December 2020

Tax Talk

A quarterly publication of Bridges & Dunn-Rankin, LLP

Inside this issue:

Dear Clients and Friends,

As we go to press with this issue of our newsletter, it appears that Joe Biden will be the next President and the U.S. House will be controlled by the Democrats. Control of the Senate will not be determined until the January 5th runoff in Georgia. Assuming a win by Perdue and/or Loeffler, control of the Senate will remain with the Republicans. In that case, a significant increase in Federal income tax rates or a significant decrease in the estate tax exemption in the near term would appear unlikely. On the other hand, given that Joe Biden campaigned on a promise to increase taxes on corporations and wealthy individuals, a win by both Warnock and Ossoff (with VP Harris casting the tie-breaker vote in the Senate) would appear to portend higher tax rates in the near term. Accordingly, all eyes are on Georgia for the next few weeks. Under no scenario does a reduction in the corporate rate or highest individual marginal rate seem likely in the near future.

We have added two new members to our firm since the last issue of our newsletter; Megan Turner and Jackson Fendley. We will profile Megan in this issue and Jackson in a future issue. In the meantime, thanks to great clients and referral sources, our firm has had the good fortune to continue to run at and beyond capacity and we need to add yet another CPA, so 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 providing an update on the tax deductibility of PPP funded expenses, syndicated conservation easements, and recently issued like-kind exchange regulations.

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

Sincerely,

Kent Bridges

Kent Bridges,
Managing Partner

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. For 2020, given the possibility of higher tax rates in 2021, most will not be looking for a short-term deferral of income from 2020 to 2021.

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 ($163,300 for singles and $326,600 for married couples, with phase-outs up to $213,300 and $426,600, 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 must be generated by a business entity (e.g. the Georgia jobs credit, research credit and retraining credit), some can essentially be purchased (e.g. the Georgia low-income

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Member in the Spotlight — Megan Turner

The first voice you usually hear when you call our office and the first face you see when you visit our office is that of Megan Turner. She is also the one who turns rough drafts of tax returns and financial statements into the nice finished package you receive, makes sure your tax returns, extensions and other documents get filed by certified mail, manages our power of attorney filings with IRS, manages our incoming and outgoing mail, FedEx, UPS and couriers, gets copies of your tax returns to your bankers when requested, manages our file room, etc., etc.

Megan grew up in Kennesaw, Georgia, received a degree in Arts Management from Oklahoma City University, and moved to New York City where she landed a position with a theatrical company on Broadway. Covid-19, unfortunately, had a devastating impact on Broadway, but we had the good fortune of being introduced to Megan upon her return to Metro Atlanta.

Bridges & Dunn-Rankin is proud to have Megan Turner as a member of our firm.

Megan Turner

Year-end Tax Planning Strategies — continued

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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 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 72, 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 72, you have a grace period up through the first three

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Year-end Tax Strategies — continued

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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 72 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 2020, consider doing so before year end.

Tax deductibility of PPP funded expenses and Georgia runoff for US Senate seats – Two things which are complicating year-end planning this year are the unknowns with respect to tax deductibility of PPP-funded expenses (see separate article in this issue) and which party will control the US Senate in 2021. Accordingly, our planning has to take into account multiple possible scenarios.

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.

Paycheck Protection Program – Expenses Tax Deductible?

Jackson L. Fendley, CPA

For most small to midsize companies, the centerpiece of the CARES Act (Covid-19 stimulus legislation) was the Paycheck Protection Program (PPP), whereby a business could apply for an SBA loan equal to roughly 2 ½ months payroll. As long as the proceeds were used for qualifying costs (basically payroll, rent, utilities and mortgage interest, with some limitations), the business could then have that loan forgiven.

Under general principles of tax law, if you take out a loan, use the proceeds to pay business expenses, and then later have the loan forgiven, the expenses are still tax deductible, but you have taxable income for the cancellation of indebtedness (COD income). In the PPP legislation, Congress specifically provided that the PPP forgiveness would be considered COD income, but that such income would be excluded from taxable income. Accordingly, Congress made clear its intent that the PPP amount would be nontaxable.

The above notwithstanding, the IRS issued a notice (2020-32) in late April that it intends to disallow the deduction of the expenses paid with PPP funds; which is essentially a backdoor way of taxing the PPP proceeds. More recently, recognizing that some businesses were delaying applying for forgiveness until 2021, the IRS issued a ruling (Revenue Ruling 2020-27) that so long as there is a reasonable expectation that the PPP loan will be forgiven, then there is no income tax deduction for the related expenses in 2020, regardless of when you apply for forgiveness.

Members of Congress on both sides of the aisle, in both the House and the Senate, have indicated that the IRS position is contrary to Congressional intent, and so it appears that Congress may override the IRS and make clear through new legislation that the intent was for the PPP funded expenses to remain tax deductible. Otherwise, a court challenge would appear likely.

Those taxpayers who are basing their quarterly estimated tax payments on actual 2020 income (rather than on 2019 tax liability) will need to make a decision by the due date for 4th quarter estimated tax payments (December 15 for C-corps and January 15 for individuals) whether to base their payment on the PPP-funded expenses being nondeductible (and hope for a refund later) or on the expenses being tax deductible (and risk having a balance due with penalty later). For those who are basing their 2020 quarterly payments on 2019 tax, this decision can be deferred until April 15.

Hopefully, Congress will provide the answer to this question soon. In the absence of new legislation providing a clear answer by the extended due date for business entity returns (September 15 for most flow-through entities and October 15 for calendar year C-corps), a decision will have to be made as to whether to file returns treating the expenses as nondeductible (and potentially amend later for refund if the courts rule against IRS) or as deductible (possibly with disclosure on a Form 8275 or 8275-R to try and minimize exposure to penalties).

An Update on Conservation Easements

As mentioned in previous issues of this newsletter, Georgia is the epicenter of the syndicated conservation easements industry, which has been in the IRS' crosshairs for quite some time. Accordingly, we continue to provide regular updates on the topic of conservation easements.

There have been too many court decisions issued to cover them in the limited space provided here, but the Tax Court has largely continued to rule in the IRS' favor on technical foot faults and express skepticism over the values claimed. The Senate Finance Committee issued a fairly scathing report from its investigation; another class action lawsuit has been filed against promoters,

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An Update on Conservation Easements — continued

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appraisers, attorneys and accountants who were involved in easement transactions; the IRS issued a Chief Counsel Memorandum to its agents explaining how to apply the 75% civil fraud penalty to easement transactions; and the IRS has begun making settlement offers to those with cases docketed at the Tax Court.

The IRS settlement offers can vary, but, in general, for those who were not involved in promoting the investment, the offer is that you forego the deduction you took and instead take deduction for amount of the investment, compute the tax on the difference, and pay that plus accrued interest and a penalty of 10%. Those who were involved in promoting the transaction get no deduction and pay the tax, accrued interest, and a penalty of 40%.

IRS Issues Final Like-Kind Exchange Regulations

Prior to enactment of the *Tax Cuts and Jobs Act* (TCJA) in late 2017, the IRC 1031 like-kind exchange rules applied not only to real estate, but also to tangible personal property which was used in a trade or business or held for investment. TCJA changed the rules to restrict the favorable tax treatment to real estate only.

In June 2020, the IRS issued proposed regulations which defined, for the first time, the term "real property" for purposes of IRC 1031. Notably, those proposed regulations did not make reference to state and local law. However, based on comments received, the final regulations issued in late November do provide that property will be treated as real property for purposes of 1031 so long as classified that way under the applicable state and local law on the date of transfer. Also, property will be treated as real property if specifically listed as such in the regulations or considered as such based on all of the facts and circumstances.

The regulations also include a safe harbor for incidental personal property acquired in an exchange if (1) in standard commercial transactions the personal property is typically transferred together with the real property, and (2) the aggregate fair market value of the incidental personal property transferred with the real property does not exceed 15% of the aggregate fair market value of the replacement property received.

Quick Notes

- For 2021, the Social Security wage base increases to $142,800, the maximum wage base for computing retirement plan contributions increases to $290,000, the maximum amount which can be contributed to a defined benefit plan remains at $230,000, the maximum amount which may be contributed to a defined contribution plan increases to $58,000, and the maximum permissible elective 401(k) deferral remains at $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 2021, the maximum amount which can be contributed to an HSA plan increases to $3,600 for individual coverage and $7,200 for family coverage. Those over age 55 can contribute an additional $1,000.
- The annual gift tax exclusion remains at $15,000 for 2021, and the lifetime estate and gift tax exclusion amount will increase to $11,700,000 (per spouse).
- Nonemployee compensation, which in past years has been reported on Form 1099-MISC, will be reported this year on new Form 1099-NEC.
- The IRS has announced that the Identity Protection PIN program (which in the past was available to individuals who were victims of identity theft or residents of DC, FL and GA, due to the high rate of fraudulent e-filing in those states) is now available to everyone. Note that once you opt into the program the IRS will send you (by mail) a new IP PIN each year. You must provide that number to your tax return preparer. Otherwise, your returns will not go through electronically.

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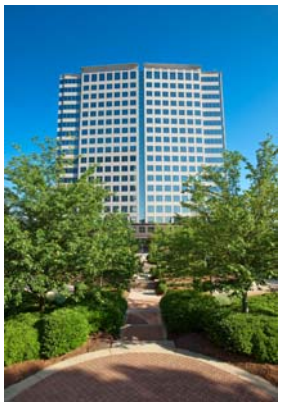

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