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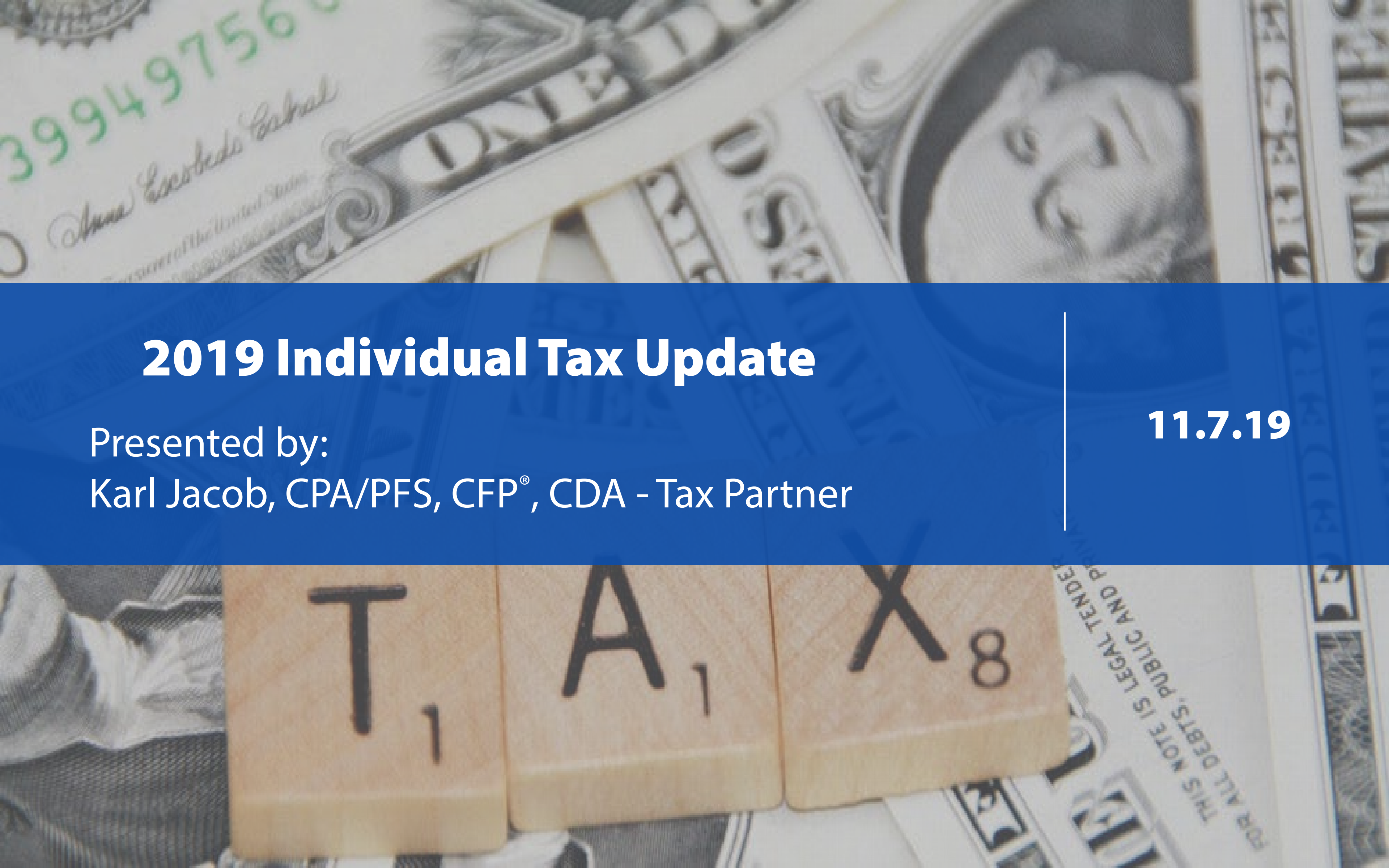

2019 Individual Tax Update

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11.7.19

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Dannible & McKee's Annual

Tax & Financial Planning Conference

Embassy Suites by Hilton Destiny USA · Syracuse, New York

Thursday, November 7, 2019

2019 Individual Tax Update

Refresher - The Tax Cuts and Jobs Act:

Most individuals felt the impact of last year's tax reform for the first time with the filing of their 2018 Federal income taxes. It was the most sweeping rewrite of the tax code in more than three decades.

One of the most touted changes in the 2018 tax reform bill was the update to income tax brackets and marginal tax rates. Tax brackets are income ranges within which a marginal tax rate is applied. The income tax brackets were expanded, and the top marginal tax rate was lowered from 39.6 percent to 37 percent.

***NOTE*:** A notable feature of the individual tax (and the estate tax) provisions is that all of them expire after 2025, except for the reduction of the ACA penalty tax.

2019 Individual Income Tax Rates

Single Filers (2019)

Under Previous Law		Tax Cuts and Jobs Act	
Rate	**Income Bracket (2017)**	**Rate**	**Income Bracket (2019)**
10%	$0-9,325	10%	$0-9,700
15%	$9,326-37,950	12%	$9,701-39,475
25%	$37,951-91,900	22%	$39,476-84,200
28%	$91,901-191,650	24%	$84,201-160,725
33%	$191,651-416,700	32%	$160,726-204,100
35%	$416,701-418,400	35%	$204,101-510,300
39.6%	$418,401 and over	37%	$510,301 and over

Married Filing Jointly - MFJ (2019)

Under Previous Law		Tax Cuts and Jobs Act	
Rate	**Income Bracket (2017)**	**Rate**	**Income Bracket (2019)**
10%	$0-18,650	10%	$0-19,400
15%	$18,651-75,900	12%	$19,401-78,950
25%	$75,901-153,100	22%	$78,951-168,400
28%	$153,101-233,350	24%	$168,401-321,450
33%	$233,351-416,700	32%	$321,451-408,200
35%	$416,701-470,700	35%	$408,201-612,350
39.6%	$470,701 and over	37%	$612,351 and over

2019 Individual Tax Update (con't.)

Impact of expanded tax brackets and lower marginal rates:

An individual (MFJ) with $175,000 of taxable income would pay the following:

2017	-	$35,884
2018	-	$30,579

A $5,305 tax reduction based on new rate structure. Approximately a 15 percent reduction.

Other Key Changes

- In addition to the reduction in tax rates, the TCJA made notable changes to Adjustments, Deductions, Credits and the Alternative Minimum Tax (AMT) which also impacted a taxpayer's tax liability.
- In many cases a taxpayer would end up with a higher taxable income but pay less tax due to the lower rates and expanded credits.

Adjustments

- **Moving Expenses:**
  - The deduction for job-related moving expenses was eliminated.
  - The exclusion for moving expense reimbursements has also been suspended making it taxable to the recipient with no offsetting deduction.
  - Still available for certain military personnel for moving expenses incurred as a result of a permanent change of station (PCS).

Adjustments

- **Alimony:**
  - For post-2018 divorce decrees and separation agreements, alimony will not be deductible by the paying spouse and will not be taxable to the receiving spouse.
    - Ex-spouses who modify their pre-2019 divorce decrees or separation agreements can elect to opt into the new tax treatment of alimony.
    - There may be situations where applying the TCJA rules voluntarily is beneficial for the taxpayers, such as a change in the income levels of the alimony payer or the alimony recipient. This also creates an opportunity for the paying spouse to reduce their payments by the tax savings of the receiving spouse.

Elimination of the Personal/Dependent Exemption

- Elimination of the personal exemption for taxpayers and their dependents ($4,050 per taxpayer and dependent in 2017).
  - High-income taxpayers received no benefit for personal exemptions under prior law due to AGI phase-outs.
  - Taxpayers subject to AMT also received no benefit for personal exemptions.
  - For a family of four, this results in a loss of a $20,250 deduction.

Changes to the Standard Deduction

- Significant Increase in the Standard Deduction.
  - Married Joint Filers - from $12,700 to $24,000. ***$24,400 in 2019.***
  - Single - from $6,350 to $12,000. ***$12,200 in 2019.***
  - Heads of Household - from $9,350 to $18,000. ***$18,350 in 2019.***
  - For 2019, the additional standard deduction for the elderly (age 65) and blind remains at $1,300 each for MFJ/MFS and increased from $1,600 to $1,650 each for Single.

Changes to the Standard Deduction (con't.)

- By increasing the standard deduction and limiting certain itemized deductions, the TCJA reduced the percentage of taxpayers that itemized and limited how much the tax code can award tax relief to taxpayers who spend in particular ways.
- It was estimated that 13.7 percent of taxpayers would itemize in 2018. This equates to more than a 17-percentage point reduction than it would have been in 2018 under pre-TCJA law.

Itemized Deductions - Medical Expenses

- Medical Expenses.
  - Still deductible if exceeds Adjusted Gross income (AGI) Threshold.
  - Beginning January 1, 2019, all taxpayers may deduct only the amount of the total unreimbursed allowable medical care expenses for the year that exceeds 10 percent of their adjusted gross income

***Planning Point*:** If you or your spouse has a large amount of out-of-pocket medical expenses it can be difficult to claim most of your expenses if you and your spouse have a high AGI. Filing separate returns in such a situation may be beneficial if it allows you to claim more of your available medical deductions by applying the threshold to only one of your incomes.

Itemized Deductions - State and Local Taxes

- The deduction for state and local income tax, sales tax and property taxes ("*SALT deduction*") was capped at $10,000.
  - This impacted taxpayers with more expensive property, generally those who live in higher-income areas, or people in states with higher state tax rates (NY, NJ, CA, etc.).
  - Deductions for state, local and foreign property taxes, and sales taxes, that are deductible in computing income on an individual's Schedule C, Schedule E or Schedule F on the individual's tax return, are allowed in full.

Itemized Deductions - State and Local Taxes (con't.)

- In response to the CAP - *New York, Connecticut, Maryland* and *New Jersey* filed a complaint with the U.S. District Court for the Southern District of New York seeking declaratory and injunctive relief to invalidate the State and Local Tax (SALT) deduction cap. According to the complaint, the cap violates the U.S. Constitution by interfering with the states' sovereign authority to decide whether and how much to invest in their residents, businesses and infrastructure.
  - *Recently, the Court dismissed the case, finding that the states failed to present any constitutional principle that would bar Congress from exercising its otherwise plenary power to impose an income tax without a limitless SALT deduction.* In addition, the Court held that the cap is not unconstitutionally coercive because it does not meaningfully constrain the states' exercise of their own sovereign tax powers.

Itemized Deductions - Interest Expense

- The mortgage interest deduction for a taxpayer's principal residence and one second home was lowered from total loan balances of $1 million under current law to $750,000.
  - Applied to debt incurred after December 15, 2017.
  - The $1 million limitation remained in place for older debt (grandfathered).
- Taxpayers who exceed the debt thresholds must calculate the deductible amount by dividing the maximum debt limit by your mortgage balance, then multiply the result by the interest paid to figure your deduction.
  - For example, if your mortgage is $1.25 million and the applicable limit is $750,000, divide $750,000 by $1.25 million to get 0.6. 60 percent of the interest paid would be deductible on Schedule A.

Itemized Deductions - Interest Expense (con't.)

- Interest from home equity loans (aka second mortgages) is no longer deductible unless used for acquisition purposes. No grandfather provision.
  - Acquisition indebtedness is indebtedness that is incurred in *acquiring*, *constructing* or *substantially improving* a qualified residence of the taxpayer and which is secured by the residence.

Important Note: If claiming a deduction for Home Equity indebtedness it is very important to document the source and use of the funds to support the deduction. Failure to do so could result in a loss of the deduction.

Itemized Deductions - Interest Expense (con't.)

Planning Point:

- Just because you may not itemize it does not mean that your interest expenses are not deductible on your return. It's very important to review the source and use of borrowed funds as the interest may fall into one of the following categories:
  - Business Interest Expense (Schedule C, Schedule F, Schedule E).
  - Investment Interest Expense (Schedule A/Form 4952).
    - The amount of interest that can be deducted in any particular year is limited to a taxpayer's net investment income for that same year. It can't exceed that amount.
    - Any amount disallowed is carried forward to the next tax year.

Itemized Deductions - Interest Expense (con't.)

- Even if you do not itemize, complete Form 4952 to calculate the allowable/disallowed portion of your investment interest. The disallowed portion will be added to any carryforward.
- If you have a sizeable investment interest carryforward, you can elect to treat net long-term capital gains or qualified dividends as investment income. If you do, that portion of the long-term capital gain or dividend will be taxed at ordinary-income rates.
- Consider recognizing LTCG's where you have a sizeable investment interest deduction carryforward.

Itemized Deductions - Contributions

- For contributions made in tax years beginning after December 31, 2017 and before January 1, 2026, the 50 percent AGI limitation under Code Section 170(b) for cash contributions to public charities and certain private foundations is <u>increased to 60 percent</u>.
- Beginning in 2018, 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.
  - Was prepaying for SU Football season tickets a smart move??

Itemized Deductions - Contributions (con't.)

***Planning Point*:**

To maximize the benefit of charitable contributions, consider bunching contributions together every other year to take advantage of the itemized deduction.

- Also, if you or your spouse are 70 ½ or older, consider using a Qualified Charitable Distribution (QCD) to fund your contributions.
  - A QCD is a direct transfer of funds from your *IRA* custodian, payable to a qualified charity. The maximum annual amount that can qualify for a QCD is $100,000.
  - Know the rules. Your tax advisor can help you determine if both your IRA and charity qualify for QCDs.

Itemized Deductions - Miscellaneous Itemized

- Beginning in 2018, the TCJA suspended all miscellaneous itemized deductions that are subject to the 2 percent AGI floor under prior law.
  - Examples include employee business expenses, tax preparation fees, job search expenses, union dues, dues to professional societies, investment expenses, etc.

***Planning Point*:**

- Employees who incur considerable amount of unreimbursed business expenses or who are reimbursed under a non-accountable plan (i.e. auto allowance) you should consider speaking with your employer about instituting an accountable plan.

Child and Family Tax Credit

- The new law increased the credit for qualifying children (i.e., children under 17) to $2,000 from $1,000, and increases to $1,400 the refundable portion of the credit.
- Also introduced a new (nonrefundable) $500 credit for a taxpayer's dependents who are not qualifying children. The adjusted gross income level at which the credits begin to be phased out has been increased to $200,000 ($400,000 for joint filers).
- In many cases, this provision more than offsets the tax savings lost on the elimination of the personal/dependent exemptions.

Alternative Minimum Tax (AMT)

- When created in 1969, it was targeted at wealthy individuals who used a lot of tax breaks to avoid paying any income tax.
  - Congress didn't adjust the AMT as other parts of the tax code changed.
  - The result was that the AMT would snare many middle-class taxpayers, especially retirees, who already would have paid substantial taxes under the regular income tax.

- Prior to the TCJA, about 5 million taxpayers were subject to AMT each year, including middle class taxpayers.

Alternative Minimum Tax (con't.)

- Three key changes in the TCJA returned the AMT to being primarily a millionaire's tax.
  - First, the AMT exemption was increased substantially.
    - MFJ/QW - Currently $111,700 ($84,500 in 2017).
    - Single/HOH - Currently $71,700 ($54,300 in 2017).
  - Second, the income levels at which the exemptions phase-out are much higher.
    - MFJ/QW - Currently $1,020,600 ($160,900 in 2017).
    - Single/HOH - Currently $510,300 ($120,700 in 2017).

Alternative Minimum Tax (con't.)

- Third, many of the tax breaks that triggered the AMT for middle-class taxpayers have been changed.
  - Middle income taxpayers frequently were subject to the AMT when they had high levels of personal and dependent exemptions, miscellaneous itemized deductions and state and local taxes.
- For the year 2018 it was expected that only about 200,000 taxpayers were expected to pay AMT compared to 5,000,000 before.
- Changes to the AMT resulted in big tax benefits for middle-class taxpayers.

More Significant Provisions of the TCJA

- In addition to the changes highlighted above, the TCJA added some additional Codes Sections that greatly impact individual taxation:
  - Code Section 199A: Qualified Business Deduction.
  - Code Section 461(l): Excess Business Loss Limitation.
  - Code Section 163(j): Business Interest Expense Limitation.

Code Section 199A: Qualified Business Deduction

- One of the more beneficial provisions added by the TCJA, the QBI deduction provides a taxpayer up to a 20 percent deduction for net qualified business income.

  ***Example*:** A Taxpayer with $100,000 of net QBI and meets all the requirements can receive a $20,000 deduction. Assuming the Taxpayer is in a 25 percent tax bracket, that equates to a $5,000 savings.

Code Section 199A: Qualified Business Deduction (con't.)

- QBI can be generated from the following:
  - Sole-proprietorships (Schedule C).
  - Rental property trade or businesses (Schedule E).
  - Disregarded entities (SMLLCs' Schedule C, Schedule E).
  - Pass-through entities (Schedule K-1 reported on Schedule E).
  - Trusts and estates, REITs and qualified cooperatives.
- The QBI calculation is performed at the individual level, its not done at the entity level.
  - Entities, however, are required to provide taxpayers with all the information required by the taxpayer to calculate the deduction.

Code Section 199A: Qualified Business Deduction (con't.)

- The QBI deduction, while very taxpayer friendly, is wrought with complexities in its application and reporting.
- ***Important Note*:** With all the complexities involved and with additional guidance being issued throughout the year, this is an area where proper planning can result in significant tax savings for taxpayers. For 2018, we have received many pass-through K-1's from other accountants that did not properly identify or report QBI. Had we not gone back and contacted the accountants, our clients would have missed available deductions.

Code Section 199A: Qualified Business Deduction (con't.)

- Complexities include:
  - Application of the different taxable income limitations and phase-outs applicable to different types of business income:
    - Non-specified service business (NSSB) and specified service businesses (SSB).
    - Application of the Property (unadjusted basis immediately after acquisition) and Wage (W-2) limitations for high income taxpayers.
    - ***Planning Points***:
      - Through income deferrals and expense planning, reduce/balance annual income to remain under thresholds.
      - Consider MFS to benefit from thresholds.
      - Review sources of income to maximize QBI - convert non-QBI income into QBI income.
        - » Reduce/eliminate guaranteed payments.
        - » Reduce SH wages in an S corporation.

Code Section 199A: Qualified Business Deduction (con't.)

- Election to Aggregate various trades or businesses in order to maximize the Section 199A deduction.
  - Absent aggregation, each trade or business is a separate trade or business for purposes of applying the limitations described in Section 199A.
  - Aggregation is not required, and trades or businesses may be aggregated only to the extent they meet certain qualifications.
  - Understand aggregation rules and reporting requirements under Treasury Regulation Section 199A-4.
    - Aggregation permits a taxpayer to combine attributes (W-2 wage and unadjusted basis in property) from more than one trade or business to maximize QBI.
    - Once aggregated, both individuals and RPE's must consistently report the aggregated trades or businesses going forward.

Code Section 199A: Qualified Business Deduction (con't.)

- Determining what is or isn't a trade or business with regard to rental real estate.
  - Rental Real Estate (for purposes of Section 199A) is a trade or business if:
    - The activity rises to the level of a trade or business under Internal Revenue Code Section 162:
      - » Facts and circumstances.
      - » Case Law: ***Commissioner v. Groetzinger***, 480 U.S. 23 (1987).
    - Is a self-rental, property?
      - » If the property is rented or licensed to a trade or business conducted by the individual or an RPE which is commonly controlled under Section 1.199A-4(b)(1)(i).
      - » ***Note***: Self-rental to a C corporation is NOT automatically a Section 162 trade or business.

Code Section 199A: Qualified Business Deduction (con't.)

- » ***Planning Point***:
  - Consider converting the corporation to an S corporation to pull rental income - plus S corporation income - into QBI eligible for the deduction.
  - Lot of factors to consider.
- – Meets the safe-harbor rule requirements under recently released (9-24-19) Revenue Procedure 2019-38.
  - » Prior guidance was issued under Notice 2019-07.
  - » While substantially similar to Notice 2019-07, the new Revenue Procedure does deviate in some notable areas.
  - » Taxpayers and RPEs may rely on the safe-harbor set forth in Notice 2019-07, for the 2018 taxable year.

Code Section 199A: Qualified Business Deduction (con't.)

- Safe-harbor rule under Revenue Procedure 2019-38.
  - The safe-harbor rule is applied to each "Rental Real Estate Enterprise" (RRE) held by an individual or "Relevant Pass-Through Entity" (RPE).
  - A taxpayer must first identify its rental real estate enterprise(s).
  - A rental real estate enterprise is an interest in real property held for the production of rents.
  - A rental real estate enterprise may consist of an interest in a single property or interests in multiple properties (via a grouping election).
  - Each interest must be held directly or through a disregarded entity.

Code Section 199A: Qualified Business Deduction (con't.)

- In determining what constitutes an RRE, a Taxpayer (individual) or RPE can elect to group *all* "similar properties" into the RRE for purposes of applying the safe-harbor rule.
  - Similar properties are either "residential" properties or "commercial" properties.
  - If a taxpayer elects to group properties, **ALL** similar properties must be grouped.
  - ***<u>Example</u>*:**
    - Taxpayer owns 3 residential and 2 commercial properties. Absent a grouping election the taxpayer would have 5 RRE's to which the safe-harbor rule would be applied to individually.
    - Taxpayer could elect to group the 3 residential properties into 1 RRE and the 2 commercial properties into 1 RRE and then would have 2 RRE's.
    - Taxpayer cannot elect to group 2 of the residential properties due to the all or nothing rule.

Code Section 199A: Qualified Business Deduction (con't.)

- Once multiple interests are grouped as a single rental real estate enterprise under the safe-harbor, they must continue to be treated as such if the taxpayer or RPE continues to rely on the safe-harbor.
  - If similar properties are treated as a single rental real estate enterprise, newly acquired similar properties *must* be added to the existing rental real estate enterprise.
- Special rules also exist for mixed used property (part residential and part commercial).
- ***Planning Point*:**
  - An election to group similar properties for application of the safe-harbor rule should be considered where a property would not otherwise meet the definition of a trade or business for the purpose of Section 199A and where the stand-alone properties would not meet the safe-harbor requirements (discussed below) on a stand-alone basis.

Code Section 199A: Qualified Business Deduction (con't.)

- Revenue Procedure 2019-38 requirements:
  - To meet the safe-harbor, each RRE must meet the following requirements.
    - **Performance of 250 or more hours of rental services.**
      - For a rental real estate enterprise in existence for at least four years, at least 250 hours of rental services must have been performed annually in any three of the five preceding tax years. For enterprises that have been in existence less than four years, the hour requirement must be satisfied in the tax year under consideration.

Code Section 199A: Qualified Business Deduction (con't.)

- Rental services for purpose of this Revenue Procedure 2019-38 include, but are not limited to:
  - (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 operation, maintenance, and repair of the property, including the purchase of materials and supplies;
  - (vi) Management of the real estate; and
  - (vii) Supervision of employees and independent contractors.
- Rental services may be performed by owners, including owners of an RPE, 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; improving property under Section 1.263(a)-3(d); or hours spent traveling to and from the real estate.

Code Section 199A: Qualified Business Deduction (con't.)

- **Triple net leases:**
  - The safe-harbor is <u>not available</u> to triple net lease arrangements.
    - » Under the new guidance, a triple net lease is defined to include a lease that requires the tenant to pay taxes, fees and insurance and to pay for maintenance activities, in addition to rent and utilities.
    - » Previous guidance defined triple net leases in a similar manner but referenced lease agreements where the tenant was responsible for maintenance activities. The revised guidance clarifies that the key factor is who pays for those activities.

Code Section 199A: Qualified Business Deduction (con't.)

» The existence of a triple net lease therefore could be:

- Detrimental to a taxpayer on property that throws off substantial income.
- Beneficial to a taxpayer on a property that throws off substantial losses.
- Somewhat controllable to the taxpayer under the 2019-38 safe-harbor definition.

Code Section 199A: Qualified Business Deduction (con't.)

» ***Planning Point***:

- Structure leases of rental property on an income generating property to avoid triple-net lease designation under the safe-harbor rule.
  - Make the landlord responsible for the payment of the maintenance cost of the property.
- Structure leases of rental property on a loss generating property to meet the triple-net lease designation under the safe-harbor rule.
  - Make the tenant responsible for the payment of the maintenance cost of the property.

Code Section 199A: Qualified Business Deduction (con't.)

- **Maintenance of separate books and records.**
  - For each rental real estate enterprise, the enterprise must maintain separate books and records.
  - If an enterprise consists of more than one property, this requirement may be satisfied if books and records are maintained for each property and are subsequently consolidated.

Code Section 199A: Qualified Business Deduction (con't.)

- **Maintenance of contemporaneous records of rental activities.**
  - The enterprise must maintain contemporaneous records documenting the hours, description and dates of all services performed, as well as who performed the services.
  - This requirement is now delayed and applicable to tax years beginning after December 31, 2019.

Code Section 199A: Qualified Business Deduction (con't.)

- **Required attachment to the taxpayer's timely filed tax return.**
  - A taxpayer relying on Revenue Procedure 2019-38 must attach a statement to the return that describes all rental real estate properties included in each rental real estate enterprise for each taxable year in which the taxpayer relies on the safe-harbor.
- **Taxpayer signature.**
  - The Revenue Procedure eliminates the previous requirement that the taxpayer sign, under penalty of perjury, a statement confirming that all requirements of the safe-harbor have been satisfied.

Excess Business Loss Limitation

- Code Section 461(l): Excess Business Loss Limitation.
  - The TCJA modified existing tax law on excess business losses by limiting losses from all types of business for noncorporate taxpayers.
  - Disallows excess business losses of noncorporate taxpayers if the amount of the loss is in excess of $250,000 ($500,000 in the case of a joint return).
  - These two thresholds are adjusted for inflation for taxable years beginning after December 31, 2018. For **2019**, inflation adjusted amounts are $255,000 and $510,000, respectively.
  - Excess business losses that are disallowed are treated as a net operating loss carryover to the following taxable year.

Excess Business Loss Limitation (con't.)

- **Example:**
  - In 2019, T, a single taxpayer, has deductions of $500,000 and gross income of $200,000 from a business or a net loss of $300,000. T's excess business loss is $45,000 ($500,000 – ($200,000 + $255,000)). The $45,000 excess business loss is treated as part of the taxpayer's NOL carryforward in later years.
- A Taxpayer's excess business loss is calculated on IRS Form 461.
  - A noncorporate taxpayer must file Form 461 if their net losses from all their trades or businesses are more than $255,000 ($510,000 for married taxpayers filing a joint return).

Excess Business Loss Limitation (con't.)

- A number of other loss deferral provisions are applied before the excess business loss limitation under Section 461(l):
  - The basis rules under Section 1366 for S corporations and Section 704(b) for partnerships;
  - The at-risk rules under Section 465; and
  - The passive loss limitations under Section 469.
  - Accordingly, the limitation is calculated on what would only be a taxpayer's utilizable loss in the tax year.
- Still some questions/confusion as to its application.
  - Do W-2 wages count as business income?
  - Does the gain on the sale of S Corporation stock count as business income?
- There does not appear to be a date on the horizon for even proposed regulations under Section 461(l).

Business Interest Expense Limitation

- Internal Revenue Code Section 163(j):
  - The business interest deduction limitation disallows all net business interest expense in excess of 30 percent of the adjusted taxable income of a business. Any amount subject to this limitation may be carried forward to a future tax year indefinitely until it is able to be applied.
  - The new business interest deduction limitation rules are complex, especially as they relate to tiered ownership. The complexities reach a whole new level for flow-through entities, due to aggregation rules, the carryforwards and tracking that take place at an owner's level.
  - Over 400 pages of Regulations issued.

Business Interest Expense Limitation (con't.)

- Partners and shareholders:
  - Partnership's disallowed business interest expense deduction ("excess business interest") is passed through to the partners and from that point on, is tracked at the partner level.
    - Any disallowed interest carried forward is treated as business interest paid or accrued by the partner in the next succeeding year in which the same partnership has "excess taxable income."
    - Partners may not include other sources of income in an attempt to deduct excess business interest from a partnership.
  - S Corporation's disallowed business interest is tracked at the corporation level and therefore no tracking is required at the individual level.

Business Interest Expense Limitation (con't.)

- Individuals are exempt from the limitation if they are involved in the trade or business of being an employee, certain regulated utilities and taxpayers operating a real property or farming businesses.
  - This provision was included based on the understanding that real estate and farming businesses will ordinarily require a greater amount of leverage for the purpose of asset acquisition than other business types.
  - This exemption is not automatically granted to these taxpayers and they must elect to be exempt from the business interest limitation; although once the election is made, the choice cannot be revoked.

Business Interest Expense Limitation (con't.)

- Additionally, taxpayers are automatically exempt from the business interest deduction limitation if they qualify as a small business.
  - A taxpayer qualifies as a small business if their average annual gross receipts for the three prior tax years are less than $25 million
  - The calculation of a business's receipts must include all receipts from related parties. The $25 million small business designation will be adjusted annually for inflation beginning in tax year 2019.
    - $26 million for years beginning after December 31, 2018.

Opportunity Zones

- The Opportunity Zone Program is a new economic development tool created by the Tax Cuts and Jobs Act of 2017.
  - Opportunity zones are designed to spur economic development by providing tax benefits to investors who invest in a Qualified Opportunity Fund (QOF).
    - First, investors can defer tax on any prior gains invested in a QOF until the earlier of the date on which the investment in a QOF is sold or exchanged, or December 31, 2026.
      - If the QOF investment is held for longer than 5 years, there is a 10 percent exclusion of the deferred gain. If held for more than 7 years, the 10 percent becomes 15 percent.
    - Second, if the investor holds the investment in the Opportunity Fund for at least 10 years, the investor is eligible for an increase in basis of the QOF investment equal to its fair market value on the date that the QOF investment is sold or exchanged.

Opportunity Zones (con't.)

- A Qualified Opportunity Fund is an investment vehicle that files either a partnership or corporation Federal income tax return and is organized for the purpose of investing in Qualified Opportunity Zone property.
  - Eligible capital gains for investment into the Opportunity Zone Fund include gains recognizable from taxable exchanges such as: the sale of stocks or bonds, the sale of a property or the sale of an interest in a partnership.
  - Both long-term and short-term capital gains can be invested into an Opportunity Zone Fund. Deferred recognition of the gain will retain the same character.
  - Each investor generally must invest capital gains into Opportunity Zone Fund within 180 days of realizing capital gains.
    - The investor may invest the return of principal as well as the recognized capital gain, but only the portion of the investment attributable to the capital gain will be eligible for the exemption from tax on further appreciation of the Opportunity Zone Investment.

Opportunity Zones (con't.)

- Qualified Opportunity Zone Property is used to refer to property that is Qualified Opportunity Zone stock, a Qualified Opportunity Zone partnership interest or a Qualified Opportunity Zone business property acquired after December 31, 2017, used in a trade or business conducted in a Qualified Opportunity Zone or ownership interest in an entity (stock and partnership interests) operating with such tangible property.
- Conceptually, the Opportunity Zone Fund must bring property new to the entity to be used in the Opportunity Zone. A fund that simply acquires property already being used in the Zone will not qualify without substantial improvement. Substantial improvement requires improvements equal to the Opportunity Zone Fund's initial investment into the existing property over a 30-month period.

Opportunity Zones (con't.)

- There are approximately 8,700 Opportunity Zones nationwide. A list can be found at:
  - https://www.cdfifund.gov/pages/opportunity-zones.aspx.
  - 14 In Onondaga County.
- An Opportunity Zone Fund investment provides potential tax savings in three ways:
  - **Tax deferral through 2026.**
    - A taxpayer may elect to defer the tax on some or all of a capital gain if, during the 180-day period beginning at the date of sale/exchange, they invest in a Qualified Opportunity Fund.
    - Any taxable gain invested in an Opportunity Zone Fund is not recognized until December 31, 2026, (due with the filing of the 2026 return in 2027) or until the interest in the fund is sold or exchanged, whichever occurs first. In addition, the deferred gain can be further reduced.

Opportunity Zones (con't.)

- **No tax on 10 percent or up to 15 percent of deferred gains.**
  - A taxpayer who defers gains through an Opportunity Zone Fund investment receives a 10 percent step-up in tax basis after 5-years and an additional 5 percent step-up after 7-years.
    - » Note: To take full advantage of the 15 percent step-up in tax basis, the taxpayer must invest by December 31, 2019. When the tax is triggered at the end of 2026, the taxpayer will have held the investment in the fund for 7-years, thereby qualifying for the 15 percent increase in tax basis.
- **No tax on appreciation** - Remaining in the qualified opportunity fund for at least 10-years results in the cost basis of the property being equal to the fair market value on the date of sale/exchange (potential to lower cost basis but does not eliminate the gain recognition event on December 31, 2026).

Opportunity Zones (con't.)

- ***Example*:**
  - In 2018, a taxpayer realizes a $1 million capital gain and invests the $1 million into a Qualified Opportunity Zone Fund.
    - For the year ended December 31, 2026, the taxpayer will have phantom income (taxable income without corresponding sale) on $850,000. The original deferred investment, less the 15 percent basis increase (10 percent for 5-year folding and additional 5 percent for 7-year holding) when the deferred gain on the original investment must be recognized.
    - In 2029, the taxpayer sells the investment for $2.5 million. The $1.5 million in appreciation is not taxable. At current Federal capital gains rates, that's a savings of approximately $300,000.

Opportunity Zones (con't.)

- Summary of available benefits:
  - *Initial benefit* is the time value of money related to the gain deferral up to the earlier of the date of sale or December 31, 2026.
    - Any deferral of short-term capital gains will result in tax at ordinary income rates at the end of the deferral period.
  - *Second potential benefit* is the permanent exclusion of gain on up to 15 percent of the original basis once the 5-year and 7-year holding period is met.
    - ***Note*:** Time is running out - In order to meet the 7-year holding period, an investment must be made on or before December 31, 2019.
  - *Third potential benefit* is the 100 percent exclusion on the appreciation in the investment if held for 10-years.
- Important Note: Taxpayer's should plan for the cash flow needed to fund the taxes on the deferral. Absent a sale before the December 31, 2026 recognition date, the taxpayer will have phantom income up to at least 85 percent of the deferred gain portion of the initial investment.

Additional Planning Ideas for 2019

- **Take advantage of 0 percent capital gains rate.**
  - It is important to always try and maximize the 0 percent capital gains rate.
    - For 2019, singles can take advantage of the 0 percent income tax rate on long-term capital gains and qualified dividends from securities held in taxable brokerage firm accounts if their taxable income is $39,375 or less. For heads of household and joint filers, that limit is increased to $52,750 and $78,750, respectively.
  - A couple (MFJ) with only net long-term capital gain income and utilizing the standard deduction would pay $0 tax on the first $103,150 of net LTCG income.
  - A single taxpayer with only net long-term capital gain income and utilizing the standard deduction would pay $0 tax on the first $51,575 of net LTCG income.

Additional Planning Ideas for 2019 (con't.)

- While your income may be too high to benefit from the 0 percent rate, you may have children, grandchildren or other loved ones who will be in the 0 percent bracket. If so, consider giving them appreciated stock or mutual fund shares that they can sell and pay 0 percent tax on the resulting long-term gains. Gains will be long-term, as long as your ownership period plus the gift recipient's ownership period (before the sale) equals at least a year and a day.
  - If the recipient is subject to the Kiddie Tax rules, they are subject to the highly compressed trust tax rates on unearned income. Under the trust tax rate structure, the 0 percent capital gain tax brackets ends at $2,600.
  - The maximum capital gains a person subject to Kiddie Tax can shelter is $4,850 while earning up to $10,900 of ordinary income and assuming no other unearned income.

Additional Planning Ideas for 2019 (con't.)

- The Kiddie Tax can potentially apply until the year during which a child (or young adult) turns age 24 and has unearned income in excess of $2,200.
  - For someone who is age 19-23 at year-end, the Kiddie Tax can only apply if he or she is a student.
  - A child who is age 18 or under at year-end is almost always exposed to the Kiddie Tax.
- With proper planning you can utilize the annual "tax-free" proceeds to fund future tuition costs through a 529 plan.
- The ability to generate tax-free income is always worth looking into.

Additional Planning Ideas for 2019 (con't.)

- **Find ways to defer income.**
  - If you expect to be in the same or lower tax bracket in 2020, it might be beneficial to defer some taxable income until next year.
  - Maximize deferral opportunities.
    - 401k Plan contributions.
    - SEP's and IRA's.
      - Roth IRA vs. Traditional IRA - what makes sense for you?
    - Section 529 plans.
      - NYS benefit only but will generate "tax-free" income if used for qualifying education expenses.

Additional Planning Ideas for 2019 (con't.)

- **Employing family members.**
  - ***One spouse employed by another.*** The wages for the services of an individual who works for their spouse are subject to income tax withholding, Social Security and Medicare taxes, but not to the Federal Unemployment Tax Act (FUTA).
  - ***Child employed by parents.*** Payments for the services of a child under age 18 aren't subject to Social Security and Medicare taxes, if the business is a sole proprietorship or a partnership in which each partner is a parent of the child.
    - Payments to a child under age 21 aren't subject to FUTA.
    - Payments are subject to income tax withholding, regardless of the child's age.

Additional Planning Ideas for 2019 (con't.)

- ***Parent employed by child.*** The wages for the services of a parent employed by their child are subject to income tax withholding, Social Security and Medicare taxes. They are not subject to FUTA tax.

Other Notable Tax Tidbits

- **New tax legislation in 2019 (did we really expect much??)**
  - As part of the TCJA the individual mandate was repealed; accordingly, there is no Federal tax penalty for forgoing coverage from 2019 on.
    - Be mindful however that some states have penalties of their own (Massachusetts).
  - Taxpayer First Act (TFA) of 2019 (July 1, 2019).
    - Key provisions:
      - Creation of an Independent Office of Appeals.
      - Improvement of IRS.
      - Limits on Structuring Seizures.
      - Expansion of Electronic Filing and Payments.
      - Require E-filing by Tax-Exempt Organizations.
      - Increased Focus on Cybersecurity and Taxpayer Identity Protection.
      - Clarifications for Equitable Innocent Spouse Relief.

Other Notable Tax Tidbits (con't.)

- **Virtual currency guidance.**
  - In 2014, the IRS issued Notice 2014-21, explaining that virtual currency is treated as property for Federal income tax purposes and providing examples of how longstanding tax principles applicable to transactions involving property apply to virtual currency.
    - The Notice set forth the IRS's official position that <u>virtual currency is treated as property for Federal tax purposes</u>. This means that taxpayers will recognize gain or loss under IRC Section 1001 every time virtual currency is exchanged for goods or services.
  - Since then, virtual currency has become more widespread, giving rise to increased IRS scrutiny and many unanswered tax questions.
  - Bitcoin has been around for 10 years. It was released in 2009 by a computer programmer with the alias "Satoshi Nakamoto." Since then, certain key events have propelled virtual currency to the top of the IRS's list of compliance concerns.

Other Notable Tax Tidbits (con't.)

- In late 2013, Bitcoin was valued at roughly $650. In the summer of 2018, Bitcoin was trading at over $8,000.
  - It was at that time that the IRS's Large Business and International (LB&I) division launched a virtual currency compliance campaign.
- In May 2019, AT&T became the first major wireless carrier in the U.S. to accept virtual currency payments.
- In July 2019, the IRS started sending letters (Letters 6173, 6174, and 6174-A) to taxpayers who potentially failed to report income and pay the resulting tax from virtual currency transactions or didn't properly report such transactions.
  - Letters 6174 and 6174-A were educational in nature.
  - Letter 6173 required a signed statement (under penalty of perjury) that returns complied with Federal tax law.

Other Notable Tax Tidbits (con't.)

- On October 9, 2019, as part of a wider effort to assist taxpayers and to enforce the tax laws in a rapidly changing area, the Internal Revenue Service issued 2 new pieces of guidance for taxpayers who engage in transactions involving virtual currency.
  - This included:
    - Revenue Ruling 2019-24; and
    - Frequently asked questions (FAQs).
      - » https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions
- If you do "dabble" in virtual currency, you should be aware of the tax consequences associated with the different types and types of transactions.

Other Notable Tax Tidbits (con't.)

- ***TIGTA finds potentially erroneous electric vehicle credit claims:***
  - IRC Section 30D authorizes a credit of up to $7,500 per vehicle for qualifying plug-in electric drive motor vehicles. In a recent report, the Treasury Inspector General for Tax Administration (TIGTA) found that the IRS does not have effective processes to identify and prevent erroneous claims for the electric vehicle credit.
  - As a result, taxpayers have received millions of dollars in potentially erroneous credits. TIGTA made 4 recommendations to improve the detection and prevention of erroneous claims, all of which the IRS agreed to. They include:
    - (1) Using data analytics to determine noncompliance;
    - (2) Initiating appropriate compliance activities;
    - (3) Developing a new audit lead sheet to assist IRS examiners; and
    - (4) Introducing a recovery program for potentially erroneous credits.

Other Notable Tax Tidbits (con't.)

- ***Income tax - credit for plug-in electric vehicles phased out for Tesla models:***
  - Under IRC Section 30D(e)(2), the credit for new qualified plug-in electric drive motor vehicles is phased out over a period of 4 calendar quarters once the total number of qualifying vehicles sold by a manufacturer after 2009 reaches 200,000.
  - In Notice No. 2018-96, the IRS announced that Tesla, Inc. reached this limit during the calendar quarter ended September 30, 2018.
    - Therefore, qualifying Tesla vehicles were eligible for the full $7,500 credit if they were purchased before January 1, 2019.
    - A reduced credit of $3,750 applies to vehicles purchased from January 1, 2019 through June 30, 2019.
    - A reduced credit of $1,875 applies to vehicles purchased from July 1, 2019 through December 31, 2019.
    - After December 31, 2019, no credit will be available.

Other Notable Tax Tidbits (con't.)

- ***Foreign reporting - taxpayer didn't have reasonable cause for failing to file FBARs:***
  - During the years at issue, the taxpayer and her spouse jointly owned two financial accounts with a Canadian entity. The accounts annual high balances ranged from approximately $400,000 to over $1 million.
    - Because the taxpayer failed to file Reports of Foreign Bank and Financial Account (FBARs) for the two accounts, the IRS assessed failure-to-file penalties, plus late payment penalties and interest.
    - The taxpayer argued she had reasonable cause for failing to file the FBARs because she relied on an advisor to complete her tax returns.
    - The District Court for the Eastern District of Michigan disagreed, finding that the taxpayer didn't take any steps to learn whether she was required to report her foreign accounts. In fact, there was no evidence that she informed her tax advisor about the accounts. Therefore, the Court upheld all penalties and interest.

Other Notable Tax Tidbits (con't.)

- **Income tax - portion of genetic testing is medical care:**
  - The taxpayer wanted to use a health care Flexible Spending Account (FSA) to purchase genetic testing services and resultant reports.
    - The reports would include information on the taxpayer's ancestry and health.
    - In addition to giving the taxpayer a deeper understanding of health risks, the reports could be delivered to a health care provider for additional testing, diagnosis or treatment.
  - The IRS privately ruled that the health portion of the testing service, such as the genotyping, qualified as medical care under IRC Section 213(d). However, the ancestry portion didn't qualify.
  - The taxpayer would be required to allocate the price of the DNA collection kit between ancestry and health services using a percentage and could use a reasonable method to value and allocate the cost of the health services between medical care and nonmedical services or items. Ltr. Rul. 201933005

Other Notable Tax Tidbits (con't.)

- ***IRS releases 2019 draft - Form 1040 and accompanying schedules:***
  - The form is slightly longer than last year's version because Schedules 1-6 have been condensed into 3 schedules.
  - In addition, the draft form:
    - (1) Asks for additional information for heads-of-household, qualifying widows/widowers, and those using a married filing separately status;
    - (2) Removes the checkbox for health care coverage; and
    - (3) Moves several common tax credits to page 2 of the return.
  - The draft Schedule A has been updated to reflect that medical expenses are deductible only if they exceed 10 percent of AGI (as opposed to 7.5 percent for 2018). There are no substantive changes to the draft Schedule B or its instructions.

Other Notable Tax Tidbits (con't.)

- ***IRS releases draft - 2019 tax return for seniors:***
  - The Bipartisan Budget Act of 2018 directed the IRS to issue a *simplified income tax return for senior citizens* (age 65 or older) starting with the 2019 tax year.
  - Recently, the IRS released a draft of the new two-page Form 1040-SR. The form is like the old Form 1040-EZ but use of the form is not restricted based on taxable income or the fact that income includes Social Security benefits, qualified retirement plan distributions or investment income.
  - In addition, the form may be used by seniors with dependents.
    - Displayed at the bottom of page 1 of the form is a chart that lists standard deduction amounts by filing status.

Other Notable Tax Tidbits (con't.)

- ***IRS to end tax transcript faxing and third-party service:***
  - Beginning June 28, 2019, the IRS stopped faxing tax transcripts to taxpayers and third parties, including tax professionals.
    - This change affected both individual and business transcripts.
    - Individual taxpayers still have several options to obtain a transcript, including the "Get Transcript Online" and "Get Transcript by Mail" applications.
    - Practitioners can obtain masked transcripts through the e-Services' Transcript Delivery System or request that the IRS mail a transcript to the taxpayer's address.
  - ***Note*:** We generally ask our clients to complete a Power of Attorney so we can obtain these transcripts online on their behalf. We find the ability to secure a transcript of what sources of income was paid to the taxpayer so we can assure a complete and accurate filing.

Other Notable Tax Tidbits (con't.)

- ***Final regulations allow truncated social security numbers on Form W-2:***
  - The IRS has issued final regulations that now permit employers to voluntarily truncate Social Security Numbers (SSNs) on copies of Form W-2 (Wage and Tax Statement) furnished to employees.
  - An SSN may appear in the form of a Truncated Taxpayer Identification Number (TTIN), which replaces the first five digits of the SSN with Xs or asterisks.
  - The final rules do not allow truncation on any return, statement or other document that is required to be filed with the Social Security Administration (SSA).
  - The final regulations, which adopt without substantive changes regulations proposed in 2017, apply to returns, statements and other documents required to be filed or furnished after December 31, 2020.

Other Notable Tax Tidbits (con't.)

- **Payments for emotional distress were nondeductible:**
  - In general, the amount of any damages (other than punitive) received as a result of a physical injury or sickness is excludable from gross income (IRC Section 104(a)(2)).
    - This exclusion can apply whether the damages are received as the result of a lawsuit or a settlement agreement.
    - Also, it doesn't matter if the damages are received in a lump sum or through periodic payments.
  - Recently, the Tax Court held that payments received by a taxpayer for alleged emotional distress caused by his former employer were fully taxable [Doyle, TC Memo 2019-8 (Tax Ct.)].
    - Worried that his employer was engaging in anticompetitive schemes, the taxpayer expressed his concerns to the company's CEO and vice president. A week later, he was fired. Shortly thereafter, the taxpayer began experiencing chronic headaches, back pain, sleepless nights, and poor digestion.
    - In this Case, the taxpayer argued that the emotional distress payments were excludable from income under IRC Section 104(a)(2). He claimed the emotional distress he experienced resulted from stress, which should be characterized as a physical injury or sickness.
    - The Tax Court disagreed with the taxpayer, finding that his symptoms were attributable to emotional distress, not an actual physical ailment.

Inflation Adjusted Amounts for 2020

- Miscellaneous:
  - **Social Security Wage Base**.
    - The Social Security Administration (SSA) announced that the maximum earnings subject to the Social Security component of the FICA tax will increase from $132,900 to $137,700 for 2020.
    - This means that for 2020, the maximum Social Security tax that employers and employees will each pay is $8,537.40 ($137,700 x 6.2 percent).
  - **Minimum Essential Health Coverage**. For calendar year 2019, the dollar amount used to determine the penalty for not maintaining minimum essential health coverage is $0, per the Tax Cuts and Jobs act; for 2018 the amount was $695.
  - **Health Flexible Spending Arrangement**. The FSA contribution limit will go up by $50 from $2,700 in 2019 to $2,750 in 2020.

Inflation Adjusted Amounts for 2020 (con't.)

- **Health Savings Accounts**. Contribution limit increased from $7,000 to $7,100 for family coverage and from $3,500 to $3,550 for single coverage.
  - Age 55+ catch up contribution fixed at $1,000.
  - Taxpayer's have until April 15th of the following year to maximize contributions.
  - Ability to maximize in initial short year.
- **Lifetime Learning Credit**. 2020 modified adjusted gross income phase-outs:
  - Single - between $56,000 and $66,000.
  - Married filing joint - between $112,000 and $132,000.

Inflation Adjusted Amounts 2020 (con't.)

- 2019/2020 Qualified retirement plan amounts.
  - Elective deferral limit. For employees participating in 401(k), 403(b) and most 457 plans, the limit will be increased from $19,000 to $19,500.
    - Age 50+ catch-up contributions increased from $6,000 to $6,500 in 2020.
  - Annual additions limit. The total employer plus employee contributions to all defined contribution plans by the same employer will increase by $1,000 from $56,000 in 2019 to $57,000 in 2020. The age-50-or-over catch-up contribution is on top of this limit.
  - Annual compensation limit. Maximum amount that can be considered for making contributions to a retirement plan is always 5X the annual additions limit. Therefore the annual compensation limit will increase by $5,000 from $280,000 in 2019 to $285,000 in 2020.

Inflation Adjusted Amounts for 2020 (con't.)

- **SIMPLE 401k and SIMPLE IRA**. These plans have a lower limit than 401(k) plans. The limit will increase by $500 from $13,000 in 2019 to $13,500 in 2020.
  - If you are age 50 or over, the catch-up contribution limit will stay the same at $3,000 in 2020 as in 2019. Employer contributions aren't included in these limits.
- **Traditional and Roth IRA**. Contribution limit will stay the same at $6,000 in both 2019 and 2020.
  - The age 50 catch up limit is fixed by law at $1,000 in all years.
- **Important Reminder**. IRA phase-outs (AGI) for active participants in a workplace retirement plan can limit your ability to contribute to a traditional IRA or ROTH IRA. Consider alternative options such as maximize employer plan contributions, contribute to Spousal IRA, contribute to nondeductible IRA followed by Roth Conversion, maximize HSA contributions or contribute to 529 plan.

Inflation Adjusted Amounts for 2020 (con't.)

- Estate and gift taxes.
  - **Basic Exclusion**. Estates of decedents who die during 2020 have a basic exclusion amount of $11,580,000, up from a total of $11,400,000, for estates of decedents who died in 2019.
    - GST exemption also increased to $11,580,000.
  - **Annual Exclusion**. The annual exclusion for gifts is $15,000 for calendar year 2020, as it was for calendar year 2019 and 2018.

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Conclusion