Peter Shannon & Co.

2023 TAX CONSIDERATIONS

CONTENTS

INDEX

Pages

Pages

Pages

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 ($27,700, $20,800, and $13,850, respectively for 2023) ($29,200, $21,900, and $14,600, respectfully for 2024).

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 $2,600 for 2024 ($2,500 for 2023). 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 $1,300 and less than $13,000 for 2024 (more than $1,250 and less than $12,500 for 2023).

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 2024, the 15% breakpoint is: $94,050 ($89,250 for 2023) for joint returns and surviving spouses (half this amount for married taxpayers filing separately), $63,000 ($59,750 for 2023) for heads of household, $3,150 ($3,000 for 2023) for trusts and estates, and $47,025 ($44,625 for 2023) for other unmarried individuals. The 20% breakpoint is $583,750 ($553,850 for 2023) for joint returns and surviving spouses (half this amount for married taxpayers filing separately), $551,350 ($523,050 for 2023) for heads of household, $15,450 ($14,650 for 2023) for estates and trusts, and $518,900 ($492,300 for 2023) 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 $1,700 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.

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.

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 2024 are as follows:

- For joint returns and surviving spouses, $133,300 ($126,500 for 2023).
- For single taxpayers, $85,700 ($81,300 for 2023).
- For marrieds filing separately, $66,650 ($63,250 for 2023).

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, $1,218,700 ($1,156,300 for 2023).
- For all other taxpayers (other than estates and trusts), $609,350 ($578,150 for 2023).
- For estates and trusts, $99,700 ($94,600 for 2023).

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 ($18,000 in 2024 and $17,000 in 2023).

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 2024, $18,000), 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 2024, 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 $1,600 ($1,500 for 2023) and an annual cap on out-of-pocket expenses (counting deductibles, copayments, and other amounts, but not premiums) of no more than $8,050 ($7,500 for 2023). For family coverage, the annual deductible must be at least $3,200 ($3,000 for 2023) and the annual out-of-pocket expense cap cannot exceed $16,100 ($15,000 for 2023). 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 2024, the maximum monthly contribution for an individual with self-only coverage is 1/12 of the lesser of the annual deductible (minimum $1,500) or $4,150 ($3,850 for 2023). For family coverage, the maximum annual contribution is 1/12 of the lesser of the annual deductible (minimum $3,000) or $8,300 ($7,750 for 2023).

Individuals age 55 and older can make catch-up contributions in addition to their regular contributions for the year. For 2024, 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 2023 HSA contributions is April 15, 2024.

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 2023 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 28% 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 $116,300 ($110,350 in 2023) for married persons filing separately, and $232,600 ($220,700 in 2023) for joint returns, for unmarried individuals and estates and trusts, the AMT rate is 28%.

The following are the 2024 exemption amounts for individuals:

- Married individuals filing jointly and surviving spouses: $133,300 in 2024, less 28% of AMTI exceeding $1,218,700;
- Unmarried individuals: $85,700 in 2024, less 28% of AMTI exceeding $609,350; and
- Married individuals filing separately: $66,650 in 2024, less 28% of AMTI exceeding $609,350.

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 2023 and 2024 regular tax must be considered in determining how much of his 2023 preferences and adjustments should be shifted into 2024 or vice versa.

To shift preferences from 2023 to 2024 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 2024, it is $14,600 ($13,850 for 2023) for individuals, and $29,200 ($27,700 for 2023) for joint filers younger than age 65. Taxpayers who are age 65 or over, blind or disabled add an additional $1,550 ($1,950 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 2023 rather than in 2024 as well as making extra charitable contributions in 2023.

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 2023, 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 2023. 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 2023. 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-2023 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.

Name, Image, & Likeness Revisited: Where We Are Now

The collegiate sports landscape has evolved in the two years since student-athletes have been able to enter into name, image, and likeness (NIL) deals. This article reviews the basics of NIL, how income from such agreements are taxed at the federal level, and recent developments from the National Collegiate Athletic Association (NCAA).

Background

As a result of the Supreme Court's landmark decision in NCAA v. Alston, 141 S. Ct. 2141 (2021), in June 2021, student athletes can profit from various uses of their name, image, and likenesses. This can range from a variety of sources, such as marketing campaigns, promotional materials, social media posts, and sponsored events. College athletes, historically, are not paid directly as players on their respective teams and unlike players in professional leagues.

Instead, student-athletes make agreements with NIL collectives and not the institutions they attend and play for. These collectives, while affiliated with schools and universities, are independent third parties. Oftentimes NIL collectives are granted status as tax-exempt entities. It has been debated if tax-write offs should be allowed for charitable contributions to tax-exempt collectives. Some lawmakers have taken issue with the nature of NIL collectives and the alleged shadiness of some programs' recruitment practices.

In the wake of Alston, the NCAA adopted its first iteration of its interim NIL policy on June 30, 2021. The guidance sought to clarify that recruiting conversations between boosters, i.e., collectives, institutions, and prospective student-athletes are expressly impermissible. "The new policy preserves the fact college sports are not pay-for-play," said NCAA Division II Presidents Council Chair Sandra Jordan at the time. "It also reinforces key principles of fairness and integrity across the NCAA and maintains rules prohibiting improper recruiting inducements. It's important any new rules maintain these principles."

A May 2022 update reinforced that recruiting inducements are in violation with the interim policy and doubled down on snuffing out performance-based NIL payments. "While the NCAA may pursue the most outrageous violations that were clearly contrary to the interim policy adopted last summer, our focus is on the future," said Division I Board Chair Jere Morehead. "The new guidance establishes a common set of expectations for the Division I institutions moving forward, and the board expects all Division I institutions to follow our recruiting rules and operate within these reasonable expectations."

The NCAA says the interim policy will be in place until federal legislation unifying NIL laws for all 50 states is enacted. Until then, the NCAA defers first to state laws, if there are any.

At the time of writing, 32 states have passed NIL laws, with some varying degrees of restriction. States commonly prohibit student-athletes from entering into deals for alcohol, tobacco, adult entertainment, gambling, and controlled substances. Some require institutions to provide financial literacy and other informational support, or allow for an agent to negotiate on the student-athlete's behalf. Alabama notably repealed its NIL law, which was believed to be more restrictive than the NCAA's policy. Several bills have been proposed at the federal level allowing for collegiate athlete compensation, some reintroduced in multiple sessions of Congress, but none have yet advanced.

Squire Patton Boggs Senior Associate Andrew King told Checkpoint that although the *Alston* decision was nearly two years ago, "NIL is still in its relative infancy. No doubt the NCAA, as well as institutions, collectives, and other entities in the NIL space are carefully considering the future as NIL rapidly develops."

NIL & Tax

On March 7, 2023, National Taxpayer Advocate Erin Collins issued a blog post outlining some tax considerations for student-athletes with NIL deals. First and foremost, as previously reported, NIL income is taxable. Collins wrote that in "most instances," student-athletes will be required to complete a Form W-9, Request for Taxpayer Number and Certification. In cases when a student-athlete is considered an employee, a Form W-4, Employee's Withholding Certificate, will also be required.

Collins goes on to explain, though, that student-athletes are, for tax purposes, considered independent contractors. "They will be regarded as self-employed and receive a Form 1099 if their income is more than $600," Collins said, detailing the following actions that will need to be taken:

- File a Schedule C, Profit or Loss from Business
- File a Schedule E, Supplemental Income and Loss
- Document and track all NIL expenses
- Remit both the employee and employer portions of the Social Security and Medicare taxes.
- Calculate and remit estimated quarterly payments

"A student-athlete who files his or her own tax return will have to pay federal income tax if his or her income is more than $12,950 for single filers (or $25,900 if married and filing taxes jointly) since that is the standard deduction for 2022," Collins continued. "All athletes have to fill out a tax return to report and pay their self-employment taxes if they make at least $400 in NIL activities."

TurboTax CPA Lisa Greene-Lewis told Checkpoint in an interview that there are ways for NIL earners to save on their taxes. According to Greene-Lewis, many student-athletes "are realizing that their expenses directly related to their NIL work is deductible. A lot of them are influencers, so if they're shooting videos and bought equipment they should make sure that they keep track of that so that they can deduct that as well and lower their taxes." She added that directly-related travel expenses can also be deductible.

Greene-Lewis said that NIL has extended to high schoolers as well and is not just limited to college sports, which can even more-so affect whether a parent or guardian of a student-athlete with NIL income should claim their child on their taxes as a dependent. If a parent is not benefiting from, for instance, education tax credits or something similar for whatever reason—be it income-related or another situation—"the child should make sure that the parent does not claim them so that they could get benefits of the tax credits," she advised.

For parents seeking to still claim their child as a dependent, Greene-Lewis explained that "kids that are in school full time can be under 24 and they would still be considered a qualifying child, so their income doesn't come into play when you're figuring out whether they're claiming them as independent." Parents will not be able to claim a child as a dependent if the child is providing over half of their support.

According to Greene-Lewis, crypto received as payment for NIL activities will be taxed as self-employment income. "The income will be reported on a 1099-NEC just like when one is self-employed or on a 1099-K if paid through a third-party provider. If they sell the crypto they received, they will be taxed on any gains from the sale. Their gain or loss will be calculated by subtracting the fair market value of the crypto at the time of receipt from the sales price."

Updated Guidance

On October 26, 2022, the NCAA Division I Board of Directors unanimously approved updated guidance to its NIL policy further emphasizing examples of what forms of involvement between schools, boosters/collectives, and prospective or current student-athletes are permissible or impermissible. The new guidance, which went into effect January 1, 2023, also encourages schools to be more involved with providing informational support on NIL-adjacent topics like financial literacy, taxes, social media, and more.

"The board also noted that—when permitted by applicable state laws—schools can and should require student-athletes to report NIL activities to the athletics department," read a NCAA press release.

Arguably the biggest takeaway from the updated guidance is the NCAA's approach to enforcing its NIL policy. Under current NCAA bylaws, a hearing panel in cases when available information indicates a violation has occurred will assume there was such a violation unless "the institution or involved individual clearly demonstrates with credible and sufficient information that all communications and conduct surrounding the name, image and likeness activity complied with NCAA legislation."

William Lawrence of Burr & Foreman wrote that previously, "the NCAA had directed its enforcement staff to review facts of individual cases but pursue only those individual cases that were clearly contrary to the NIL Policy, including the most severe violations of Institutional involvement or pay-for-play."

The "NIL Presumption," as it is now colloquially referred to, is regarded by some as a "guilty until proven innocent" standard, as opposed to the core concept of the phrase "innocent until proven guilty."

"While we are not talking about actual criminal charges in the NIL context, just by way of analogy the new presumption reverses this standard," said King. "Institutions are now incentivized to cooperate with any NCAA investigation, as the failure to submit evidence or cooperate would hinder their ability to show they did not commit an infraction. Institutions should carefully review their internal policies and work with staff, collectives, and student-athletes on understanding the import of this change."

First NIL Penalty

In February, the NCAA handed down its first NIL-related punishment. At issue was a dinner hosted by prominent University of Miami booster John Ruiz to help recruit star basketball players and social media influencers Haley and Hanna Cavinder—or the Cavinder Twins—to the school's women's team at the behest of its coach, Katie Meier.

Reportedly, Meier met Ruiz at a university event and went about connecting the wealthy donor with the Cavinder Twins, who agreed to meet over dinner to discuss the possibility of transferring to the University of Miami. The dinner was made public knowledge through a social media post online, which is where the NCAA found out about it and deemed it in violation of its bylaws for impermissible contact, improper publicity, and atmosphere of compliance.

Meier was suspended for three games at the beginning of the 2022-2023 season. University of Miami's women's basketball program was also handed down a one-year probationary period, a $5,000 fine plus 1% of its budget, reductions in the number of official visiting and recruiting days.

King said the penalty is "not binding precedent," but it remains to be seen how it influences future infractions, especially since the case was processed before the NIL Presumption went into effect despite the penalty being resolved after by the independent Committee on Infractions. "That said, it could serve as a guidepost for any future penalties arising from similar conduct."

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 $2,500 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 2023 income phaseout begins at $80,000 for single taxpayers and at $160,000 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 2024 the deduction phases out ratably for single taxpayers with modified AGI between $80,000 and $95,000 (between $75,000 and $90,000 for 2023) and between $165,000 and $195,000 (between $155,000 and $185,000 for 2023) 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 ($80,000 to $95,000 for taxpayers other than joint filers; $165,000 to $195,000 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 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).

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 2024 will begin at modified adjusted gross income above $96,800 ($91,850 for 2023) for single taxpayers, and $145,200 ($137,800 for 2023) 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 $17,000 a year and $500,000 over the life of the account are permitted in Bright Start.

Provisions for lump sum contributions as large as $85,000 ($170,000 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.

2024 Rate Schedule for Trusts and Estates:

If taxable income is:	The tax would be:
Not over $3,100	10% of taxable income
Over $3,101 but not over $11,150	$310 plus 24% of the excess over $3,100
Over $11,151 but not over $15,200	$2,242 plus 35% of the excess over $11,150
Over $15,201	$3,660 plus 37% of the excess over $15,200

2023 Rate Schedule for Trusts and Estates:

If taxable income is:	The tax would be:
Not over $2,900	10% of taxable income
Over $2,900 but not over $10,550	$290 plus 24% of the excess over $2,900
Over $10,550 but not over $14,450	$2,126 plus 35% of the excess over $10,550
Over $14,450	$3,491 plus 37% of the excess over $14,450

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, $11,700,000 in 2021, $12,060,000 in 2022, 12,920,000 in 2023, and 13,610,000 in 2024.

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.

2024 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 $13,610,000 in 2024 and $12,920,000 in 2023. 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 2024, the exclusion amount will be $13,610,000 ($12,920,000 for 2023).

Generation-Skipping Transfer (GST) Tax Exemption

The exemption from GST tax will be $13,610,000 for transfers in 2024 ($12,920,000 for 2023).

Gift Tax Annual Exclusion

For gifts made in 2024, the gift tax annual exclusion will be $18,000 ($17,000 for 2023).

Special Use Valuation Reduction Limit

For estates of decedents dying in 2024, the limit on the decrease in value that can result from the use of special valuation will be $1,390,000 ($1,310,000 for 2023).

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 2024, the tentative tax will be computed on $1,850,000 ($1,750,000 for 2023) plus the applicable exclusion amount.

Annual Exclusion for Gifts to Noncitizen Spouses

For gifts made in 2024, the annual exclusion for gifts to noncitizen spouses will be $185,000 ($175,000 for 2023).

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, $275,000 for 2024 ($265,000 for 2023).

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 $68,000 for 2024 ($66,000 for 2023).

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, $340,000 for 2024 ($330,000 for 2023).

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 $23,000 for 2024 ($22,500 for 2023).

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 $16,000 for 2024 ($15,500 for 2023).

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 $23,000 for 2024 ($22,500 for 2023).

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 $7,500 for 2024 ($7,500 for 2023).

The dollar amount under a SIMPLE plan is $3,500 for 2024 ($3,500 for 2023).

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 2024, the IRA deduction for single taxpayers phased out over $72,000 to $87,000 ($73,000 to $83,000 in 2023) of Adjusted Gross Income, $123,000 to $145,000 ($116,000 to $136,000 in 2023) for married taxpayers filing jointly. For a nonactive participant who had an active-participant spouse, the IRA deduction phaseout begins at $230,000 of Adjusted Gross Income in 2024 ($218,000 in 2023).

Contributions to Roth IRAs are subject to income limits. For 2023, 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 $146,000 and $161,000 (between $138,000 and $153,000 for 2023) and for joint filers with Adjusted Gross Income between $230,000 and $240,000 (between $218,000 and $228,000 for 2023).

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

Tax Years Beginning in	Maximum Deductible IRA Amount
2024	$7,000

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., $23,000 in 2024). 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 2024, 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 -	$46,000	$ - 0 -	$34,500	$ - 0 -	$23,000	50%
$46,000	$50,000	$34,500	$37,500	$23,000	$25,000	20%
$50,000	$76,500	$37,500	$57,375	$25,000	$38,250	10%
$76,500		$57,375		$38,250		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 $46,000.

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 72 (73 if you reached age 72 after December 31, 2022). By contrast, Roth IRAs are not 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 2023 for MAGI between $230,000 and $240,000 (between $218,000 and $228,000 for 2023). For single taxpayers and heads of household it will be phased out ratably for MAGI between $146,000 and $166,000 (between $138,000 and $153,000 for 2023). 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 2023).

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 $30,500 for 2024 (28,900 for 2023).

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 $1,220,000 for 2024 (1,160,000 for 2023), and the phase-out threshold amount is increased to $3,050,000 ($2,890,000 2023). 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

The IRS recently released Rev. Proc. 2023-14, issuing sharply higher new depreciation limitations for passenger automobiles for the second consecutive year.

The revenue procedure covers the Sec. 280F(a) inflation-adjusted dollar limitations on depreciation deductions for passenger automobiles, including trucks and vans, obtained after September 27, 2017, and placed in service during 2023, for 2023 and each tax year thereafter.

For passenger automobiles for which the Sec. 168(k) first-year, or "bonus," depreciation is applied, the limitation is $20, 200 for the first tax year, an increase of $1,000 from the 2022 amount. The succeeding-year limitations are $19,500 for the second tax year (up by $1,500 over 2022); $11,700 for the third year (up by $900); and $6,960 for each year after (up by $500).

If bonus depreciation does not apply, the 2023 first-year limitation is $12,200 an increase of $1,000 from 2022, and the succeeding years' limitations are the same as for vehicles eligible for the bonus depreciation.

The depreciation limits are updated annually for inflation in accordance with the automobile component of the chained consumer price index for urban consumers.

> If a sport utility vehicle (SUV) is exempt from the annual "luxury car" depreciation caps the amount of the section 179 deduction is limited to $30,500 for 2024 ($28,900 for 2023). An exemption to the luxury car depreciation caps applies to vehicles with a gross vehicle weight rating (loaded weight rating) in excess of 6,000 pounds. The SUV expensing limit also applies to exempt pick-up trucks with a cargo bed under six feet in length and exempt vans that seat more than nine persons behind the driver's seat.
>
> Without the SUV expensing limit, taxpayers might be encouraged to purchase large "gas guzzlers" that are exempt from the annual depreciation caps in order to deduct their entire cost in a single tax year under Section 179.
>
> Nevertheless, for a limited time, a taxpayer may deduct the entire cost of an exempt vehicle in the year of purchase as a 100 percent bonus deduction. The 100 percent bonus deduction applies to vehicles acquired and placed in service after September 27, 2017 and before January 1, 2023. While the 100 percent bonus is in effect, the SUV limitation has no practical significance.

<u>Limits on Deduction of Business Interest</u>

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 $26 million ($27 million for 2022). The business-interest-limit provision does not apply to certain regulated public utilities and electric cooperatives. <u>***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.***</u>

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 $10 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 $27 million ($29 million for 2023). 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 $27 million ($29 million for 2023) 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 $27 million ($29 million for 2023) (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 $27 million ($29 million for 2023) 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 $27 million ($29 million for 2023) 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 $27 million ($29 million for 2023) 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 $27 million ($29 million for 2023) 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 2024 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 $383,850 ($364,200 for 2023) for married individuals filing jointly, and $191,925 ($182,100 for 2023) 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 $383,850 ($364,200 for 2023) for married individuals filing jointly; $191,925 ($182,000 for 2023) 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.

INFLATION REDUCTION ACT OF 2022

The Inflation Reduction Act of 2022, signed by President Joe Biden on August 16, 2022, includes changes to the credit available for electric vehicles. The changes are complex, and phase in over time. If you are in the market for an electric vehicle, we should review the new rules to help you maximize the credit you are allowed.

North American assembly requirement. One of the new rules is in effect right now. To qualify for the electric vehicle credit, final assembly of the vehicle must take place in North America. You can check whether a particular vehicle meets this requirement by entering its vehicle identification number (VIN) into the VIN decoder. There is also a list of makes and models that generally should meet the requirement, but you should double-check for any particular vehicle by using the VIN decoder.

Manufacturer limitation. The good news is that, effective as of January 1, 2023, the manufacturer limitation is going away. Under the manufacturer limitation, once a manufacturer had sold 200,000 electric vehicles, a taxpayer's ability to take a tax credit for vehicles produced by that manufacturer began to phase out. Taxpayers are currently prevented from taking the electric vehicle credit for automobiles manufactured by General Motors and Tesla. Starting at the beginning of 2023, taxpayers will be able to take the credit for GM and Tesla vehicles once again, but see the manufacturer's suggested retail price (MSRP) limits below.

Calculation of the credit. The way the credit is calculated is changing later this year. We do not know when the rules are changing yet, but it will be as soon as the IRS issues regulations implementing the new rules. Under the previous rules, the base amount of the electric vehicle credit is $2,500 per vehicle. The allowable credit increases to $7,500 per vehicle based on a formula which increases the credit by $417 for every kilowatt hour of battery capacity in excess of five.

Under the new rules, the amount of the credit will be based on two separate requirements, each one based on where the vehicle's battery is sourced:

- Taxpayers get a $3,750 credit for meeting the critical minerals requirement (which requires that a minimum percentage of the minerals contained in the battery be sourced in the United States or a country with which the United States has a free trade agreement in effect).
- Taxpayers also can get a $3,750 credit for satisfying the battery component requirement (which requires that a minimum percentage of the value of the components of the battery be manufactured or assembled in North America.

Taxpayers can satisfy either or both requirements, for either a $3,750 credit (if only one requirement is satisfied) or a $7,500 credit (if both requirements are satisfied).

The new rules are designed to encourage electric vehicle manufacturers to move their battery supply chains from China to North America or countries with which the United States has better relations than China.

New qualified fuel cell motor vehicle. Effective January 1, 2023, the credit will also be available for new qualified fuel cell motor vehicles. New qualified fuel cell motor vehicles are vehicles propelled by power derived from one or more cells that convert chemical energy directly into electricity by combining oxygen with hydrogen fuel, and that meets certain additional requirements. New qualified fuel cell motor vehicles have to meet the North American final assembly requirement. They can qualify for either a $3,750 or $7,500 credit based on whether they satisfy one or both of the critical minerals requirement and battery components requirements.

Modified adjusted gross income limitation. Starting on January 1, 2023, your ability to take the electric vehicle credit will be limited based on your modified adjusted gross income (MAGI). MAGI is adjusted gross income (AGI) with adjustments for income received from U.S. territories. For most taxpayers, MAGI will be equal to AGI. You may not take the credit if your MAGI exceeds the threshold amount. The threshold amount is:

- For married taxpayers filing a joint return or a surviving spouse, $300,000.
- For taxpayers filing as head of household, $225,000.
- For all other taxpayers (single, married filing separately), $150,000.

These amounts are not adjusted for inflation. If your MAGI exceeds this amount, you should buy the electric car before the first of the year.

MSRP limitation. Also starting on January 1, 2023, vehicles will not be eligible for the credit if they exceed an MSRP limit: $80,000 for vans, pickup trucks, and sport utility vehicles; $55,000 for other vehicles. This means that if you are looking at a higher-end electric vehicle, you need to act by the end of December.

Unfortunately, the manufacturer limitation (see above) will not go away until January 1, so you will not be able to claim the credit for higher-end GM and Tesla vehicles that exceed the MSRP limits.

Transition rule. Finally, if you had a binding contract to purchase an electric vehicle as of August 15, 2022, or earlier, you can choose to apply the old rules.

Analysis of Key Tax Provisions in SECURE 2.0

The following is a breakdown of tax provisions in the Setting Every Community Up for Retirement Enhancement 2.0 Act of 2022 (SECURE 2.0 or the Act).

Modification of Credit for Small Employer Pension Plan Start-up Costs

The Act changes the small employer pension plan start-up cost credit by (i) providing that the credit is equal to the entire amount of creditable costs (qualified start-up costs) of an employer with 50 or fewer employees (up to an annual cap), (ii) allowing a credit amount for employer contributions to small employer pensions, and (iii) fixing a technical glitch pertaining to small employers who join multiemployer plans.

Increased credit for start-up costs. The Act increases the small employer pension plan start-up cost credit from 50% to 100% of qualified start-up costs for employers with up to 50 employees. Employers with 51 to 100 employees will continue to be eligible for a small employer pension credit of 50% of qualified start-up costs. In either case, an annual cap based on the number of employees, with a maximum of $5,000, applies (unchanged from existing law). The small employer pension credit is available for the first three tax years of the plan's existence.

Credit for employer contributions. The Act also provides a credit amount for all or a portion of employer contributions to small employer pensions for the first five employer tax years beginning with the one that includes the plan's start date. Specifically, the amount of the small employer pension credit allowed is increased by the applicable percentage of employer contributions on behalf of employees, up to a per-employee cap of $1,000. The applicable percentage is 100% in the first and second tax years, 75% in the third year, 50% in the fourth year, and 25% in the fifth year. No credit is available in the sixth and subsequent years.

> The applicable percentage is based on the date the plan was established, not when employees begin to participate in the plan.

The amount of the credit allowed for employer contributions is reduced for employers with between 51 and 100 employees (inclusive). The reduction is equal to 2% multiplied by the number of employees is in excess of 50 multiplied by the amount of the credit.

- ***Example***. A, an employer with 70 employees, establishes a small employer pension. A contributes $1,000 per employee to the plan in the first year. The amount of its small employer pension credit for employer contributions is determined as follows: First, multiply its total contributions ($70,000) by the applicable percentage (100%) for a result of $70,000. Next, determine the reduction by multiplying 2% by the number of A's employees greater than 50 (70-50=20) for a result of 40%. So, the $70,000 figure in the first step will have to be reduced by 40% ($70,000 x 40%), or $28,000. Thus, A can take a small employer pension credit of $42,000 ($70,000-$28,000). (Of course, once A determined the 40% reduction percentage, it could have obtained the same result by simply multiplying $70,000 by 60%.)

No credit is allowed for employer contributions if the employer has more than 100 employees.

In addition, no credit is allowed for employer contributions on behalf of an employee who makes more than $100,000. The $100,000 figure is adjusted for inflation (in multiples of $5,000, rounding down) in tax years beginning after 2023.

The credit amount for employer contributions is not available either for elective deferrals under Code Sec. 402(g)(3) or for contributions to a defined benefit plan under Code Sec. 414(j).

> The Act changes the credit so it now has two portions, calculated separately: a qualified start-up cost portion available for the first three years of the plan's existence and an employer-contribution portion, available for the first five years of the plan's existence.

The above rules apply to tax years beginning after December 31, 2022.

Multiemployer plans. The Act also allows employers joining a multiple employer plan (MEP, which includes pooled employer plans) to take the portion of the SEP credit for qualified start-up costs for the first three years after they join an MEP, regardless of how long the MEP has been in existence.

> Under prior law, the credit had been available for only the first three years the MEP itself was in existence. For example, if the MEP had been in existence for one year when the employer joined, the employer would only get to claim the SEP credit for two years. If the MEP had been in existence for three or more years, the employer would get no credit. The Act fixes this technical glitch.

The MEP rule is effective retroactively for tax years beginning after December 31, 2019.

New Credit for Small Employers for when Military Spouses Start Their Participation in Employers' Defined Contributed Plans

The Act adds a new tax credit for small employers-those with no more than 100 employees that earned at least $5,000 for the preceding year. The credit is for each military spouse that starts participating in an eligible defined contribution plan of the employer. Highly compensated employees (under Code Sec. 414(q)) are excluded from credit consideration.

The annual credit amount is (1) $200 for each military spouse who participates in the employer's plan, plus (2) the amount of related employer contributions to the plan (but capped at $300 of contributions for any individual). A military spouse is counted for the credit only for the tax year which includes the date they begin participating in the plan and for the two succeeding tax years. Additionally, the Act provides safeguards for eligibility, and for employer contribution entitlement, that plans must satisfy to qualify for the credit.

The credit is available for tax years beginning after the date of enactment of the Act.

Age Requirement for Qualified ABLE Programs Modified

States may establish tax-exempt ABLE programs to assist persons with disabilities. An individual who is disabled or blind may establish and become the designated beneficiary of an ABLE account under a state's program. Under pre-Act law, the disability or blindness must have occurred before age 26.

The Act would increase this age limit to 46, thus making more individuals eligible to establish an ABLE account. The amendment would be effective for tax years beginning after December 31, 2025.

Tax-free Rollovers From 529 Accounts to Roth IRAs Permitted

The Act permits beneficiaries of 529 college savings accounts to make direct trustee-to-trustee rollovers from a 529 account in their name to their Roth IRA without tax or penalty. This provides an option for 529 accounts that have a balance remaining after the beneficiary's education is complete.

The 529 account must have been open for more than 15 years. The rollover can't exceed the aggregate amount contributed to the account (and earnings thereon) more than five years before the rollover.

Aggregate rollovers under the provision can't exceed $35,000 over the beneficiary's lifetime. Rollovers are subject to the Roth IRA annual contribution limits, but the limit based on the taxpayer's adjusted gross income is waived.

The amendments are effective for distributions after December 31, 2023.

Certain Disability-related First Responder Retirement Payments Excluded From Income

The Act allows first responders (law enforcement officers, fire fighters, paramedics, or emergency medical technicians) to exclude from gross income certain service-related disability pension or annuity payments (from a 401(a), 403(a), governmental 457(b), or 403(b) plan) after they reach retirement age.

The exclusion would be effective for amounts received for tax years beginning after December 31, 2026.

Statute of Limitations on Assessment of Excise Tax on Excess Contributions to, and Certain Accumulations in, Individual Retirement Plans

The Act provides that the statute of limitations for the assessment of excise taxes due to excess contributions to tax-favored accounts and accumulations on qualified retirement plans begins to run on the filing of the taxpayer's income tax return for the year of the violation. The limitations period is three years (six years in the case of excess contributions).

Therefore, the filing of the Form 5329 excise tax return by the private foundation, plan, trust, or other organization administering the plan would no longer be required to start the statute of limitations.

If an individual is not required to file an income tax return for that year, the statute of limitations would nevertheless begin on the date the return would have been due.

The section is effective as of the date of the enactment of the Act.

Deductions for Qualified Conservation Contributions are Limited for Pass-through Entities

SECURE 2.0 disallows a charitable deduction for an otherwise-qualified conservation contribution-also known as a conservation easement-that is made by a partnership, S corporation, or other pass-through entity, if the amount of the contribution exceeds 2.5 times the sum of each partner/member's relevant basis in the contributing entity. Exceptions to this disallowance rule apply where the contribution meets a three-year holding period test, where substantially all of the contributing entity is owned by members of a family, or where the contribution relates to the preservation of a certified historic structure. For contributions for the preservation of certified historic structure, a new reporting requirement applies. Certain existing penalty rules and statute-of-limitations extension rules apply to the new disallowance provision.

In a separate rule, unrelated to the disallowance rule for pass-throughs, taxpayers can correct easement deed language for extinguishment clauses and boundary line adjustments, substituting safe-harbor language to be issued by IRS. But this safe-harbor correction provision doesn't apply to easement deeds involving: tax shelters; contributions to which the above disallowance rule applies; docketed Tax Court cases; and deductions to which certain penalties applied, where the penalties have been administratively or judicially finalized.

This provision applies to contributions made after the date of enactment of the Act.

Changes to the Retirement Rules for Tax Court Judges

The Act allows Tax Court judges to receive Thrift Savings Plan automatic and matching contributions as long as they are not covered by a judicial retirement plan. This aligns the rules for Tax Court judges with the rules for other federal judges. Tax Court judges who later elect to receive judicial retirement benefits will have offsets for automatic and matching contributions. The Act also provides parity with other federal judges in the vesting schedules for benefits for surviving spouses and dependent children. The Act also makes changes with respect to the rules for retired Tax Court judges who receive compensation for teaching courses as well as rules coordinating the Tax Court judicial retirement with the Federal Employee Retirement system and the retirement and survivors' annuities plans.

This provision is effective on the date of enactment of the Act, except as otherwise stated for specific provisions.

Changes to the Retirement Rules for Tax Court Special Trial Judges

The Act allows Tax Court Special Trial Judges to participate in a judicial retirement program. The Act establishes a retirement plan so that Special Trial Judges can receive retired pay similar to regular judges of the Tax Court. The program provides parity between Special Trial Judges and other federal judges.

This provision allows Tax Court Special Trial Judges to elect to receive retired pay 180 days after the enactment of the Act, including Special Trial Judges who retire on or after the date of enactment and before the 180-day period after the adoption of the Act has passed.

Extension of Telehealth Exemption for HDHPs Through 2024

Health savings accounts (HSAs) are tax-favored IRA-type trust or custodial accounts that can be contributed to by, or on behalf of, eligible individuals to pay for certain medical expenses on a tax-favored basis. Under Code Sec. 223, tax-advantaged contributions generally cannot be made to an HSA unless the account holder is covered by a qualifying high-deductible health plan (HDHP) and does not have disqualifying non-HDHP coverage. To facilitate the use of telehealth during the COVID pandemic, the CARES Act provided that coverage for telehealth and other remote care services would be considered disregarded coverage-i.e., coverage that may be provided before the HDHP minimum deductible is satisfied without causing a loss of HSA eligibility-for plan years beginning on or before December 31, 2021. The Consolidated Appropriations Act, 2022 restored the telehealth exceptions for months beginning after March 31, 2022, and before January 1, 2023.

The Act amends Code Sec. 223(c)(2)(E) to provide that the exception for telehealth and other remote care services applies to plan years beginning after December 31, 2022, and before January 1, 2025 (in addition to the time periods described above).

This provision is effective for plan years beginning after December 31, 2022.

Analysis of Key Retirement Provisions in SECURE 2.0

The following is a breakdown of non-tax provisions in the Setting Every Community Up for Retirement Enhancement 2.0 Act of 2022.

Expanding Automatic Enrollment in Retirement Plans

Defined contribution plans that permit salary deferrals (such as Code Sec. 401(k) and Code Sec. 403(b) arrangements) can be designed to automatically enroll employees at a predetermined contribution percentage unless the employee opts out or elects a different percentage. For plans that include automatic contributions, specific requirements apply for the arrangement to qualify as an automatic contribution arrangement under ERISA Sec. 514(e), eligible automatic contribution arrangement (EACA) under Code Sec. 414(w), or qualified automatic contribution arrangement (QACA) under Code Sec. 401(k)(13).

New law. The Act adds new Code Sec. 414A, which provides that an arrangement generally will not be treated as a Code Sec. 401(k)qualified cash or deferred arrangement or a Code Sec. 403(b)annuity contract unless it is an EACA under Code Sec. 414(w)(3) and satisfies three additional requirements.

First, it must allow permissible withdrawals (as defined in Code Sec. 414(w)(2)) within 90 days after the first elective contribution.

Second, it must provide for automatic contributions of at least 3% and not more than 10% during a participant's first year of participation, unless the participant elects otherwise. And effective on the first day of each plan year after a completed year of participation, the contribution percentage must automatically increase (unless the participant elects otherwise) by 1 percentage point, to at least 10% but not more than 15%, except that for plan years ending before January 1, 2025, the maximum percentage is 10% for any arrangement that is not a safe harbor plan under Code Sec. 401(k)(12) or Code Sec. 401(k)(13).

Third, if the participant makes no investment election, automatically contributed amounts must be invested in accordance with the rules for qualified default investment alternatives under DOL Reg.

Automatic enrollment is not required for: (A) SIMPLE 401(k) plans (under Code Sec. 401(k)(11)); (B) plans established before the Act's enactment date; (C) governmental (Code Sec. 414(d)) or church (Code Sec. 414(e)) plans; (D) any plan maintained by an employer in existence for less than 3 years (including any predecessor employer); and (E) any plan maintained by an employer that employs not more than 10 employees. For multiple employer plans, the automatic enrollment requirements, including the exceptions, are applied separately to each employer.

Effective date. This provision is effective for plan years beginning after December 31, 2024.

Increase in Age for Required Beginning Date for Mandatory Distributions

Employer-sponsored qualified retirement plans (e.g., Code Sec. 401(k), Code Sec. 403(b), or Code Sec. 457(b) plans), traditional IRAs under Code Sec. 408(a), and individual retirement annuities under Code Sec. 408(b)are subject to required minimum distribution rules, which require that benefits be distributed or commence being distributed by the Required Beginning Date (RBD).

Under current law, the RBD for IRAs is April 1 following the calendar year in which the IRA owner attains age 72. For employer-sponsored qualified retirement plans, for non-5% company owners, the RBD is April 1 following the later of the calendar year in which the employee attains age 72 or retires. For an employee who is a 5% owner, the RBD is the same as for IRAs, even if the employee continues to work past age 72.

New law. Under the Act, the current required age component used to determine RBDs is referred to as the "applicable age," and increases from age 72 to: (A) age 73 starting on January 1, 2023 (for individuals who attain age 72 after December 31, 2022, and age 73 before January 1, 2033); and (B) age 75 starting on January 1, 2033 (for individuals who attain age 74 after December 31, 2032).

Effective date. This provision applies to distributions required to be made after December 31, 2022, with respect to individuals who attain age 72 after such date.

Higher Catch-up Limit to Apply at Age 60, 61, 62, and 63

Defined contribution retirement plans under Code Sec. 401(k), Code Sec. 403(b), or Code Sec. 457(b)are permitted, but not required, to allow participants who are age 50 or older to make additional pre-tax elective deferrals, known as "catch-up" contributions. Code Sec. 414(v). Catch-up contributions are elective deferrals that, among other things, are not subject to the annual elective deferral dollar limit ($22,500 for 2023). The annual dollar limit on catch-up contributions is $7,500 for 2023. Deferrals under SIMPLE plans are subject to a reduced annual elective deferral dollar limit ($15,500 for 2023). The annual dollar limit on catch-up contributions to SIMPLE plans is $3,500 for 2023.

New law. Starting in 2025, the Act increases the current catch-up limit to the greater of $10,000 ($5,000 for SIMPLE plans) or 50% more than the regular catch-up amount in 2024 (2025 for SIMPLE plans) for individuals who attain ages 60, 61, 62 and 63. The statutory dollar amounts are indexed for inflation commencing in 2026.

Participants will need to be wary of making catch-up contributions if they have income greater than $145,000. Under Section 603 of the Act, discussed below, catch-up contributions under Code Sec. 401(k), Code Sec. 403(b), or Code Sec. 457(b)plans are subject to mandatory Roth tax treatment (i.e., may not be made on a pre-tax basis) when made by participants whose wages for the preceding calendar year exceed $145,000, as annually indexed for inflation.

It is unclear whether the reference to the catch-up amount in 2025 for SIMPLE plans and 2024 for all other plans is a typo, or intentional.

Effective date. This provision applies to tax years beginning after December 31, 2024.

Penalty-Free Withdrawals For Certain Emergency Expenses

Code Sec. 72(t) imposes a 10% penalty tax on the taxable amount of distributions from tax-preferred retirement accounts, such as 401(k) plans and IRAs, received before age 59½ (early distributions).

The Code provides a number of exceptions to the 10% tax on early distributions, including in the case of distributions described below:

1. Made on or after the employee's death.
2. Attributable to the employee's becoming disabled.
3. Part of a series of substantially equal payments for the life of the employee or the joint lives of the employee and the employee's designated beneficiary.
4. Used to pay medical expenses to the extent a deduction for the expenses is allowable for the tax year of the distribution.
5. From an IRA if used to pay deductible medical insurance of certain unemployed individuals.
6. From an IRA to an individual qualifying as a first-time home buyer, subject to a lifetime cap.
7. From an IRA to pay higher education expenses.
8. Made on account of an IRS levy on the plan.

New law. The Act adds a new exception for certain distributions used for emergency expenses, which are unforeseeable or immediate financial needs relating to personal or family emergency expenses. Only one distribution is permissible per year of up to $1,000, and a taxpayer has the option to repay the distribution within three years. No further emergency distributions are permissible during the three-year repayment period unless repayment occurs.

The Act contains two emergency savings provisions. One of those provisions is described above, and the other provision is provided under SECURE 2.0 Act Sec. 127, which allows employers to offer non-highly compensated employees emergency savings accounts linked to individual account plans. Specifically, Act Sec. 127 permits employers to automatically opt employees into these accounts at no more than 3% of their salary, and the portion of an account attributable to the employee's contribution is capped at $2,500 (or lower as set by the employer). Contributions are after-tax, and withdrawals (in whole or in part) are permitted at least once per calendar month. At separation from service, employees can take their emergency savings account as cash, or roll the account into a Roth defined contribution plan or IRA.

Effective date. The provision is effective for distributions made after December 31, 2023.

Starter 401(k) Plans For Employers With No Retirement Plan

A 401(k) plan is a type of profit-sharing plan that permits employees to contribute a portion of their salary to an individual account. Section 403(b) plans provide tax benefits similar to qualified retirement plans, and can be maintained only by tax-exempt organizations and public schools.

New law. The Act establishes two new plan designs: a new type of section 401(k) plan (called a "starter 401(k) deferral-only arrangement") and a new type of 403(b) plan (called a "safe harbor 403(b) plan").

Starter 401(k) deferral-only plans. A "starter 401(k) deferral-only arrangement" is a cash or deferred arrangement maintained by an eligible employer that meets certain requirements relating to automatic enrollment, contributions, eligibility, and employee notices. It is treated as satisfying the actual deferral percentage (ADP) nondiscrimination test.

Under the starter 401(k) deferral-only arrangement, each employee who is eligible to participate must be treated (unless the employee elects otherwise) as having elected to have the employer make elective contributions in an amount equal to the applicable qualified percentage of compensation. All employees of the employer must be eligible to participate in the arrangement other than those that do not meet the age and service requirements.

The qualified percentage is determined under the terms of the arrangement, but must not be less than 3%, or more than 15%, and must be applied uniformly. The election to make elective deferrals at the qualified percentage ceases to apply to an employee if the employee makes an affirmative election not to contribute or to contribute at a different level.

Under the starter 401(k) deferral-only arrangement, the only contributions that may be permitted are elective contributions of employees eligible to participate. Thus, the employer may not make matching or nonelective contributions to the starter 401(k) deferral-only arrangement.

An employer is eligible to offer a starter 401(k) deferral-only arrangement if neither the employer nor a predecessor employer maintains another qualified plan for the year in which the determination is being made. There is a limited exception for an employer who maintains a plan in which the only participants are employees covered by a collective bargaining agreement. A transition rule also applies for an employer who may fail to meet this requirement due to an acquisition, disposition, or other similar transaction during a specified transition period.

The aggregate amount of any employee's elective contributions for a calendar year may not exceed $6,000, adjusted for cost of living. Catch-up contributions are permitted (for an employee who attains age 50 by the end of the tax year) up to $1,000, indexed for inflation.

Safe harbor deferral-only plan. The Act also establishes a new type of 403(b) plan, called a "safe harbor deferral-only plan." Similar conditions as those described with starter 401(k) deferral-only arrangements apply for purposes of a safe harbor deferral-only plan. That is, a safe harbor deferral-only plan must also satisfy certain requirements that generally parallel the requirements described above.

All employees of the employer must be eligible to participate in a safe harbor deferral-only plan with certain limited exceptions. A safe harbor deferral-only plan is treated as satisfying the universal availability requirement applicable to 403(b) plans.

Effective date. The provision is effective for plan years beginning after December 31, 2023.

Improving Coverage For Part-Time Workers

The SECURE Act of 2019 (Sec. 112, PL 116-94, Div O, 12/20/2019) amended Code Sec. 401(k)(2)(D) to provide that, for plan years beginning in 2021, 401(k) plans must generally permit an employee to make elective deferrals if the employee has worked at least 500 hours per year with the employer for at least three consecutive years and has met the minimum age requirement (age 21) by the end of the three-consecutive-year period (a "long-term part-time employee") Thus, a long-term part-time employee may not be excluded from the plan merely because the employee has not completed a year of service.

Once a long-term part-time employee meets the age and service requirements, the employee must be permitted to begin participation no later than the earlier of (1) the first day of the first plan year beginning after the date on which the employee satisfied the age and service requirements, or (2) six months after the date on which the individual satisfied those requirements.

New law. The Act modifies the rules that apply to long-time part-time employees under a 401(k) plan to reduce the service requirement for those employees from three years to two years. Thus, under the Act, a 401(k) plan generally must permit an employee to make elective deferrals if the employee has worked at least 500 hours per year with the employer for at least two consecutive years and has met the minimum age requirement (age 21) by the end of the two-consecutive-year period.

In addition, the Act clarifies the effective date of the long-term part-time employee rules. Under the Act, 12-month periods beginning before January 1, 2021 are not taken into account in determining a year of service for purposes of the rules applicable to the vesting of employer contributions. Thus, in addition to being disregarded for purposes of determining whether the employee has completed three consecutive years of service (as under present law), 12-month periods beginning before January 1, 2021 are disregarded for vesting purposes.

Finally, the Act clarifies that a 401(k) safe harbor plan that is eligible for an exemption from the top heavy rules does not fail to qualify for the exemption merely because the plan does not provide safe harbor matching contributions to long-term part-time employees.

The Act also extends the long-term part-time coverage rules to 403(b) plans that are subject to ERISA.

Effective date. The reduction in service requirement from three years to two years is effective for plan years beginning after December 31, 2024.

The clarification of the vesting rule and the top-heavy rule is effective as if included in the enactment of Sec. 112 of the SECURE Act of 2019.

<u>Reduction in Excise Tax on Certain Accumulations in Qualified Retirement Plans</u>

Under Code Sec. 4974(a), an excise tax is imposed on a payee under any qualified retirement plan (including IRAs) or eligible deferred compensation plan under Code Sec. 457(b) if the amount distributed during the payee's tax year is less than the required minimum distribution for the tax year. Under current law, the amount of the excise tax is 50% of the amount by which the required minimum distribution (RMD) exceeds the actual amount distributed during the calendar year.

New law. The Act reduces the penalty under Code Sec. 4974(a) for failure to take RMDs from 50% to 25%.

The Act also adds Code Sec. 4974(e) to provide that if the failure to take the RMD is corrected in a timely manner, the penalty is reduced from 25% to 10%. The Act specifies that new Code Sec. 4974(e) provides that if a taxpayer receives, during the correction window, a shortfall of distributions from a plan that resulted in imposition of the excise tax, and submits a return, during the correction window, reflecting such tax, the excise tax on the failure to take the RMD is 10%.

For these purposes, a correction window means the period of time beginning on the date on which the excise tax discussed above is imposed with respect to a shortfall of distributions from a plan, and ending on the earliest of: (A) the date a notice of deficiency with respect to the excise tax is mailed; (B) the date on which the excise tax is assessed; or (C) the last day of the second tax year that begins after the end of the tax year in which the excise tax is imposed.

Effective date. This provision applies to tax years beginning after the date of enhancement of the Act.

<u>Expansion of Employee Plans Compliance Resolution System</u>

The current version of the IRS' Employee Plans Compliance Resolution System (EPCRS) includes three programs: the Self-Correction Program (SCP), the Voluntary Correction Program (VCP), and the Audit Closing Agreement Program (Audit CAP). Only SCP allows for self-correction without IRS approval. SCP is only available for qualified plans and 403(b) plans. EPCRS does not apply to IRAs (other than to certain SIMPLE IRA plans and SEP IRAs).

SCP may be used to correct insignificant operational failures at any time, but significant operational failures and plan document failures eligible for SCP generally must be completed during a correction period that ends on the last day of the third year after the plan year for which the failure occurred. SCP cannot be used for significant operational failures and plan document failures if the plan does not have a favorable determination letter. The ability to use SCP is also lost if correction of a significant operational failure has not been substantially completed before the plan or plan sponsor comes under examination.

New law. The Act expands access to self-correction in multiple ways.

First, it expands self-correction under EPCRS (except as otherwise provided by the Code or regulations) to cover any eligible inadvertent failure to comply with the rules under Code Sec. 401(a), Code Sec. 403(a), Code Sec. 403(b), Code Sec. 408(k)(simplified employee pensions or SEPs), and Code Sec. 408(p) (simple retirement accounts or SIMPLE IRAs), unless the error is identified by the Treasury Secretary before any actions have been taken demonstrating a specific commitment to implement a self-correction, or the self-correction is not completed within a reasonable time after the failure is identified.

Second, it directs the Secretary to allow custodians to use EPCRS to address various IRA failures, including failures to make required minimum distributions and attempted rollovers by nonspouse beneficiaries from inherited IRAs.

Third, "eligible inadvertent failure" is defined expansively to include any failure that occurs despite compliance practices and procedures that satisfy the standards of EPCRS (or similar standards for IRAs). The term does not, however, include failures that are egregious, related to the diversion or misuse of plan assets, or relate to an abusive tax avoidance transaction.

Fourth, participant-loan-related errors may be self-corrected under EPCRS according to the rules in EPCRS Sec. 6.07, which currently makes some corrections available only under the IRS-supervised VCP or Audit CAP programs. Loan failures self-corrected under EPCRS as permitted by the Act will be treated as meeting the requirements of the DOL's Voluntary Fiduciary Correction (VCP) Program, although the Secretary of Labor may impose reporting or other procedural requirements.

The Act's expansion of EPCRS is available only if correction is made in accordance with the general principles for corrections under the Code, including those articulated in EPCRS and regulations or other guidance.

Finally, the Act directs the Secretary to issue guidance on correction methods required to correct eligible inadvertent failures, including general principles of correction where a specific method is not given.

Effective date. This provision is effective as of the date of enactment and the Secretary is required to revise EPCRS for these changes no later than two years from the date of enactment of the Act.

Retroactive First Year Elective Deferrals For Sole Proprietors

If an employer adopts a qualified plan after the close of a tax year, but before the time prescribed by law for filing the employer's tax return for the tax year (including extensions thereof), the employer may elect to treat the plan as having been adopted as of the last day of the tax year. That rule allows employers to establish and fund a qualified plan by the due date for filing the employer's return for the preceding plan year. However, that rule does not override other rules requiring certain plan provisions to be in effect during a plan year, such as the provision for elective deferrals under a 401(k) plan.

A 401(k) plan of a sole proprietor can be funded with employer contributions as of the due date for the business's return, but the elective deferrals must be made as of December 31 of the prior year. However, an individual is deemed to have made a contribution to an IRA for a tax year if it's contributed after the tax year has ended, but is made "on account of" that year, and before the due date for filing the IRA owner's tax return for that year without extensions (generally, April 15).

New law. The provision provides that in the case of an individual who owns the entire interest in an unincorporated trade or business, and who is the only employee of that trade or business, any elective deferral under a 401(k) plan which is made by that individual before the time for filing the individual's return for the tax year (determined without regard to any extensions) ending after or with the end of the plan's first plan year, will be treated as having been made before the end of the plan's first plan year.

Under the provision, 401(k) plans sponsored by sole proprietors can receive employee contributions up to the date of the employer's tax return filing date, but only for the first plan year in which the plan is established.

Effective date. The provision is effective for plan years beginning after the date of enactment.

Eliminating Unnecessary Plan Requirements Related to Unenrolled Participants

Under both the Code and ERISA, employees that are eligible to participate in a defined contribution plan must receive numerous intermittent notices and explanations of their rights and options under the plan, such as an explanation of available investment options. These intermittent notice requirements generally apply even where eligible employees have opted not to participate in the plan.

New law. The Act amends the Code and ERISA to provide that defined contribution plans are exempt from intermittent notification requirements with respect to participants that elect not to participate, and who have already received a summary plan description, and any other notices related to initial eligibility to participate in the plan (unenrolled participants). Intermittent notifications include disclosures, notices and plan documents. However, an unenrolled participant must still receive: (A) an annual reminder notice of their eligibility to participate in the plan, as well as any applicable plan deadlines; and (B) any document they request that they would be entitled to receive under existing law absent this Act provision.

Effective date. This provision applies to plan years beginning after December 31, 2022.

Surviving Spouse Election to be Treated as Employee

Before the enactment of the Act, a surviving spouse that was designated as the beneficiary of an employee who died before the distribution of required minimum distributions (RMDs) began under an employer-provided qualified retirement plan would receive a more favorable distribution period of his or her spouse's interest in the retirement plan if the surviving spouse rolled the amount into an individual retirement account (IRA).

New law. Surviving spouse's election to be treated as employee. Under the Act, in the case of an employee who dies before RMDs have begun under an employer-provided qualified retirement plan, and who has designated a spouse as sole beneficiary, the designated beneficiary surviving spouse may elect to be treated as if the surviving spouse were the employee for purposes of the required minimum distribution rules of Code Sec. 401(a)(9). The date on which the distributions are required to begin will not be earlier than the date on which the employee would have attained the applicable age. If the surviving spouse dies before the distributions begin, the surviving spouse is treated as the employee for purposes of determining the distribution period.

The elections must be made in such time and manner as prescribed by the IRS. The election must include a timely notice to the plan administrator, and once made it may not be revoked except with the consent of the IRS.

Extension of at least as rapidly rule. Under the Act, IRS is directed to amend Reg §1.401(a)(9)-5, Q&A-5(a) (or any successor regulations) to provide that if the surviving spouse is the employee's sole designated beneficiary and the spouse elects the treatment described above, then the applicable distribution period for distribution calendar years after the distribution calendar year including the employee's date of death is determined under the uniform lifetime table.

This provision allows a designated beneficiary who is a spouse to receive a similar distribution period for lifetime distributions under an employer-sponsored retirement plan as is permitted if the surviving spouse rolls the amount into an IRA.

Effective date. The provision is effective for calendar years beginning after December 31, 2023.

Elimination of Additional Tax on Corrective Distributions of Excess Contributions

Generally, a distribution from a qualified retirement plan, a Code Sec. 403(b) plan, or an IRA that is received before a participant attains age 59½ is subject to an additional 10% early withdrawal tax on any amounts included in income.

A 6% excise tax is imposed on the amount of "excess contributions" to an IRA. Code Sec. 4973(a). Any contribution (including net earnings allocable to the contribution) distributed from an IRA on or before the due date of a participant's tax return (including extensions), however, where no IRA deduction was allowed is treated as an amount not contributed, and therefore escapes excise taxation.

Any earnings that are attributable to returned excess contributions from an IRA are not expressly exempt from the additional 10% early withdrawal tax under Code Sec. 72(t).

New law. The Act specifically provides that earnings attributable to excess contributions to an IRA that are returned by the due date for the taxpayer's return for the year (including extensions) are exempt from the 10% early withdrawal tax. The taxpayer must not claim a deduction for the distributed excess contribution.

Effective date. This provision applies to any determination of, or affecting, liability for taxes, interest, or penalties made on or after the date of the enactment of the Act, without regard to whether the act (or failure to act) upon which the determination is based occurred before the date of enactment.

Extended Amendment Period and Anti-Cutback Relief for Certain Plan Amendments

For a retirement plan to be tax-qualified, it must be operated in accordance with the written plan terms. Failure to timely amend plan documents to reflect changes in the law (or changes in plan design and operation) may risk the plan's tax-qualified status. In addition, under the Code Sec. 411(d) and ERISA Sec. 204(g) anti-cutback rules, a plan amendment may not decrease the accrued benefit of a plan participant. When Congress changes the laws relating to plan qualification, it typically establishes a deadline by which amendments reflecting the changes must be adopted, and sometimes provides relief from the anti-cutback rules for retroactive amendments reflecting the changes (so long as the amendments are timely adopted).

New Law. The deadline for plan amendments made pursuant to the Act or any IRS or DOL regulation issued thereunder is the end of the first plan year beginning on or after January 1, 2025 (2027 for governmental and collectively bargained plans). If, in the interim, a plan operates as if a retroactive amendment were already in effect, the retroactive amendment will not be treated as violating the anti-cutback rules (unless otherwise provided in IRS guidance). The Act also conforms certain plan amendment deadlines under the SECURE Act (PL 116-94, 12/20/2019), the CARES Act (PL 116-136, 3/27/2020), and the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (PL 116-260, 12/27/2020) to these new dates. Accordingly, amendments generally must be adopted by the end of the first plan year beginning on or after January 1, 2025 (instead of 2022) or, for certain plans, 2027 (instead of 2024).

Effective date. The provision is effective on the date of enactment of the Act.

Elective Deferrals Generally Limited to Regular Contribution Limit

Defined contribution retirement plans under Code Sec. 401(k), Code Sec. 403(b), or Code Sec. 457(b), may allow eligible participants to elect to make deferral contributions from their compensation on a pre-tax basis. The maximum amount of elective deferrals that can be made by a participant under such plans is subject to an annual dollar limit ($22,500 for 2023). These types of plans are permitted, but not required, to allow participants who are age 50 or older to make additional pre-tax elective deferrals, known as "catch-up" contributions. Code Sec. 414(v). Catch-up contributions are elective deferrals that, among other things, are not subject to the annual elective deferral dollar limit. The annual dollar limit on catch-up contributions is $7,500 for 2023.

These plans may also permit participants to designate a portion of their elective deferrals as "designated Roth contributions." These contributions are made on an after-tax basis and qualified distributions from a designated Roth account generally are excluded from income when made. Roth contributions and their earnings must be kept in separate "Roth accounts." Contributions and distributions of designated Roth contributions must be recorded separately in a Roth account, and a separate record must be maintained of the participant's "investment in the contract." Investment gains and losses (and any other credits or charges) also must be separately allocated to the Roth account on a reasonable and consistent basis.

New law. The Act provides that catch-up contributions under Code Sec. 401(k), Code Sec. 403(b), or Code Sec. 457(b)plans are subject to mandatory Roth tax treatment, except those made by participants whose wages for the preceding calendar year do not exceed $145,000, as annually indexed for inflation. This rule does not apply to simplified employee pensions under Code Sec. 408(k), or to SIMPLE IRAs under Code Sec. 408(p).

Effective date. This provision is effective for tax years beginning after December 31, 2023.

Optional Treatment of Employer Matching or Nonelective Contributions as Roth Contributions

Elective deferrals under Code Sec. 401(k), Code Sec. 403(b), or Code Sec. 457(b) plans are generally made on a pre-tax basis. These plans may also permit participants to designate a portion of their elective deferrals as "designated Roth contributions." These contributions are made on an after-tax basis and qualified distributions from a designated Roth account generally are excluded from income when made.

A defined contribution plan is permitted, but not required, to provide matching contributions. Matching contributions are those contributions that an employer makes on behalf of participants "on account of" their elective deferrals (which, in some plan designs, might include Roth and catch-up contributions). Some plans also match after-tax contributions. Matching contributions are not included in a participant's income until the amount is distributed from the plan.

A defined contribution plan may also provide for nonelective contributions. Nonelective contributions are contributions made by the employer that are not tied to the amount of a participant's elective deferrals (pre-tax or after-tax). Nonelective contributions can be a fixed amount, such as a percentage of pay, or a discretionary amount that the employer determines at the end of the plan year.

Employers currently are not permitted to make matching or nonelective contributions on a Roth basis.

New law. A Code Sec. 401(a) qualified plan, a Code Sec. 403(b) plan, or a governmental Code Sec. 457(b)plan may permit a participant to designate some or all matching contributions and nonelective contributions as designated Roth contributions. This applies only to the extent that a participant is fully vested in these contributions.

Effective date. This provision applies to contributions made after the date of the enactment of the Act.

ILLINOIS MAKES CHANGES AFFECTING VARIOUS 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.

SALT Cap Workaround

On August 27, 2021, Governor Pritzker signed into law the Optional Pass-Through Entity Tax, a state and local tax cap ("SALT Cap") workaround for partnerships and S-corporations for tax years 2021-2025. The SALT Cap workaround allows the partnership or S-corporation to elect to pay income tax on its Illinois net income and the partners and shareholders to circumvent the $10,000 cap on SALT itemized deductions on their federal individual income tax returns.

- Applicable Tax Years: This election is effective for tax years ending on or after December 31, 2021 and beginning prior to January 1, 2026. If the federal state and local tax cap is repealed, this election will be revoked.
- Election: This election must be made annually, and once made, is irrevocable for that tax year. Additional guidance from the Illinois Department of Revenue is required to determine the form and date of the election.
- Tax Rate: The tax rate is 4.95% of Illinois net income.
- Eligible Taxpayers: Partnerships and S-corporations are eligible to make this election.
- Credit: The taxpayer is allowed an amount equal to 4.95% of the partner or shareholder's distributive share of the Illinois net income of the electing partnership or S-corporation.
- Nonresident: A nonresident is not required to file an Illinois tax return if the only source of net income is from the entity making the PTE tax election and the credit allowed to the partner equals or exceeds the individual's liability for the tax imposed.

Decoupling from 100% Bonus Depreciation Deduction

Illinois decouples from the 100% federal bonus depreciation for all taxpayers starting with tax years ending on or after December 31, 2021. Under the new depreciation provisions, taxpayers are required to add back the full bonus depreciation and are provided a subtraction for depreciation computed using IRC Sec. 168 as if they elected out of 100% bonus depreciation.

$100,000 NOL Limitation

C-corporations are limited to a $100,000 net operating loss deduction for tax years ending on or after December 31, 2021, and prior to December 31, 2024. The carryforward period for the limitation on utilizing net operating losses will toll in years a taxpayer could have utilized more than $100,000 of net operating loss. However, if a taxpayer has a loss or uses $100,000 or less of loss during the limitation period, no additional years will be added to the carryforward. The net operating loss limitation does not apply to S-corporations and partnerships.

Foreign Income Deduction Addback and IRC Section 1248 Income

The bill contains several modifications related to foreign income. For taxable years ending on or after June 30, 2021, corporate taxpayers are required to add back the deduction allowed under IRC Sec. 250(a)(1)(B)(i), commonly referred to as the GILTI deduction. Additionally, taxpayers are required to add back federal dividend received deductions under IRC Sec. 243(e) and Sec. 245A(a). Note that Illinois disallowed the federal income tax deduction for foreign-derived intangible income (FDI) starting with tax years beginning after December 31, 2018.

While these changes will increase the Illinois starting point of taxable income, the state has not changed the subtraction provided for income included under IRC Sec. 951 through 956. As such, many taxpayers will likely end up in a similar, if not the same, spot as they would have prior to these legislative changes.

Illinois changed the definition of "dividend" for purposes of the Illinois dividends received deduction. No longer included for taxable years ending on or after June 30, 2021, is income treated as dividend under IRC Sec. 1248. Under IRC Sec. 1248, a taxpayer may be required to recharacterize a portion of their gain from the sale of a foreign corporation from capital gain to dividends, to the extent of untaxed earnings and profits in the foreign corporation. However, this change does not apply to dividends for which a deduction is allowed under IRC Sec. 245(a).

Elimination of Franchise Tax Repeal

Senate Bill 2017 eliminates the phase out of the franchise tax while retaining the current $1,000 tax liability offset (i.e., tax is paid on the excess of a $1,000 liability). Pursuant to Senate Bill 689, passed in the spring of 2019, the Illinois franchise tax was set to gradually phase out starting 2020 with complete elimination for taxes due and payable after December 31, 2023.

Extension of Sunset Dates for Credit

The following credits that were set to expire after 2021 have been extended to 2026:

- Angel Investment Credit
- Affordable Housing Donations Credit
- River Edge Redevelopment Zone Credit
- Live Theater Production Credit

Illinois Secure Choice Savings Program Act

Under the Illinois Secure Choice Savings Program Act (820 ILCS 80/), Illinois employers with at least five (5) employees, that have been in business for two or more years, and that do not offer a qualified retirement plan must either begin offering a qualified plan or automatically enroll their employees into the Illinois Secure Choice Savings Program ("Secure Choice"). Secure Choice is a program administered by the Illinois Secure Choice Savings Board for the purpose of providing a retirement savings option to private-sector employees in Illinois who lack access to an employer-sponsored plan. Funded by employee savings (no employer fees or contributions). Employee participation is completely voluntary; employees can opt in or out at any time. Administered by a private-sector financial services firm overseen by a public board chaired by the State Treasurer.

The program began in May 2018 with a small pilot group of employers. The program has gone through its initial waves for larger employers with 25 or more employees and will roll out to additional employers starting in 2022. Employers who do not comply with the Illinois Secure Choice Savings Program Act may be subject to fines and penalties as described in 820 ILCS 80/85. The registration deadlines for employers based on employer size is outlined below:

- An employer employing 500 or more employees: 11/1/2018
- An employer employing 100 to 499 employees: 7/1/2019
- An employer employing 25 to 99 employees: 11/1/2019
- An employer employing 16 to 24 employees: 11/1/2022
- An employer employing 5 to 15 employees: 11/1/2023

Employers who do not meet their required enrollment deadlines or report an exemption from Secure Choice may be subject to financial penalties. For information on registration, reporting an exemption, and related deadlines, visit ilsecurechoice.com.

THINGS TO CONSIDER BEFORE THE END OF 2023

- ☑ Use up expiring loss and credit carryovers.
- ☑ Increase basis in Partnership or S-corporation to make possible 2023 loss deduction.
- ☑ Buy equipment by December 31st to get depreciation deductions in 2023.
- ☑ 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 $17,000 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.

2023 Tax Rate Schedule

	Taxable Income	Tax
Married Individuals Filing Joint Returns and Surviving Spouses	Not over $22,000	10% of taxable income
	Over $22,000 but not over $89,450	$2,200 plus 12% of the excess over $22,000
	Over $89,450 but not over $190,750	$10,294 plus 22% of the excess over $89,450
	Over $190,750 but not over $364,200	$32,580 plus 24% of the excess over $190,750
	Over $364,200 but not over $462,500	$74,208 plus 32% of the excess over $364,200
	Over $462,500 but not over $693,750	$105,664 plus 35% of the excess over $462,500
	Over $693,750	$186,602 plus 37% of the excess over $693,750
Heads of Household	Not over $15,700	10% of taxable income
	Over $15,700 but not over $59,850	$1,570 plus 12% of the excess over $15,700
	Over $59,850 but not over $95,350	$6,868 plus 22% of the excess over $59,850
	Over $95,350 but not over $182,100	$14,678 plus 24% of the excess over $95,350
	Over $182,100 but not over $231,250	$35,498 plus 32% of the excess over $182,100
	Over $231,250 but not over $578,100	$51,226 plus 35% of the excess over $231,250
	Over $578,100	$172,624 plus 37% of the excess over $578,100
Unmarried Individuals (Other Than Surviving Spouses and Heads of Household)	Not over $11,000	10% of taxable income
	Over $11,000 but not over $44,725	$1,100 plus 12% of the excess over $11,000
	Over $44,725 but not over $95,375	$5,147 plus 22% of the excess over $44,725
	Over $95,375 but not over $182,100	$16,290 plus 24% of the excess over $95,375
	Over $182,100 but not over $231,250	$37,104 plus 32% of the excess over $182,100
	Over $231,250 but not over $578,125	$52,832 plus 35% of the excess over $231,250
	Over $578,125	$174,238 plus 37% of the excess over $578,125
Married Individuals Filing Separate Returns	Not over $11,000	10% of taxable income
	Over $11,000 but not over $44,725	$1,100 plus 12% of the excess over $11,000
	Over $44,725 but not over $95,375	$5,147 plus 22% of the excess over $44,725
	Over $95,375 but not over $182,100	$16,290 plus 24% of the excess over $95,375
	Over $182,100 but not over $231,250	$37,104 plus 32% of the excess over $182,100
	Over $231,250 but not over $346,875	$52,832 plus 35% of the excess over $231,250
	Over $346,875	$93,301 plus 37% of the excess over $346,875

2024 Tax Rate Schedule

	Taxable Income	Tax
Married Individuals Filing Joint Returns and Surviving Spouses	Not over $23,200	10% of taxable income
	Over $23,201 but not over $94,300	$2,320 plus 12% of the excess over $23,200
	Over $94,301 but not over $201,050	$10,852 plus 22% of the excess over $94,300
	Over $201,051 but not over $383,900	$34,337 plus 24% of the excess over $201,050
	Over $383,901 but not over $487,450	$78,221 plus 32% of the excess over $383,900
	Over $487,451 but not over $731,200	$111,357 plus 35% of the excess over $487,450
	Over $731,201	$196,670 plus 37% of the excess over $731,200
Heads of Household	Not over $16,550	10% of taxable income
	Over $16,551 but not over $63,100	$1,655 plus 12% of the excess over $16,550
	Over $63,101 but not over $100,500	$7,241 plus 22% of the excess over $63,100
	Over $100,501 but not over $191,950	$15,469 plus 24% of the excess over $100,500
	Over $191,951 but not over $243,700	$37,417 plus 32% of the excess over $191,950
	Over $243,701 but not over $609,350	$53,977 plus 35% of the excess over $243,700
	Over $609,351	$181,955 plus 37% of the excess over $609,350
Unmarried Individuals (Other Than Surviving Spouses and Heads of Household)	Not over $11,600	10% of taxable income
	Over $11,601 but not over $47,150	$1,160 plus 12% of the excess over $11,600
	Over $47,151 but not over $100,525	$5,426 plus 22% of the excess over $47,150
	Over $100,526 but not over $191,950	$17,169 plus 24% of the excess over $100,525
	Over $191,951 but not over $243,725	$39,111 plus 32% of the excess over $191,950
	Over $243,726 but not over $609,350	$55,629 plus 35% of the excess over $243,725
	Over $609,351	$183,647 plus 37% of the excess over $609,350
Married Individuals Filing Separate Returns	Not over $11,600	10% of taxable income
	Over $11,601 but not over $47,150	$1,160 plus 12% of the excess over $11,600
	Over $47,151 but not over $100,525	$5,426 plus 22% of the excess over $47,150
	Over $100,526 but not over $191,950	$17,169 plus 24% of the excess over $100,525
	Over $191,951 but not over $243,725	$39,111 plus 32% of the excess over $191,950
	Over $243,726 but not over $365,600	$55,679 plus 35% of the excess over $243,725
	Over $365,601	$98,335 plus 37% of the excess over $365,600