $160,700 ($163,300 for 2020) for other individuals, both indexed for inflation after 2018. The benefit of the deduction for service businesses is phased out over the next $100,000 of taxable income for joint filers ($50,000 for other individuals). The deduction also does not apply to the trade or business of being an employee.

Safe Harbor for when Rental Real Estate Enterprise is Sec. 199A Trade or Business

In a Notice that contains a proposed revenue procedure, IRS has provided a safe harbor under which a rental real estate enterprise will be treated as a trade or business solely for the purposes of Code Sec. 199A, the qualified business income deduction.

Congress enacted Code Sec. 199A to provide a deduction to non-corporate taxpayers of up to 20% of the taxpayer's qualified business income from each of the taxpayer's qualified trades or businesses, including those operated through a partnership, S corporation, or sole proprietorship, as well as a deduction of up to 20% of aggregate qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership income.

Code Sec. 199A(d) defines a qualified trade or business as any trade or business other than a specified service trade or business (SSTB) or the trade or business of performing services as an employee. Reg 1.199A-1 (b)(14) defines trade or business, in relevant part, as a trade or business under Code Sec. 162 other than the trade or business of performing services as an employee.

The proposed revenue procedure provides a safe harbor for treating a rental real estate enterprise as a trade or business solely for purposes of the Code Sec. 199A deduction. If an enterprise fails to satisfy these requirements, the rental real estate enterprise may still be treated as a trade or business for purposes of Code Sec. 199A if the enterprise otherwise meets the definition of trade or business in Reg. 1.99A-1(b)(14). Relevant pass-through entities (RPEs), as defined in Reg. 1.199A-1(b)(10), may use the safe harbor in order to determine whether a rental real estate enterprise is a trade or business.

Solely for purposes of this safe harbor, a rental real estate enterprise is defined as an interest in real property held for the production of rents and may consist of an interest in multiple properties. The individual or RPE relying on the revenue procedure must hold the interest directly or through an entity disregarded as an entity separate from its owner under Reg. 301.7701-3. Taxpayers must either treat each property held for the production of rents as a separate enterprise or treat all similar properties held for the production of rents (with the exception of those described in the paragraph below that begins "Real estate used by a taxpayer.") as a single enterprise. Commercial and residential real estate may not be part of the same enterprise. Taxpayers may not vary this treatment from year-to-year unless there has been a significant change in facts and circumstances.

Solely for the purposes of Code Sec. 199A, a rental real estate enterprise will be treated as a trade or business if the following requirements are satisfied during the tax year with respect to the rental real estate enterprise:

1) Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise;
2) For tax years beginning prior to January 1, 2023, 250 or more hours of rental services are performed (as described below) per year with respect to the rental enterprise. For tax years beginning after December 1, 2022, in any three of the five consecutive tax years that end with the tax year (or in each year for an enterprise held for less than five years), 250 or more hours of rental services are performed (as described below) per year with respect to the rental real estate enterprise; and
3) The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. Such records are to be made available for inspection at the request of the IRS. The contemporaneous records requirement will not apply to tax years beginning prior to January 1, 2019.

Rental services for purpose of the proposed revenue procedure include: (i) advertising to rent or lease the real estate; (ii) negotiating and executing leases; (iii) verifying information contained in prospective tenant applications; (iv) collection of rent; (v) daily operating, maintenance, and repair of the property; (vi) management of the real estate; (vii) purchase of materials and (viii) supervision of employees and independent contractors. Rental services may be performed by owners or by employees, agents, and/or independent contractors of the owners. The term rental services does not include financial or investment management activities, such as arranging financing; procuring property; studying and reviewing financial statements or reports on operations; planning, managing, or constructing long-term capital improvements; or hours spent traveling to and from the real estate.

Real estate used by the taxpayer (including an owner or beneficiary of an RPE relying on this safe harbor) as a residence for any part of the year under Code Sec. 280A is not eligible for this safe harbor. Real estate rented or leased under a triple net lease is also not eligible for this safe harbor. For purposes of the revenue procedure, a triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities.

Repeal of Partnership Technical Termination

Under a "technical termination" under Code Sec. 708(b)(1)(B), a partnership is considered as terminated if, within any 12-month period, there is a sale or exchange of 50% or more of the total interest in partnership capital and profits. A technical termination gives rise to a deemed contribution of all the partnership's assets and liabilities to a new partnership in exchange for an interest in the new partnership, followed by a deemed distribution of interests in the new partnership to the purchasing partners and the other remaining partners. As a result of a technical termination, some of the tax attributes of the old partnership terminate; the partnership's tax year closes; partnership-level elections generally cease to apply; and the partnership depreciation recovery periods restart.

For partnership tax years beginning after December 31, 2017, the Code Sec. 708(b)(1)(B) rule providing for the technical termination of a partnership is repealed. The repeal does not change the pre-Act law rule of Code Sec. 708(b)(1)(A) that a partnership is considered as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

Treatment of S Corporation Converted to C Corporation

Under present law, in the case of an S corporation that converts to a C corporation, distributions of cash by the C corporation to its shareholders during the post-termination transition period (PTTP), to the extent of the amount in the accumulated adjustment account), are tax-free to the shareholders and reduce the adjusted basis of the stock.

The PTTP is:

1) The period beginning on the day after the last day of the corporation's last tax year as an S corporation and ending on the later of (a) the day that is one year after that day, or (b) the due date for filing the return for the corporation's last tax year as an S corporation (including extensions);
2) The 120-day period beginning on the date of any determination (as defined in Reg. §1.1377-2(c)) with respect to an audit of the taxpayer that follows the termination of the corporation's election and that adjusts a Subchapter S income, loss or deduction item that arises during the S corporation period (i.e., the most recent continuous period during which the corporation was an S corporation); and
3) The 120-day period beginning on the date of a determination that the corporation's S election had terminated for an earlier year.

On the date of enactment, any Code Sec. 481(a) adjustment of an eligible terminated S corporation attributable to the revocation of its S corporation election (i.e., a change from the cash method to an accrual method) is taken into account ratably during the 6-tax year period beginning with the year of change. An eligible terminated S corporation is any C corporation which (1) is an S corporation the day before the date of enactment; (2) during the 2-year period beginning on the date of enactment revokes its S corporation election; and (3) all of the owners of which on the date the S corporation election is revoked are the same owners (and in identical proportions) as the owners on the date of such enactment.

In the case of a distribution of money by an eligible terminated S corporation, the accumulated adjustments account shall be allocated to such distribution, and the distribution shall be chargeable to accumulated earnings and profits, in the same ratio as the amount of the accumulated adjustments account bears to the amount the accumulated earnings and profits.

UBTI Separately Computed for Each Trade or Business Activity

A tax-exempt organization determines its unrelated business taxable income (UBTI) by subtracting, from its gross unrelated business income, deductions directly connected with the unrelated trade or business. Under regs, in determining UBTI, an organization that operates multiple unrelated trades or businesses aggregates income from all such activities and subtracts from the aggregate gross income the aggregate of deductions. As a result, an organization may use a deduction from one unrelated trade or business to offset income from another, thereby reducing total unrelated business taxable income.

For tax years beginning after December 31, 2017 (subject to an exception for net operating losses (NOLs) arising in a tax year beginning before January 1, 2018, that are carried forward), losses from one unrelated trade or business may not be used to offset income derived from another unrelated trade or business. Gains and losses have to be calculated and applied separately.

CORONAVIRUS AID, RELIEF, AND ECONOMIC SECURITY ACT (CARES ACT)
BUSINESS TAX PROVISIONS

Temporary Repeal of Taxable Income Limitation for Net Operating Losses (NOLs)

Under pre-Act law, the amount of the NOL deduction is equal to the lesser of (1) the aggregate of the NOL carryovers to such year and NOL carrybacks to such year, or (2) 80% of taxable income computed without regard to the deduction allowable in this section. Thus, NOLs are currently subject to a taxable-income limitation and cannot fully offset income.

The CARES Act temporarily removes the taxable income limitation to allow an NOL to fully offset income. The amendments made apply to tax years beginning after December 31, 2017, and to tax years beginning on or before December 31, 2017, to which NOLs arising in tax years beginning after December 31, 2017 are carried.

Modification of Rules Relating to Net Operating Loss (NOL) Carrybacks

Under pre-Act law, an NOL for any tax year is carried forward to each tax year following the tax year of the loss but is not carried back to any tax year preceding the tax year of the loss.

The CARES Act provides that NOLs arising in a tax year beginning after December 31, 2018 and before January 1, 2021 can be carried back to each of the five tax years preceding the tax year of such loss. The amendments apply to NOLs arising in tax years beginning after December 31, 2017 and to tax years beginning before, on or after such date to which such NOLs are carried.

Deductibility of Interest Expense Temporarily Increased

Under pre-Act law, The Tax Cuts and Jobs Act of 2017 (P.L. 115-97, the "TCJA") generally limited the amount of business interest allowed as a deduction to 30% of adjusted taxable income. (Code Sec. 163(j)(10))

The CARES Act temporarily and retroactively increases the limitation on the deductibility of interest expense under Code Sec. 163(j)(1) from 30% to 50% for tax years beginning in 2019 and 2020.

Special rules for partnerships. Under a special rule for partnerships, the increase in the limitation will not apply to partners in partnerships for 2019 (it applies only in 2020). For partners that do not elect out, any excess business interest of the partnership for any tax year beginning in 2019 that is allocated to the partner will be treated as follows.

…50% of the excess business interest will be treated as paid or accrued by the partner in the partner's first tax year beginning in 2020 and is not subject to any limits in 2020.

…50% of the excess business interest will be subject to the limitations of paragraph (relating to the usual treatment of excess business interest allocated to partners) in the same manner as any other excess business interest that is so allocated. In other words, it will remain suspended until the partnership allocates excess taxable income or excess interest income to the partner (or the partnership is no longer subject to Code Sec. 163(j)).

Election out of the increased limitation. Taxpayers may elect out of the increase, for any tax year, in the time and manner IRS prescribes. Once made, the election can be revoked only with IRS consent. For partnerships, the election must be made by the partnership and can be made only for tax years beginning in 2020.

Election to calculate 2020 interest limitation using 2019 adjusted taxable income. In addition, taxpayers can elect to calculate the interest limitation for their tax year beginning in 2020 using the adjusted taxable income for their last tax year beginning in 2019 as the relevant base. For partnerships, this election must be made by the partnership.

If an election is made to calculate the interest limitation using 2019 adjusted taxable income for a tax year that is a short tax year, the adjusted taxable income for the taxpayer's last tax year beginning in 2019 which is substituted under the election will be equal to the amount which bears the same ratio to such adjusted taxable income as the number of months in the short taxable year bears to 12.

The amendments made by Act Sec. 2306 apply to tax years beginning after December 31, 2018.

Bonus Depreciation Technical Correction for Qualified Improvement Property

Under pre-Act law, The Tax Cuts and Jobs Act of 2017 amended Code Sec. 168 to allow 100% additional first-year depreciation deductions ("100% Bonus Depreciation") for certain qualified property. The TCJA eliminated pre-existing definitions for (1) qualified leasehold improvement property, (2) qualified restaurant property, and (3) qualified retail improvement property. It replaced those definitions with one category called qualified improvement property ("QI Property"). A general 15-year recovery period was intended to have been provided for QI Property. However, that specific recovery period failed to be reflected in the statutory text of the TCJA. Thus, under the TCJA, QI Property falls into the 39-year recovery period for nonresidential rental property. That makes the QI Property category ineligible for 100% Bonus Depreciation.

The CARES Act provides a technical correction to the TCJA, and specifically designates QI Property as 15-year property for depreciation purposes. This makes QI Property a category eligible for 100% Bonus Depreciation. QI property also is specifically assigned a 20-year class life for the Alternative Depreciation System. The amendments made by Act Sec. 2307 are effective for property placed in service after December 31, 2017.

CORONAVIRUS AID, RELIEF, AND ECONOMIC SECURITY ACT (CARES ACT)
INDIVIDUAL TAX PROVISIONS

Individual Recovery Rebate/Credit

Under pre-Act law, credit allowed for 2020.

The CARES Act allows an eligible individual is allowed an income tax credit for 2020 equal to the sum of: $1,200 ($2,400 for eligible individuals filing a joint return) plus $500 for each qualifying child of the taxpayer. The credit is refundable.

> Observation. For purposes of the child tax credit, the term "qualifying child" means a qualifying child of the taxpayer, as defined for purposes of the dependency exemption by Code Sec. 152(c), who has not attained age 17.

> Observation. Individuals who have no income, as well as those whose income comes entirely from non-taxable means-tested benefit programs such as SSI benefits, are eligible for the credit and the advance rebate.

For purposes of the credit, an "eligible individual" is any individual other than a nonresident alien or an individual for whom a Code Sec. 151 dependency deduction is allowable to another taxpayer for the tax year. Estates and trusts are not eligible for the credit.

> Observation. Children who are (or can be) claimed as dependents by their parents are not eligible individuals, even if they have enough income to have to file a return. It makes no difference if the parent chooses not to claim the child as a dependent, because the dependency deduction is still "allowable" to the parent.

> Observation. An individual who was not an eligible individual for 2019 may become one for 2020, e.g., where the individual was a dependent for 2019 but not for 2020. IRS will not send an advance rebate to such an individual, because advance rebates are generally based on information on the 2019 return (see below). However, the individual will be able to claim the credit when filing the 2020 return.

The amount of the credit is reduced (but not below zero) by 5% of the taxpayer's adjusted gross income (AGI) in excess of: (1) $150,000 for a joint return, (2) $112,500 for a head of household, and (3) $75,000 for all other taxpayers.

> Observation. Under these rules, the credit is completely phased-out for a single filer with AGI exceeding $99,000 and for joint filers with no children with AGI exceeding $198,000. For a head of household with one child, the credit is completely phased out when AGI exceeds $146,500.

Each individual who was an eligible individual for 2019 is treated as having made an income tax payment for 2019 equal to the advance refund amount for 2019. The "advance refund amount" is the amount that would have been allowed as a credit for 2019 had the credit provision been in effect for 2019.

IRS will refund or credit any resulting overpayment as rapidly as possible. No interest will be paid on the overpayment.

If an individual has not yet filed a 2019 income tax return, IRS will determine the amount of the rebate using information from the taxpayer's 2018 return. If no 2018 return has been filed, IRS will use information from the individual's 2019 Form SSA-1099, Social Security Benefit Statement, or Form RRB-1099, Social Security Equivalent Benefit Statement.

> Observation. In other words, even though the credit is technically for 2020, the law treats it as an overpayment for 2019 that IRS will rebate as soon as possible during 2020.

> Observation. Most eligible individuals will not have to take any action to receive an advance rebate from IRS. This includes many low-income individuals who file a tax return to claim the refundable earned income credit and child tax credit.

IRS may make the rebate electronically to any account to which the payee authorized, on or after January 1, 2018, the delivery of a refund of federal taxes or of a federal payment.

No later than 15 days after distributing a rebate payment, IRS must mail a notice to the taxpayer's last known address indicating how the payment was made, the amount of the payment, and a phone number for reporting any failure to receive the payment to IRS.

No advance rebate will be made or allowed after December 31, 2020.

Advance rebate reduces credit allowed for 2020. The amount of credit that is allowable for 2020 must be reduced (but not below zero) by the aggregate advance rebates made or allowed to the taxpayer during 2020.

> Observation. If the taxpayer received an advance rebate during 2020 that was less than the credit to which the taxpayer is entitled for 2020, the taxpayer will be able to claim the balance of the credit when filing the 2020 return. If, on the other hand, the advance rebate received was greater than the credit to which the taxpayer is entitled, the taxpayer will not have to pay back the excess. That is because the 2020 credit cannot be reduced below zero.

If an advance rebate was made or allowed for a joint return, half of the rebate is treated as having been made or allowed to each spouse who filed the joint return.

> Observation. Thus, if taxpayers filed a joint return for 2019 and received an advance rebate, but were divorced or filed separate returns for 2020, each individual will take into account half of the advance rebate when reducing the credit allowed for 2020.

Identification number requirement. No credit will be allowed to an eligible individual who does not include the individual's valid identification number on the tax return for the tax year.

On a joint return, the valid identification number of the individual's spouse must be included. But this requirement does not apply if at least one spouse was a member of the U.S. Armed Forces at anytime during the tax year and at least one spouse's valid identification number is included on the joint return.

No 10% Additional Tax for Coronavirus-Related Retirement Plan Distributions

Under pre-Act law, a distribution from a qualified retirement plan is subject to a 10% additional tax unless the distribution meets an exception under Code Sec. 72(t).

The CARES Act provides that the Code Sec. 72(t) 10% additional tax does not apply to any coronavirus-related distribution, up to $100,000.

A coronavirus-related distribution is any distribution (subject to dollar limits discussed below), made on or after January 1, 2020, and before December 31, 2020, from an eligible retirement plan, made to a qualified individual.

A qualified individual is an individual (1) who is diagnosed with the virus SARS-CoV-2 or with coronavirus disease 2019 (COVID-19) by a test approved by the Centers for Disease Control and Prevention (CDC), (2) whose spouse or dependent (as defined in Code Sec. 152) is diagnosed with such virus or disease by such a test, or (3) who experiences adverse financial consequences as a result of being quarantined, being furloughed or laid off or having work hours reduced due to such virus or disease, being unable to work due to lack of child care due to such virus or disease, closing or reducing hours of a business owned or operated by the individual due to such virus or disease, or other factors as determined by the Secretary of the Treasury.

The administrator of an eligible retirement plan may rely on an employee's certification that the employee satisfies the conditions of (3) above in determining whether any distribution is a coronavirus-related distribution.

The aggregate amount of distributions received by an individual which may be treated as coronavirus-related distributions for any tax year cannot exceed $100,000.

If a distribution to an individual would (without regard to the $100,000 limit) be a coronavirus-related distribution, a plan is not treated as violating the Code merely because the plan treats such distribution as a coronavirus-related distribution, unless the aggregate amount of such distributions from all plans maintained by the employer (and any member of any controlled group which includes the employer) to such individual exceeds $100,000.

Distribution can be contributed back to retirement plan. Any individual who receives a coronavirus-related distribution may, at any time during the 3-year period beginning on the day after the date on which such distribution was received, make one or more contributions in an aggregate amount not to exceed the amount of such distribution to an eligible retirement plan of which such individual is a beneficiary and to which a rollover contribution of such distribution could be made.

If a contribution is made with respect to a coronavirus-related distribution from an eligible retirement plan other than an individual retirement plan, then the taxpayer is, to the extent of the amount of the contribution, treated as having received the coronavirus-related distribution in an eligible rollover distribution and as having transferred the amount to the eligible retirement plan in a direct trustee to trustee transfer within 60 days of the distribution.

If a contribution is made with respect to a coronavirus-related distribution from an individual retirement plan, then, to the extent of the amount of the contribution, the coronavirus-related distribution is treated as a distribution and as having been transferred to the eligible retirement plan in a direct trustee to trustee transfer within 60 days of the distribution.

Distribution can be included in income over three years. In the case of any coronavirus-related distribution, unless the taxpayer elects not to, any amount required to be included in gross income for such tax year will be so included ratably over the 3-taxyear period beginning with such tax year.

Loans from qualified plans. The CARES Act provides flexibility for loans from certain retirement plans for coronavirus-related relief.

This applies to distributions made on or after January 1, 2020, and before December 31, 2020.

RMD Requirement Waived for 2020

Under pre-Act law, in general, Code Sec. 401(a)(9) requires a retirement plan or IRA owner to take required minimum distributions (RMDs) annually once the owner reaches age 72.

The CARES Act provides that the RMD requirements do not apply for calendar year 2020 to: (1) a defined contribution plan; (2) a defined contribution plan which is an eligible deferred compensation plan but only if such plan is maintained by an employer described in Code Sec. 457(e)(1)(A); or (3) an individual retirement plan.

The RMD requirements also do not apply to any distribution which is required to be made in calendar year 2020 by reason of: (1) a required beginning date occurring in calendar year 2020, and (2) such distribution not having been made before January 1, 2020.

For purposes of the RMD rules: (1) the required beginning date with respect to any individual is determined without regard to the temporary RMD waiver rules of Code Sec. 401(a)(9)(I) for purposes of applying the RMD rules for calendar years after 2020; and (2) if the 5-year rule applies (in general requiring a retirement plan to distribute its assets within five years of the death of the employee), the 5-year period is determined without regard to calendar year 2020.

Eligible rollover distributions. If all or any portion of a distribution during 2020 is treated as an eligible rollover distribution but would not be so treated if the minimum distribution requirements had applied during 2020, such distribution is not to be treated as an eligible rollover distribution.

The amendments made apply for calendar years beginning after December 31, 2019.

$300 Above-the-Line Charitable Deduction

Under pre-Act law, adjusted gross income is gross income less certain deductions.

The CARES Act adds a deduction to the calculation of gross income, in the case of tax years beginning in 2020, for the amount (not to exceed $300) of qualified charitable contributions made by an eligible individual during the tax year.

For this purpose, the term "eligible individual" means any individual who does not elect to itemize deductions. The term "qualified charitable contribution" means a charitable contribution: (A) which is made in cash; (B) for which a deduction is allowable; (C) which is made to an organization described in Code Sec. 170(b)(1)(A); (D) which is not for the establishment of anew, or maintenance of an existing, donor advised fund.

The amendments made by Act Sec. 2204 apply to tax years beginning after December 31, 2019.

Modification of Limitations on Individual Cash Charitable Contributions During 2020

Under pre-Act law, individuals are allowed a deduction for cash contributions to certain charitable organizations (such as churches, educational organizations, hospitals, and medical research organizations) up to 60% of their contribution base (generally, adjusted gross income (AGI)). If the aggregate amount of an individual's cash contributions to these charities for the year exceeds 60% of the individual's contribution base, then the excess is carried forward and is treated as a deductible charitable contribution in each of the five succeeding tax years.

The CARES Act provides that (except as stated below) qualified contributions are disregarded in applying the 60% limit on cash contributions of individuals and the rules on carryovers of excess contributions.

Qualified contributions are allowed as a deduction only to the extent that the aggregate of those contributions does not exceed the excess of the individual's contribution base over the amount of all other charitable contributions allowed as deductions for the contribution year.

Qualified contributions are charitable contributions if:

1. They are paid in cash during calendar year 2020 to an organization (i.e. 501(c)(3) and certain other charitable organizations); and
2. The taxpayer has elected to apply this provision with respect to the contribution.

However, contributions to a Code Sec. 509(a)(3) supporting organization or a donor advised fund are not qualified contributions.

In the case of a partnership or S corporation, the election in item (2) above is made separately by each partner or shareholder.

The amendments made apply to tax years beginning after December 31, 2019.

Modification of Limitations on Corporate Cash Charitable Contributions During 2020

Under pre-Act law, a corporation's charitable deduction cannot exceed 10% of its taxable income, as computed with certain modifications. If a corporation's charitable contributions for a year exceed the 10% limitation, the excess is carried over and deducted for each of the five succeeding years in order of time, to the extent the sum of carryovers and contributions for each of those years does not exceed 10% of taxable income.

The CARES Act provides that (except as stated below) qualified contributions (see above) are disregarded in applying the 10% limit on charitable contributions of corporations and the Code Sec. 170(d)(1) rules on carryovers of excess contributions.

Qualified contributions are allowed as a deduction only to the extent that the aggregate of those contributions does not exceed the excess of 25% of the corporation's taxable income over the amount of all other charitable contributions allowed to the corporation as deductions for the contribution year.

If the aggregate amount of qualified contributions exceeds the limitation in the previous paragraph, the excess is taken into account under the carryover rule, subject to its limitations.

The amendments made apply to tax years beginning after December 31, 2019.

Tax-Excluded Education Payments by an Employer Temporarily Include Student Loan Repayments

Under pre-Act law, an employee's gross income does not include up to $5,250 per year of employer payments, in cash or kind, made under an educational assistance program for the employee's education (but not the education of spouses or dependents).

The CARES Act adds to the types of educational payments that are excluded from employee gross income "eligible student loan repayments" (below) made before January 1, 2021. The payments are subject to the overall $5,250 per employee limit for all educational payments.

Eligible student loan repayments are payments by the employer, whether paid to the employee or a lender, of principle or interest on any qualified higher education loan for the education of the employee (but not of a spouse or dependent).

To prevent a double benefit, student loan repayments for which the exclusion is allowable cannot be deducted (which allows the deduction of student loan interest subject to a dollar limit and a phase-out above specified taxpayer income levels.)

The amendments made by Act Sec. 2206 apply to payments made after the date of enactment of the Act.

Repeal of Maximum Age for Traditional IRA Contributions

Section 107(a) of the SECURE Act repealed Code Sec. 219(d)(1). Prior to the repeal of Code Sec. 219(d)(1), an individual was not permitted to make contributions to the individual's traditional Individual Retirement Arrangement (IRA) for a tax year if the individual had attained age 70½ by the last day of the year.

Section 107(b) of the SECURE Act amended Code Sec. 408(d)(8)(A), which provides for exclusion from an individual's gross income of up to $100,000 in qualified charitable distributions. Code Sec. 408(d)(8)(B) defines qualified charitable distributions as distributions from an individual's IRA, made directly to certain organizations described in Code Sec. 170(b)(1)(A) on or after the date the individual has attained age 70½.

The amendment to Code Sec. 408(d)(8)(A) provides that the excludable amount of qualified charitable distributions for a tax year is reduced by the aggregate amount of IRA contributions deducted for the tax year and any earlier tax years in which the individual was age 70½ or older by the last day of the year (post-age 70½ contributions). The amendment further provides that the excludable amount of qualified charitable distributions for a tax year is not reduced by the amount of post-age 70½ contributions that caused a reduction in the excludable amount of qualified charitable distributions for earlier tax years.

Section 107(d) of the SECURE Act provides that these changes apply to contributions and distributions made for tax years beginning after December 31, 2019.

The following example illustrates the rules:

Example: An individual who turned age 70½ before 2020 deducts $5,000 for contributions for each of 2020 and 2021 but makes no contribution for 2022. The individual makes no qualified charitable distributions for 2020 and makes qualified charitable distributions of $6,000 for 2021 and $6,500 for 2022.

a) The excludable amount of qualified charitable distributions for 2021 is the $6,000 of qualified charitable distributions reduced by the $10,000 aggregate amount of post-age 70½ contributions for 2021 and earlier tax years. For this individual, these amounts are $5,000 for each of 2020 and 2021, resulting in no excludable amount of qualified charitable distributions for 2021 (that is, $6,000 - $10,000 = ($4,000)).
b) The excludable amount of the qualified charitable distributions for 2022 is the $6,500 of qualified charitable distributions reduced by the portion of the $10,000 aggregate amount of post-age 70½ contributions deducted that did not reduce the excludable portion of the qualified charitable distributions for earlier tax years. Thus $6,000 of the aggregate amount of post-age 70½ contributions deducted does not apply for 2022 because that amount has reduced the excludable amount of qualified charitable distributions for 2021. The remaining $4,000 of the aggregate amount of post-age 70½ contributions deducted reduces the excludable amount of any qualified charitable distributions for subsequent tax years. Accordingly, the excludable amount of the qualified charitable distributions for 2022 is $2,500 ($6,500 - $4,000 = $2,500).

c) As described above, because the $4,000 amount reduced the excludable amount of qualified charitable distributions for 2022, that $4,000 amount does not apply again in later years, and no amount of post-age 70½ contributions remains to reduce the excludable amount of qualified charitable distributions for subsequent tax years.

401(k) Plan Participation

Under pre-Act law, Code Sec. 401(k)(2)(D) limits the period of service with the employer (or employers) maintaining the plan that a qualified cash or deferred arrangement (CODA) may require an employee to complete as a condition to participate.

Section 112(a) of the SECURE Act amended Code Sec. 401(k)(2)(D) to provide that a CODA may not require an employee to complete a period of service that extends beyond the close of the earlier of: (i) the period permitted under Code Sec. 410(a)(1) (disregarding Code Sec. 410(a)(1)(B)(i)); or (ii) subject to Code Sec. 401(k)(15), the first period of three consecutive 12 month periods during each of which the employee has completed at least 500 hours of service.

Section 112(a) of the SECURE Act also amended the Code to add Code Sec. 401(k)(15), which sets forth additional provisions related to Code Sec. 401(k)(2)(D)(ii) (the new rule regarding three consecutive 12 month periods for eligibility purposes). Code Sec. 401(k)(15)(A) provides that Code Sec. 401(k)(2)(D)(ii) will not apply to an employee unless the employee has attained age 21 by the close of the three consecutive 12 month periods.

Code Sec. 401(k)(15)(B)(iii) provides special vesting rules for an employee who becomes eligible to participate in a CODA solely by reason of having completed three consecutive 12 month periods during each of which the employee completed at least 500 hours of service (long-term, part-time employee). Under Code Sec. 401(k)(15)(B)(iii), a long-term, part-time employee must be credited with a year of service for purposes of determining whether the employee has a nonforfeitable right to employer contributions (other than elective deferrals) for each 12 month period during which the employee completes at least 500 hours of service. In addition, Code Sec. 401(k)(15)(B)(iii) modifies the break-in-service rules of Code Sec. 411(a)(6) for a long-term, part-time employee. Under Code Sec. 401(k)(15)(B)(iv), the special vesting rules of Code Sec. 401(k)(15)(B)(iii) continue to apply to a long-term, part-time employee even if the long-term, part-time employee subsequently completes a 12 month period during which the employee completes at least 1,000 hours of service.

Section 112(b) of the SECURE Act provides that the amendments made by § 112 of the SECURE Act apply to plan years beginning after December 31, 2020, except that, for purposes of Code Sec. 401(k)(2)(D)(ii), 12 month periods beginning before January 1, 2021, are not taken into account.

> Observation. Does the exception in § 112(b) of the SECURE Act that excludes 12 month periods beginning before January 1, 2021, from being taken into account for purposes of the special eligibility rule in Code Sec. 401(k)(2)(D)(ii) also apply for purposes of the special vesting rules in Code Sec. 401(k)(15)(B)(iii)?
>
> No. Generally, all years of service with the employer or employers maintaining the plan must be taken into account for purposes of determining a long-term, part-time employee's nonforfeitable right to employer contributions under the special vesting rules in Code Sec. 401(k)(15)(B)(iii).

Code Sec. 401(k)(15)(B)(iii) provides that, for purposes of determining whether a long-term, part-time employee has a nonforfeitable right to employer contributions (other than elective deferrals) under the arrangement, each 12 month period for which the employee has at least 500 hours of service is treated as a year of service. Code Sec. 411(a)(4) generally requires that all years of service with the employer or employers maintaining the plan be taken into account for purposes of determining an employee's nonforfeitable right to employer contributions, subject to certain exceptions. Those exceptions include, for example, years of service before the employee attains age 18 (see Code Sec. 411(a)(4)(A)).

Section 112(b) of the SECURE Act excludes 12 month periods beginning before January 1, 2021, for purposes of determining a long-term, part-time employee's eligibility to participate under Code Sec. 401(k)(2)(D)(ii). However, § 112(b) of the SECURE Act does not exclude 12 month periods beginning before January 1, 2021, for purposes of determining a long-term, part-time employee's nonforfeitable right to employer contributions under Code Sec. 401(k)(15)(B)(iii). Therefore, unless a long-term, part-time employee's years of service may be disregarded under Code Sec. 411(a)(4), all years of service with the employer or employers maintaining the plan must be taken into account for purposes of determining the long-term, part-time employee's nonforfeitable right to employer contributions under Code Sec. 401(k)(15)(B)(iii), including 12 month periods beginning before January 1, 2021.

Qualified Birth or Adoption Distributions

Under pre-Act law, Code Sec. 72(t)(1) generally imposes a 10% additional tax on an early distribution from a qualified retirement plan (including an IRA or Roth IRA), unless the distribution qualifies for one of the exceptions listed in Code Sec. 72(t)(2).

Section 113 of the SECURE Act amended Code Sec. 72(t)(2) to add a new exception to the 10% additional tax for any qualified birth or adoption distribution. Code Sec. 72(t)(2)(H) permits an individual to receive a distribution from an applicable eligible retirement plan of up to $5,000 without application of the 10% additional tax if the distribution meets the requirements to be a qualified birth or adoption distribution.

A qualified birth or adoption distribution is includible in gross income, but is not subject to the 10% additional tax under Code Sec. 72(t)(1).

A qualified birth or adoption distribution is defined as any distribution from an applicable eligible retirement plan to an individual if made during the 1 year period beginning on the date on which the child of the individual if made during the 1 year period beginning on the date on which the child of the individual is born or the legal adoption by the individual of an eligible adoptee is finalized.

An individual generally may recontribute a qualified birth or adoption distribution (not to exceed the aggregate amount of all qualified birth and adoption distributions made to the individual from the plan) to an applicable eligible retirement plan in which the individual is a beneficiary and to which a rollover can be made.

ILLINOIS MAKES CHANGES IN 2019 AFFECTING VARIOUS TAXES

Income Taxes

Income Taxation on Non-Residents Working in Illinois

Starting in 2020, non-residents who spend more than 30 days working in Illinois are deemed to have Illinois earned compensation and will be subject to Illinois income tax based on the total number of days worked in state.

In addition, employers with nonresident employees performing services in Illinois are required to maintain records of days worked by each nonresident employee or obtain a written statement from its nonresident employee with an estimate of the number of days reasonably expected to be performing services in state during the tax year.

Finally, Illinois residents may be allowed a credit for taxes paid to other states if they pay income taxes for days spent working in another state.

THINGS TO CONSIDER BEFORE THE END OF 2020

- ☑ Use up expiring loss and credit carryovers.
- ☑ Increase basis in Partnership or S-corporation to make possible 2020 loss deduction.
- ☑ Buy equipment by December 31st to get depreciation deductions in 2020.
- ☑ Apply bunching strategy to medical expenses to increase deductible amounts.
- ☑ Increase withholding to eliminate estimated tax penalty.
- ☑ Set up self-employed retirement plan.
- ☑ Make gifts taking advantage of $15,000 gift tax exclusion.
- ☑ Avoid personal-holding company tax by making dividend payments.
- ☑ Minimize income tax on social security benefits.
- ☑ Dispose of passive activity in order to free-up suspended losses.
- ☑ Make IRA contributions as early as possible.
- ☑ Delay late year mutual fund investments until after the fund's dividend date.
- ☑ Maximize your contribution to a tax-deferred retirement plan.

2020 TAX RATE SCHEDULE

	Taxable Income	Tax
Married Individuals Filing Joint Returns and Surviving Spouses	Not over $19,750	10% of taxable income
	Over $19,750 but not over $80,250	$1,975 plus 12% of the excess over $19,750
	Over $80,250 but not over $171,050	$9,235 plus 22% of the excess over $80,250
	Over $171,050 but not over $326,600	$29,211 plus 24% of the excess over $171,050
	Over $326,600 but not over $414,700	$66,543 plus 32% of the excess over $326,600
	Over $414,700 but not over $622,050	$94,735 plus 35% of the excess over $414,700
	Over $622,050	$167,308 plus 37% of the excess over $622,050
Heads of Household	Not over $14,100	10% of taxable income
	Over $14,100 but not over $53,700	$1,410 plus 12% of the excess over $14,100
	Over $53,700 but not over $85,500	$6,162 plus 22% of the excess over $53,700
	Over $85,500 but not over $163,300	$13,158 plus 24% of the excess over $85,500
	Over $163,300 but not over $207,350	$31,830 plus 32% of the excess over $163,300
	Over $207,350 but not over $518,400	$45,926 plus 35% of the excess over $207,350
	Over $518,400	$154,794 plus 37% of the excess over $518,400
Unmarried Individuals (Other Than Surviving Spouses and Heads of Household)	Not over $9,875	10% of taxable income
	Over $9,875 but not over $40,125	$988 plus 12% of the excess over $9,875
	Over $40,125 but not over $85,525	$4,618 plus 22% of the excess over $40,125
	Over $85,525 but not over $163,300	$14,606 plus 24% of the excess over $85,525
	Over $163,300 but not over $207,350	$33,272 plus 32% of the excess over $163,300
	Over $207,350 but not over $518,400	$47,368 plus 35% of the excess over $207,350
	Over $518,400	$156,235 plus 37% of the excess over $518,400
Married Individuals Filing Separate Returns	Not over $9,875	10% of taxable income
	Over $9,875 but not over $40,125	$988 plus 12% of the excess over $9,875
	Over $40,125 but not over $85,525	$4,618 plus 22% of the excess over $40,125
	Over $85,525 but not over $163,300	$14,606 plus 24% of the excess over $85,525
	Over $163,300 but not over $207,350	$33,272 plus 32% of the excess over $163,300
	Over $207,350 but not over $311,025	$47,368 plus 35% of the excess over $207,350
	Over $311,025	$83,654 plus 37% of the excess over $311,025

2021 TAX RATE SCHEDULE

	Taxable Income	Tax
Married Individuals Filing Joint Returns and Surviving Spouses	Not over $19,900	10% of taxable income
	Over $19,900 but not over $81,050	$1,990 plus 12% of the excess over $19,900
	Over $81,050 but not over $172,750	$9,328 plus 22% of the excess over $81,050
	Over $172,750 but not over $329,850	$29,502 plus 24% of the excess over $172,750
	Over $329,850 but not over $418,850	$67,206 plus 32% of the excess over $329,850
	Over $418,850 but not over $628,300	$95,686 plus 35% of the excess over $418,850
	Over $628,300	$168,994 plus 37% of the excess over $628,300
Heads of Household	Not over $14,200	10% of taxable income
	Over $14,200 but not over $54,225	$1,420 plus 12% of the excess over $14,200
	Over $54,225 but not over $86,350	$6,223 plus 22% of the excess over $54,225
	Over $86,350 but not over $164,900	$13,290 plus 24% of the excess over $86,350
	Over $164,900 but not over $209,425	$32,142 plus 32% of the excess over $164,900
	Over $209,425 but not over $523,600	$46,390 plus 35% of the excess over $209,425
	Over $523,600	$156,352 plus 37% of the excess over $523,600
Unmarried Individuals (Other Than Surviving Spouses and Heads of Household)	Not over $9,950	10% of taxable income
	Over $9,950 but not over $40,525	$995 plus 12% of the excess over $9,950
	Over $40,525 but not over $86,375	$4,664 plus 22% of the excess over $40,525
	Over $86,375 but not over $164,925	$14,751 plus 24% of the excess over $86,375
	Over $164,925 but not over $209,425	$33,603 plus 32% of the excess over $164,925
	Over $209,425 but not over $523,600	$47,843 plus 35% of the excess over $209,425
	Over $523,600	$157,804 plus 37% of the excess over $523,600
Married Individuals Filing Separate Returns	Not over $9,950	10% of taxable income
	Over $9,950 but not over $40,525	$995 plus 12% of the excess over $9,950
	Over $40,525 but not over $86,375	$4,664 plus 22% of the excess over $40,525
	Over $86,375 but not over $164,925	$14,751 plus 24% of the excess over $86,375
	Over $164,925 but not over $209,425	$33,603 plus 32% of the excess over $164,925
	Over $209,425 but not over $314,150	$47,843 plus 35% of the excess over $209,425
	Over $314,150	$84,497 plus 37% of the excess over $314,150