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Tax Talk

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Inside this issue:

Kent Bridges,
Managing Partner

Dear Clients and Friends,

Thanks to great clients and referral sources, our firm has had the good fortune to run at and beyond capacity for some time now, and so we need to add two more CPAs to our firm; one on the audit side and one on the tax side. If you know of a good potential candidate for us, please let me know.

This is the time of the year for year-end tax planning, and so we will focus on year-end planning in this issue, along with discussing the IRC 1202 capital gains exclusion, the basics of partnership taxation, avoiding the risk of double taxation at the state level, and the potential use of a flow-through entity to avoid the SALT deduction limit.

Most people (including, sometimes, tax professionals) find navigating through the IRS to be confusing and frustrating. The reason for this is well-illustrated by a recent roadmap published by the IRS itself. Just for fun, and for those of you who enjoy mazes, attached as a separate .pdf is the roadmap of the IRS.

We hope that you will enjoy this issue and gain from it some useful information.

Sincerely,

Kent Bridges

Year-end Tax Planning Strategies

Late November through year end is the time for year-end tax planning. While every client's situation is unique, here are some of the more common strategies we employ.

Acceleration or deferral of income and deductions – Businesses which use the cash basis of accounting for income tax purposes often have a great deal of control over the timing of income and deductions. Similarly, individuals can often time the recognition of significant gains or a significant deduction (e.g. charitable contributions). Shifting income from a high-rate bracket year to a low-rate bracket year can obviously result in a permanent tax savings.

Harvesting of capital losses – Capital losses can, for the most part, only be deducted against capital gains. And while capital losses can be carried forward, for individuals they cannot be carried back to previous years. Accordingly, it is generally a good strategy to go ahead and recognize any potential capital losses you have.

Deferral of capital gain into a QOF - As discussed in much greater detail in recent issues of our newsletter, included in *The Tax Cuts and Jobs Act* legislation enacted in late 2017 was a new provision often referred to as the "Qualified Opportunity Fund", "QOF", "Opportunity Zone", or "OZ" rules which provides taxpayers who have recognized a capital gain the opportunity to defer tax on the gain for up to 8 years, the opportunity to have up to 15% of that gain permanently escape tax, and the opportunity to permanently avoid any tax on the appreciation in the value of the reinvested gain; provided the gain is invested in a "qualified opportunity zone" and you meet the other requirements of the statute. In general, you have 180 days from the time you realize a gain to reinvest it in a QOF. However, for gains allocated to you on a Schedule K-1 or IRC 1231 gains, the 180-day period starts to run at the end of the year.

Optimizing the "qualified business income" deduction – The *Tax Cuts and Jobs Act* included a new 20% deduction for business income from most flow-through entities (other than "specified services businesses" like accounting and law firms). For individuals with taxable income over the threshold amounts ($160,700 for singles and $321,400 for married couples, with phase-outs up to $210,700 and $421,400, respectively), the deduction is generally limited to the lesser of 20% of the K-1 profit or 50% of your share of the W-2 wages paid by the business. For companies with a significant amount of payroll, this W-2 wages limitation is generally not a problem. However, for companies with few if any employees other than the owners, the deduction may be maximized by paying the optimal level of owners' compensation.

Use of tax credits to minimize state income tax – There are various tax credits which can be utilized to minimize state income tax. Some (e.g. the Georgia jobs credit, research credit and retraining credit) must be generated by a business entity, some can essentially be purchased (e.g. the Georgia low-income housing credit and film credit), and others are based on taking some action which the government is encouraging (e.g. the Georgia credits for donations to Student Scholarship Organizations, Innovation Fund Foundation, and rural hospitals).

Timing of charitable donations – It is generally advantageous to time significant charitable donations to coincide with a year in which you have significant income and are in a higher rate bracket. Because of the percentage of income limitations on

(Continued on page 2)

Year-end Tax Planning Strategies — continued

(Continued from page 1)
charitable deductions and the inability to carry the deduction back to earlier years, making a substantial donation in the year after a big gain can potentially result in the permanent loss of a tax benefit versus having made the donation in the same year as the substantial gain. On the other hand, if you have charitable carryforwards that are in danger of expiring, deferring additional donations to the next tax year may be prudent.

Estimated tax payments – In order to avoid a penalty, you are generally required to pay in through withholding or quarterly tax payments the lesser of 90% of your current year tax liability or 110% of your prior year tax liability. With respect to estimated tax payments, you get credit the day you actually make the payment. Withholding, however, is generally deemed to have occurred ratably throughout the year. Accordingly, if you realize late in the year that you have a shortfall for earlier quarters, you can sometimes avoid the penalty by increasing your withholding late in the year (e.g. having all of a year-end bonus withheld for taxes).

S-corp and LLC basis and at-risk limitations – In general, you can deduct your share of losses from S-corps and LLCs, and distributions from such entities are generally tax-free. However, the ability to deduct losses or receive tax-free distributions is limited by the "basis" and "at-risk" rules. Basically, the amount of loss you can deduct or distributions you can receive tax-free is limited to your unreturned investment in the entity (including past undistributed profits and, in the case of partnerships and LLCs, your share of the entity's liabilities which are either bank debt on a real estate project or debts for which you are personally liable). With respect to flow-through entities in which you own a stake, you should review your basis and at-risk amounts prior to year end to determine whether any tax advantage can be gained by increasing such amounts and whether such is prudent from an economic standpoint.

Exercise of ISOs in year not in AMT – "Incentive stock options" (ISOs) hold out the promise of being able to potentially convert what would otherwise be ordinary income into long-term capital gain. However, because the bargain element is an "alternative minimum tax" (AMT) adjustment on the date of exercise, the AMT often eliminates much of the hoped-for benefit. A tax year in which you will not be in the AMT represents an opportunity to exercise some ISOs at no tax cost, meaning a potential permanent tax savings if you hold the stock for the requisite period.

Sale of ISO shares that have fallen in value - If you exercise ISOs and sell in the same tax year, then the AMT issue goes away. Accordingly, we typically advise our clients who want to exercise and hold ISOs to do so early in the year, giving us almost a full year to watch the stock price and to sell the stock before year end if necessary in order to cure the AMT problem. If you exercised ISOs earlier this year, you still hold the shares, and the value of the shares has fallen dramatically, then now may be the time to sell.

Bonus first-year depreciation and Section 179 expense – For most depreciable assets (other than buildings and with some limitation on "luxury automobiles"), 100% of the cost can be expensed immediately.

Selection of accounting methods – New businesses can, within certain limitations, select the tax accounting methods (e.g. cash or accrual) which are most beneficial for them; and existing businesses have some latitude to later change their accounting methods. Your situation should be reviewed each year in order to determine which accounting methods are most advantageous for you.

Conversion of IRA to Roth status - With a traditional deductible IRA, you get a tax deduction on the front end when you make the contribution, but then are subject to ordinary income tax rates on withdrawals. With a nondeductible traditional IRA, you get no tax deduction on the front end, but then a portion of your withdrawals is tax-free recovery of basis. With a "Roth IRA", you get no front-end tax deduction but the appreciation in value permanently escapes tax. Traditional IRAs can be converted to Roth IRAs. The conversion is a taxable event, so careful planning is necessary to determine if a conversion makes sense for you.

IRA Required Minimum Distributions (RMDs) – Once you attain age 70 ½, and for each year thereafter, you are required to take distributions from your IRAs (and other qualified retirement plans) at least equal to a minimum amount computed using IRS-provided tables. Failure to take at least this minimum amount can subject you to a penalty of 50% of the shortfall. For the year you first reach 70 ½, you have a grace period up through the first three months of the next tax year in which to take your RMD. However, utilizing the grace period will mean doubling up your RMD amount in that next calendar year, which could force some of the income into a higher rate bracket. The years between age 59 ½ (the earliest date at which you can take IRA distributions without incurring an early distribution penalty) and 70 ½ may represent a good time to begin taking some IRA distributions (even though not required) if you are otherwise in a very low rate bracket for those years or have excess deductions which may otherwise be wasted.

Utilization of annual gifting exclusion – With respect to the estate and gift tax, there is an annual exclusion which permits you to give up to $15,000 per year per donee, without incurring any tax or eating into your lifetime exemption. For married couples, this amount is effectively doubled to $30,000. For those with a significant number of potential heirs, this represents an opportunity to remove a significant amount of value from the taxable estate, especially when gifting assets that may be subject to discounted valuation. The annual exclusion is on a use-it-or-lose-it basis with no carryover, so if you haven't maximized your annual exclusion gifts yet for 2019, consider doing so before year end.

Setting expectations and avoiding surprises – One of the key advantages to engaging in year-end planning is that it enables you to appropriately plan your required cash outlay for taxes and avoid any unpleasant surprises at April 15 or any regrets as to actions that could have been taken by year end but were not.

IRC 1202 Capital Gains Exclusion —Almost too Good to be True

Generally, when something sounds too good to be true, that's because, in fact, it is not true. An exception to that general rule is the IRC 1202 capital gains exclusion.

Internal Revenue Code Section 1202 provides that for C-corp stock in a qualifying business received after September 27, 2010 and held for at least 5 years, the selling shareholders can enjoy a 100% capital gains exclusion on up to the greater of $10,000,000 (per shareholder limit at individual shareholder level) or 10 times the amount invested in the stock. Thus, in the right set of circumstances, it may be possible to sell C-corp stock without incurring any tax on the gain.

In order for the C-corp stock to qualify, the corporation must be conducting an active business and cannot be in a disqualified industry (performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services, or in banking, insurance, financing, leasing, investing, farming, natural resources, hotels and restaurants). Also, the company must not have had (at the time of issuance of the stock and essentially at all times before that) assets in excess of $50,000,000.

For C-corp stock acquired between August 10, 1993 and September 26, 2010, a 50% or 75% exclusion may apply, in lieu of the 100% exclusion.

Scott A. Fincher, CPA

The Basics of Partnership Taxation

The partnership form of doing business (which, for income tax purposes, includes most LLCs with more than one member) offers a combination of flow-through treatment and great flexibility.

Similar to a Subchapter S corporation, a partnership generally does not pay any income tax, and, instead, its items of income, gain, loss, deduction and credit flow through to the tax returns of its owners. Unlike an S-corp, however, a partnership is not limited in terms of the number or types of owners it can have or the classes of stock it can have, appreciated property can generally be distributed to the owners without triggering the gain, the partners can include in their tax basis debt of the partnership, and items of income, gain, loss, deduction and credit can be allocated amongst the partners in any manner they choose; so long as the allocations have "substantial economic effect". Along with this great flexibility, however, often comes great complexity and confusion.

Beyond just the tax ramifications, the economics of an arrangement (including the amounts and timing of distributions) may hinge on tax accounting concepts, as the allocation and distribution provisions of partnership agreements and LLC operating agreements are often based on references to the Internal Revenue Code and regulations thereunder.

In a very simplistic situation, two individuals may come together to form a venture, contributing equal amounts of cash, expertise and services, with an agreement to split the fruits thereof equally. In this situation, partnership taxation is not overly complex. However, in the real world, often the partners enter and exit the venture at differing times, some may contribute cash while others contribute appreciated property or services, those contributing cash may be entitled to a priority return of their investment plus a return thereon, there may be debt in the capital structure, etc. Simplicity can quickly give way to complexity.

At the heart of partnership taxation is the concept of "capital accounts". A partner's capital account is essentially a measure at any point in time of the cumulative capital contributed by the partner plus income allocated to the partner minus losses allocated to and distributions received by the partner. A partner may have several different capital accounts; a "tax basis capital account", a "704(b) book economic capital account", and a "GAAP basis capital account". In a very simplistic situation, all three of these may be the same. In more complex situations, they may all three be different.

The tax basis capital account tends to be more of a historical cost basis amount; whereas the 704(b) capital account tends to be more of a fair market value amount. E.g. assume you have a tract of land which you acquired many years ago for $100,000, which you contribute to a partnership at a time when it is valued at $1,000,000. Your tax basis capital account would be $100,000, while your 704(b) capital account would be $1,000,000. Your 704(b) capital account tends to govern the economics of your arrangement with your partners (and also determines whether allocations meet the "substantial economic effect" test), while the tax basis amount governs how much gain you have for income tax purposes.

Partnership rules permit a partner to include in the tax basis of their partnership interest their allocated share of the liabilities of the partnership, and the "at-risk" rules permit inclusion of such so long as the partner is personally at risk for the debt (e.g. under a personal guarantee or as the maker of the loan) or the debt is "qualified nonrecourse" (e.g. bank debt secured by real estate). While these rules are generally advantageous and can permit a partner to deduct tax losses in excess of their actual investment or permit tax-free distributions to the partner in excess of their investment plus income allocated to them, they can also, unfortunately, result in "phantom income" down the road for the partner when the debt goes away. So, careful planning is required in this area.

Avoiding the Risk of Double Taxation at the State Level

Most states tax their residents on their worldwide income, while permitting them a credit for taxes paid to other states, so long as the effective rate paid to the other state does not exceed the effective rate paid to the state of residence on that same income.

We advise our clients who are residents of a state like Georgia with a state income tax and who may have meaningful exposure to tax of other states that they are generally better off to go ahead and file with the other state(s) and pay the tax, since they can generally get a credit for such against the tax of their state of residence (with the result being that often the only net out of pocket cost to them is our fees to prepare the other returns); whereas if they do not file with the other state and the other state

(Continued on page 4)

Avoiding the Risk of Double Taxation at the State Level — continued

(Continued from page 3)

assesses them years down the road, then they will incur penalty and interest and potentially miss out on the opportunity to claim the OSTC (other state tax credit) against their state of residence tax. This risk was made clear in a recent Mississippi case (*Kansler v Mississippi DOR*).

The Kanslers moved from New York to Mississippi in 2007, and filed returns as Mississippi residents for 2008 and 2009. In 2014, New York assessed the Kanslers tax for those years on a portion of the same income they had reported on their Mississippi returns. The Kanslers paid the New York tax, and then sought a refund from Mississippi of $257,140. The MS DOR denied the refund request, because the 3-year statute of limitations for making a refund claim had expired. The Mississippi Supreme Court upheld the MS DOR's position, and the US Supreme Court recently declined to hear the case.

Use of Flow-Through Entity to Avoid Limitation on SALT Deduction

Prior to August 28, 2018, Georgia residents (and residents of other states with similar programs) could potentially avoid the $10,000 limitation on the deduction for state and local taxes imposed by the *Tax Cuts and Jobs Act,* and enjoy a net profit, by making a donation to an organization like Georgia HEART (benefitting rural hospitals), Georgia GOAL (private school scholarships), or Georgia Innovation Fund Foundation (benefitting public schools). This was because Georgia provides a dollar-for-dollar reduction in its state tax for such donations, and you could also claim a Federal charitable contributions deduction.

In August 2018, the IRS issued proposed regulations (finalized in June 2019) which provide that (for donations made after August 27, 2018) if you receive a state tax credit for a donation, then you cannot claim a Federal charitable contributions deduction for such. This essentially shut down the SALT limitation workaround and the opportunity to make a net profit from such donations.

However, to the extent a flow-through entity (e.g. partnership, LLC or S-corp) has a business reason for making a donation to such an organization, it may be possible for the flow-through entity to claim a business deduction for the donation, while passing the related Georgia tax credit through to the owners. Regulations issued by the Georgia DOR earlier this year essentially bless this approach.

Quick Notes

- For 2020, the Social Security wage base increases to $137,700, the maximum wage base for computing retirement plan contributions increases to $285,000, the maximum amount which can be contributed to a defined benefit plan increases to $230,000, the maximum amount which may be contributed to a defined contribution plan increases to $57,000, and the maximum permissible elective 401(k) deferral increases to $19,500 ($26,000 for those age 50 and older). The maximum permissible contribution to an IRA remains at $6,000 ($7,000 for those age 50 and older). Also, for 2020, the maximum amount which can be contributed to an HSA plan increases to $3,550 for individual coverage and $7,100 for family coverage. Those over age 55 can contribute an additional $1,000.
- The annual gift tax exclusion remains at $15,000 for 2020, and the lifetime estate and gift tax exclusion amount will increase to $11,580,000.
- In a win for the affordable housing industry, on September 23, 2019, the Georgia Supreme Court ruled (in *Heron Lake II Apartments v Lowndes County*) that low-income housing tax credits do not constitute income for purposes of valuing tax-credit financed apartments for property tax calculation.

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