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Find out how to be prepared for the upcoming filing season challenges, receive useful strategies for the yearend tax planning and tax return preparation process



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Learn about the criticality of planning for the sunset of the TJCA as it relates to the enormous rewards for thinking ahead and the consequences of failing to do so

THURSDAY, NOV. 2 & FRIDAY, NOV. 3
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MATERIALS AT A GLANCE

The following materials are from the Friday afternoon sessions of the 2023 WICPA Tax Conference held on Thursday, Nov. 2 & Friday, Nov. 3, including:

- How to Recognize & Correct Code 409A Failures
- Why Should You Care About Social Security Benefits?
- Preparing for Sunset



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1 – 2 p.m.

How to Recognize & Correct Code 409A Failures

Martin P. Tierney, JD, *Partner, Michael Best & Friedrich LLP*



How to Recognize and Correct Code Section 409A Failures



Martin Tierney
November 3, 2023



Code Section 409A Basics

Code section 409A imposes certain requirements upon any deferred compensation arrangement between a service provider and a service recipient.

- Must be in writing
 - Must comply with 409A's requirements in writing and in operation
- Basic 409A Requirements:
 - Payment Timing
 - Death
 - Disability
 - Change in Control
 - Separation from Service
 - Unforeseeable emergency
 - Fixed date
 - No acceleration of payment
 - Deferral elections must meet strict timing rules



Cost of a 409A Failure

- The tax penalties for failure to meet the requirements of Section 409A are severe and are imposed on the service provider (employee or consultant), not the service recipient (employer)
- Compensation under the non-compliant arrangement (and any similar arrangements that must be aggregated with it) is included in income when it vests.
- A 20% penalty tax is imposed on the amount involved.
- An increased interest rate is imposed on the late payment of the income tax due on the compensation.



What is deferred compensation subject to Code section 409A?

- Deferred compensation is very broadly defined as any form of compensation which is or may be paid in a year following the year in which the legal right to the payment arises. The critical concept is that the service provider has a legally binding right to a payment in a year following the year in which the services are provided.
- Compensation can be considered deferred compensation as soon as the legal right to compensation arises, even if that right is not vested (that is, the right to compensation is subject to the performance of future services or to a future event).
- For example, the legal right to severance arises when the agreement is signed and becomes effective, but the severance may be paid in a later year, if at all.
- BUT the real action is in the exceptions...



What is deferred compensation subject to Code section 409A?

Short Term Deferral Exception

- Payments made within a short time frame following the end of the year in which the compensation is no longer subject to a substantial risk of forfeiture (SROF) are not considered deferred compensation and therefore are not subject to Section 409A.
- In the calendar year context, this short-term deferral exception applies to compensation paid not later than March 15 of the year following the year in which the employee's right to the compensation is no longer subject to a SROF.
- Cannot have other contingent events (e.g., paid upon completion of audit).

SROF is very specifically defined in the regulations.

- A SROF exists if an employee's entitlement to an amount is conditioned on either:
 - The performance of substantial future services.
 - The occurrence of a condition related to a purpose of the compensation which relates to:
 - the employee's performance; or
 - the employer's business activities or organizational goals (for example, the attainment of a certain level of earnings).
- The possibility of forfeiture must be substantial, as determined based on the facts and circumstances.
- Involuntary termination and good reason can be SROF, non-compete cannot.



What is deferred compensation subject to Code section 409A?

Severance Pay Exception

- Certain severance payments are treated as exempt from Section 409A if the severance pay meets the following requirements:
 1. It is payable only on an involuntary termination.
 2. It is paid by December 31 of the second year after the year in which the termination occurs.

3. The amount does not exceed two times the lesser of:
 - (i) the employee's annual compensation for the year before termination of employment (or in the case of an employee whose employment begins and ends in the same taxable year, the employee's annualized compensation for the year of termination of employment) or
 - (ii) the IRS limit on compensation under a qualified pension plan for the year of termination of employment (\$330,000 for 2023).



Plan Document Failure vs. Operational Failures

- Two types of 409A compliance failures
- Written plan document is required
- Plan document failure
 - Failure of plan to comply with 409A's requirements
 - Applies to all participants in the plan
 - But plan aggregation rules do not apply, so the negative tax impacts of 409A are limited to the amounts deferred under the plan.
 - What is the "plan"?
- Operational Failure
 - Failure to follow the terms of the plan or code section 409A
 - Applies only to the participant with respect to which error was made
 - All such participant's nonqualified deferred compensation in the same category is aggregated (for these purposes, there are nine different categories of deferred compensation)



409A Failures Apply to Each Tax Year Independently

- Proposed Regulations for Calculating the 409A Tax, if incurred
 - Extremely complicated
 - Critical concept: A failure to meet the requirements of section 409A during one taxable year generally would not affect the taxation of amounts deferred under the plan for a subsequent taxable year during which the plan complies with section 409A in form and in operation with respect to all amounts deferred under the plan.
- Each taxable year is analyzed independently to determine if there was a failure.
- As a result, assessment of tax liabilities due to a plan's failure to comply with the requirements of section 409A in a closed year would be time-barred.
- But, if there is a failure to include amounts in income in an earlier year as a result of the assessment becoming time-barred, then the taxpayer's duty of consistency would prevent the service provider from claiming a tax benefit in a later year with respect to such amount (such as, for example, by claiming any type of "basis" or "investment in the contract" when the amount is paid in a future year).



Common Code section 409A Errors: Separation from Service

- Termination of employment is "...based on whether the facts and circumstances indicate that the employer and employee reasonably anticipated that no further services would be performed after a certain date or that the level of bona fide services the employee would perform after such date (whether as an employee or as an independent contractor) would permanently decrease to no more than 20 percent of the average level of bona fide services performed (whether as an employee or an independent contractor) over the immediately preceding 36-month period (or the full period of services to the employer if the employee has been providing services to the employer less than 36 months)."
- Separation from Service is very explicitly defined in the regulations and includes termination of employment
- Separate rules apply for independent contractors (expiration of contract – good faith and complete termination of the contractual relationship)
- BUT changing to an independent contractor does not result in a Separation from Service unless it would result in a termination of employment using the termination of employment rules.



Common Code section 409A Errors: Substitutions

- "...the payment of an amount as a substitute for a payment of deferred compensation will be treated as a payment of the deferred compensation. A forfeiture or voluntary relinquishment of an amount of deferred compensation will not be treated as a payment of the compensation, but there is no forfeiture or voluntary relinquishment for this purpose if an amount is paid, or a legally binding right to a payment is created, that acts as a substitute for the forfeited or voluntarily relinquished amount."
- If you replace an existing right to deferred compensation, even if the existing right is not vested, then the new right is a substitution. If the new right will result in a change in the timing of payment (either earlier or later) the result is a violation of Code section 409A.
- Very tricky, hard to spot, often seems innocuous.



Common Code section 409A Errors: Short-Term Deferral Errors

- Short term deferral rule generally requires payment by March 15th of the year following the year in which the compensation becomes vested (no longer subject to a substantial risk of forfeiture).
- Common Error 1: Payment actually occurs after March 15th
 - Impact depends on what's in writing
- Common Error 2: Bonus plan indicates that payment will not happen until an event occurs (e.g., the audit is complete, the financials are closed, etc.)
 - Automatically a 409A failure (unless there is great savings language)



Common Code section 409A Errors: Elective Deferrals; Definition of Compensation

- Elective deferral arrangements generally allow for deferrals based on a definition of compensation
- Often the definition of compensation is not well developed or properly coordinated with other deferrals (such as those under a 401(k) plan).
- If the Plan's definition of compensation is not followed, the result is an operational violation of Code section 409A
- Even tiny dollar amounts cause a violation with respect to the entire account balance (and any other aggregated plans)
- Correction can be difficult and costly



Common Code section 409A Errors: Accelerations; Changes in Time or Form

- Participants will often request or demand early payments of deferred compensation
- In most cases this is not possible and results in a violation of Code section 409A
- Some exceptions can be applied, but they are very detailed in their requirements.
- Participants planning for retirement or trying to avoid taxes often request further deferrals or changes in the time or form of payment
- The general rule is that this is not allowed, but there is a special "5-year kick-out" rule
- Employers may, but are not generally required to, allow participants to further defer or change the form of payment if the 5-year kick-out rule requirements are met
 - Election must occur 12 months before payment date
 - Election effective 12 months after made
 - Must delay payment a minimum of 5 years
 - Application of these rules is extremely complicated



Common Code section 409A Errors: Stock Options and Valuations

- Stock options and stock appreciation rights that are not designed to meet the payment timing rules of Code section 409A must meet certain requirements in order to avoid being considered deferred compensation.
- Must be granted with an exercise price equal to fair market value
- May not have any other features for the deferral of compensation
- Valuation issues present a risk
- Previously common plan provisions create issues as well (e.g., provisions that pay the purchase price over time)



Common Code section 409A Errors: Offsets

- Many employment and deferred compensation agreements contain language indicating that payments under the plan/agreement may be used to offset other debts incurred by the employee to the company
- These are generally noncompliant plan terms under Code section 409A
- The regulations do allow a maximum offset of \$5,000.



Correction Programs

Notice 2010-6

- Allow for corrections of certain plan document failures
- Generally requires filings with the IRS by both the employee and employer in the year of correction
- Can still impose partial 409A taxes if certain events occur within a set time period after the correction
- Commonly correctable provisions include:
 - Incorrect definitions of Separation from service, Disability, Change in Control
 - Impermissible toggles (e.g., lump sum if involuntary termination, but installments if voluntary termination)
 - Impermissible payment period following a permissible payment event (e.g., payment period of more than 90 days after a permissible event or a period that allows the employee to choose the tax year).



Correction Programs

Notice 2010-6

- Also allows for interpretive room in the event of ambiguous plan terms and ambiguous payment timing, but must comply in operation
- Scope is limited
- For definitions, they must actually be ambiguous or undefined (e.g., payment upon “termination of employment”)
- If plan contains savings language, then it is not ambiguous
- Ambiguous payment timing includes phrases such as “as soon as reasonably practicable” – but they must still be tied to an otherwise good payment event and must be interpreted consistently with 409A



Correction Programs

Notice 2008-113

- Allows for correction of operational errors under Code section 409A
- Generally requires both employer and employee to provide corrective filings with their tax returns for the year in which the correction is made (and sometimes certain other tax years)
- There’s usually a price in the form of the partial payment of the 409A tax – but it’s worth it because the aggregation rule is generally waived!
- Types of failures that can be corrected:
 - Acceleration failures (includes early payments and failures to implement deferral elections)
 - Six month rule violations
 - Further deferrals (either failures to pay or erroneous deferrals)
 - Stock option and stock appreciation rights failures (erroneous establishment of the exercise price)
- The penalty generally gets worse depending on how long ago the failure occurred
- Generally not available if the failure is not corrected by the end of the second year following the year in which it occurred



Correcting Outside of the 409A Correction Programs

Same year tax correction principle

- Using this rule is “expert mode” and requires a good understanding of applicable case law
- Generally can unwind transactions in the same year in which they arise under the doctrine of rescission and the rule for reversing mistaken payments under *Couch v. Commissioner* and *Russel v. Commissioner*.

Correcting unvested amounts

- The preamble to the proposed regulations for calculating the tax indicate that a correction can occur with no consequences if the correction occurs in a tax year before the year in which vesting occurs
- This makes sense because the 409A taxes do not apply until the first year in which there is first no longer a substantial risk of forfeiture



Thank you, and now for the disclaimer section of this presentation...

- This presentation is intended for general information purposes only and does not constitute legal advice. Specific questions and requests for legal advice should be addressed to legal counsel. Nothing contained in this presentation is intended as tax advice. Any taxpayer should seek advice based on the taxpayer’s particular circumstances from an independent tax advisor with respect to any federal or state tax transaction or matter described in this presentation.

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1 – 2 p.m.

Why Should You Care About Social Security Benefits?

Ruthann Driscoll, JD, CFP, CLU, RICP, *Partner, Driscoll Law LLC*

Why Should You Care About Social Security Benefits?



Ruthann M. Driscoll, JD, CFP, CLU, RICP
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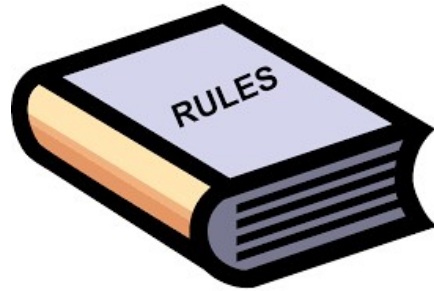
In 2023, almost 67M people (more than 1 of every 6 U.S. residents) receive social security benefits every month



Social Security accounts for 40% of average retiree's income and among elderly beneficiaries, 12% of men and 15% of women rely on Social Security for more than 90% of their income.

Source: Social Security Administration, April 2018

A brief
review of
the
rules



Social Security Retirement Benefits Formula

$$B(a) = PIA(a) \times (1 - e(n)) \times (1 + d(n)) \times Z(a) + \max((.5 \times PIA^*(a) - PIA(a) \times (1 + d(n))) \times E(a), 0) \times (1 - u(a, q, n, m)) \times D(a)$$

Eligibility And Primary Insurance Amount

Eligibility



Primary Insurance Amount (PIA)



Retiree's 3 Choices:

1. Early Retirement

- Age 62 until FRA
- Permanent reduction in benefits

2. Full Retirement Age (FRA)

- Primary Insurance Amount (PIA)

3. Delaying to age 70

- Delayed Retirement Credits (DRCs)



Year of Birth	Full Ret. Age	Months Early if 62	Reduced \$1000 Benefit	Reduction
1943-1954	66	48	\$750	25.00%
1955	66 and 2 months	50	\$741	25.83%
1956	66 and 4 months	52	\$733	26.67%
1957	66 and 6 months	54	\$725	27.50%
1958	66 and 8 months	56	\$716	28.33%
1959	66 and 10 months	58	\$708	29.17%
1960 and later	67	60	\$700	30.00%

The Future of Social Security and Medicare



By the Numbers: 2023 Trustees Report

MEDICARE

2031 -- Hospital Insurance Trust Fund reserves will be Exhausted.

- Medicare will still be able to pay 90% of scheduled benefits.

SOCIAL SECURITY

- 2035 – The surplus in the trust funds will be depleted.
- Social Security will still be able to pay about 77% of the benefits to which retired and disabled workers are entitled.

But did you know...
Social Security has been nearly broke
twice before.

1977

-Changed benefit structure and increased withholding

1983

FRA was increased from age 65 to current staggered ages; taxation of Social Security benefits.

Sources:

Social Security Amendments of 1977: Legislative History and Summary of Provisions (Social Security Bulletin, March 1978)

Social Security Amendments of 1983: Legislative History and Summary of Provisions (Social Security Bulletin, July 1983)

Spousal Benefits

- Must have been married to worker for at least 1 year
- Benefits can begin as early as age **62**
 - Any age if caring for the worker's child who is under 16 or disabled
- Primary worker **MUST HAVE** applied for their own benefit before spouse can receive spousal benefit



Spousal Benefit Amount

Spouse at FRA receives 50% of worker's PIA

- Benefit is calculated on the full payment, not on what the worker is actually receiving

If spouse collects prior to FRA, benefits are reduced

- Earnings limit applies

A spousal benefit **NEVER** EARNS DRCs

Former Spouse Benefits



- Can begin as early as age 62
- Must be currently unmarried
- Must have been married for at least 10 years
 - If 62, can begin receiving benefits on the worker's record as soon as the worker reaches 62



**Former
Spouse
Benefit
Amount**

Former spouse at FRA receives 50% of worker's PIA

- Benefit is calculated on the full payment, not on what the worker is actually receiving

If former spouse collects prior to FRA, benefits are reduced

- Earnings limit applies

Survivor Benefits



- Must have been married to worker for at least 9 months
- Survivor can begin to collect benefits at 60
 - Any age if caring for the worker's child who is under 16 or disabled
- Survivor benefits based on insured worker's PIA on date of death
- A divorced spouse may also be entitled to survivor's benefits.

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Survivor Benefit Amount

A widow(er) at FRA will receive 100% of deceased worker's full benefit

- Benefit reduced if taken prior to survivor's FRA
- Be aware of slightly different FRA table for survivor benefits

A survivor benefit DOES NOT EARN DRCs

- Can receive them, but never earns them

A divorced spouse may also be entitled to survivor's benefits.

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Earnings Limit



- Only applies to wages or salary earned **prior to full retirement age**
- Applies to ALL benefits-retirement, spousal, former spouse, survivor, child
- In 2023, benefit reduced by \$1 for every \$2 over \$21,240. Benefit reduced by \$1 for every \$3 over \$56,520 (2023) in the year you reach full retirement age (FRA).

Taxation of Social Security Benefits

- You will pay tax on only 85 percent of your Social Security benefits, based on Internal Revenue Service (IRS) rules. If you:
 - **file a federal tax return as an "individual"** and your *combined income** is
 - between \$25,000 and \$34,000, you may have to pay income tax on up to 50 percent of your benefits.
 - more than \$34,000, up to 85 percent of your benefits may be taxable.
 - **file a joint return**, and you and your spouse have a *combined income** that is
 - between \$32,000 and \$44,000, you may have to pay income tax on up to 50 percent of your benefits.
 - more than \$44,000, up to 85 percent of your benefits may be taxable.
- *Combined Income = Your adjusted gross income + your taxable income + ½ of your Social Security benefits



The Strategies – What's Left?



Clever Strategy #1: FILE AND SUSPEND



Clever Strategy #2:
Claim Now; Claim More Later



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Clever Strategy #3:
The Merry Widow(er)



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Survivor Benefit: Case Example



- Sue is 60 yrs old. Her husband recently passed away unexpectedly.
- Her retirement benefit at her FRA (66 + 6 months) is \$1,030/month and at age 70 it would be \$1,325/month.
- The survivor benefit at age 60 is \$1,423/month and is \$1,991/month at her FRA.
- **Recommendation:**
 - Sue plans to continue to work and use life insurance proceeds of \$100,000 to supplement income until age 62
 - Begin taking her reduced retirement benefit of \$735/month at age 62
 - At her FRA, switch to full survivor benefit of \$1,991/month

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Clever Strategy #4: The Old Guy and the Baby



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Child Benefit While Delaying Retirement Benefit



John



Jackie



Amanda

- John is 62, wife Jackie is 60 and daughter Amanda is 12
- John's retirement benefit is \$1,465/month at 62 and \$1,991/month at FRA

Recommendation:

- John claim's retirement benefit of \$1,465/month making daughter eligible for benefit of \$995/month
- Upon daughter turning age 18, John will stop retirement benefit and begin receiving Delayed Retirement Credits of 8%/year
 - John will have received \$105,480 of benefits and his daughter will have received \$71,640 of benefits
- At age 70, he will begin receiving benefit of \$1,699/month and his wife will receive \$995/month

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Do-Over Strategy

- Individual can withdraw application within 12 months of first claiming benefits.
 - ✓ Repay all benefits received, including spouse and children
 - ✓ No interest due



Another Do-Over Strategy

- Claim benefits at 62 and then change mind
- Example:
 - Eligible for \$2,000/month at full retirement age
 - Starts benefit at 62, receiving \$1,500/month
 - At full retirement age (66), suspends benefits, but cannot repay (>12 months)
 - Receives delayed retirement credits of 8%/year from 66 – 70
 - At age 70, begins receiving benefit of \$1,980 ($75\% \times 1.32\%$)



Thank you!



2:15 – 3:45 p.m.

Preparing for Sunset

Robert Keebler, CPA/PFS, MST, AEP (Distinguished), *Partner,*
Keebler & Associates, LLP

TCJA Sunset

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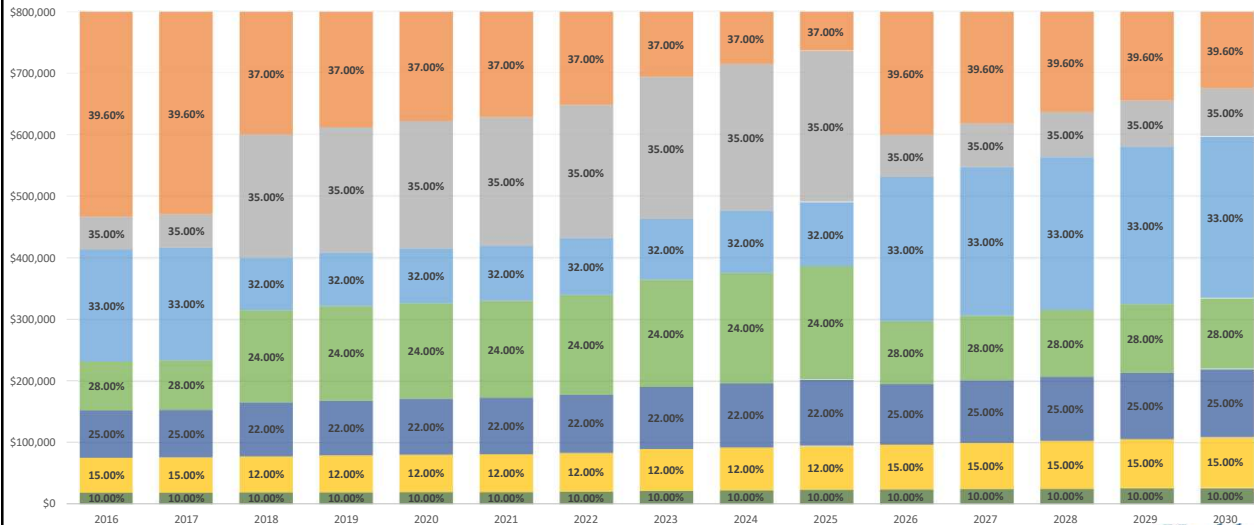
The Tax Cuts & Jobs Act Sunset

Coming Sooner than You Think



Individual Income Tax Rates

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Provisions Important for Individuals

- Individual tax brackets
- Child tax credit
- AMT
- Standard deduction
- Personal exemptions
- Home mortgage interest – acquisition and equity loans
- Charity cash percent limitation
- Misc. itemized deductions, including casualty losses
- PEASE limitation
- Moving expenses
- Student loan & home mortgage discharge
- Certain ABL account provisions
- 199A
- Estate & gift tax exemption

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Individual Taxpayer General Review

	2018-2025	2026+
Individual Rates	Rate decrease; 7 brackets	Rate increase; 7 brackets
Standard Deduction	\$27,700 2023 MFJ (Doubled of prior/sunset law)	\$16,000 2026 MFJ (projected) (projected using the average rate of inflation over the TJCA period)
Personal Exemptions	\$0; Repealed	\$5,300 2026 MFJ (projected) (projected using the average rate of inflation over the TJCA period)
Child/Family Credit	Doubled to \$2,000 and AGI-limit increased to 400k	Reverts to \$1,000/child AGI-limit reverts to \$110,000
AMT	Exemption increased; Exemption phaseout threshold substantially increased	Exemption reduced; Exemption phaseout threshold substantially reduced
Pease Limitation	Suspended	Reinstated

Individual provisions sunset December 31, 2025

Tax Reform Review – Critical Changes

- AMT exemption increase & upcoming sunset

AMT	2017	2023	2026 ?
Single or Head of Household	\$54,300	\$81,300	
Married Filing Jointly	\$84,500	\$126,500	
Begin of Phaseout, Single or HoH	\$120,000	\$578,150	"I'm Back!"
Begin of Phaseout, MFJ	\$160,900	\$1,156,300	
28% Bracket Starts	\$187,800	\$220,700	

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Itemized Deduction Review

	2018-2025	2026+
SALT Deduction (§ 164, § 11042)	Limited to \$10,000	Prior law reinstated: No limit
Mortgage Interest Deduction (§ 163, § 11043)	Limited to interest on up to \$750,000 of acquisition indebtedness; Repeals deduction for home equity indebtedness	Prior law reinstated: Home equity indebtedness deduction allowed Acquisition debt reverts to \$1,000,000
Charitable Contributions (§ 170, § 11023)	Percentage Limit increased from 50% to 60% (for cash);	Prior law reinstated: 50%-AGI limit for cash applies
Personal Casualty Losses (§165, § 11044)	Repealed, except for declared disasters	Prior law reinstated
Medical Expenses (§213, § 11027)	Expanded for two years by setting the deduction threshold to 7.5% of AGI for all taxpayers	7.5% limitation continues to apply
Job Expenses & Miscellaneous Deductions (§67, § 11045)	Deductions subject to the 2% floor generally suspended	Prior law reinstated
Alimony Paid (§71, § 11051)	Repealed for any divorce or separate instrument executed after 12/31/18	Permanent change; Section 71 is not scheduled to be reinstated at sunset
Moving Expenses (§217, § 11049)	Suspended (except for armed forces)	Prior law reinstated

Deductions

TIMING WILL BE KEY

PEP/PEASE Review

- Phase-out of personal exemptions (PEP) and limitations on itemized deductions (Pease) as income rises above the following threshold amounts:

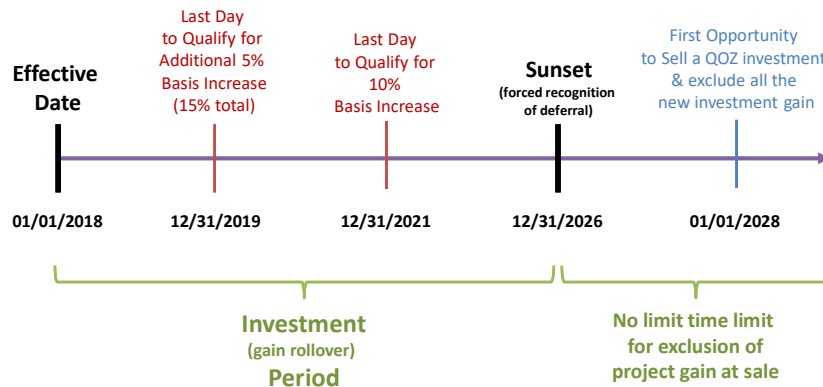
	Statutory Amount	Indexed Amount as of 2017	Projected Figure for 2026
Single	\$250,000	\$261,500	\$329,400
HoH	\$275,000	\$287,650	\$362,300
MFJ	\$300,000	\$313,800	\$395,200

PEP/PEASE Review

- PEP reduces personal exemption by 2% (up to \$0) for every -
 - \$2,500 of income above the threshold amount for single taxpayers
 - \$1,250 of income above the threshold amount for married taxpayers filing jointly
- Pease cuts itemized deductions by 3% of AGI above the threshold amounts up to a maximum of 80%.
 - Standard deduction not reduced; i.e. will apply if the reduction is too great
 - Deductions not limited: Investment interest; Medical expenses; Casualty, theft and wagering losses

BUSINESS PROVISIONS

Opportunity Zone Timeline



Limitation on Excess Business Losses

- The TCJA amended Section 461 to add a new subsection (l)
- The new section disallows certain excess business losses
 - Must be carried-forward
 - Applies to taxpayers with income exceeding \$500,000 (MFJ)
 - Applies at the partner or shareholder level
- The current statute sunsets the limitation for tax years beginning after 12/31/25



IRC § 461(l), TCJA § 11012

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Bonus Depreciation

- The TCJA provided for 100% bonus depreciation through 2022 (i.e. 100% deduction for property that would otherwise be capitalized & depreciated)
- It is scheduled to be phased out in 20% intervals from 2023-2026

2022	100%
2023	80%
2024	60%
2025	40%
2026	20%
2027	0%

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Section 179

- Before the TCJA, a taxpayer could expense up to \$500,000 of property.
 - However, it was phased out if a business places over \$2,000,000 of property in service during the tax year.
 - This phaseout of course makes it less useful for larger businesses, but those subject to the limitation could still use bonus depreciation.
- The TCJA increased the deduction limit to \$1,000,000 and the start of the placed in-service limit to \$2,500,000.
 - **This change was permanent; i.e. not subject to sunset.**
 - Section 179 will remain the useful for your client's small businesses following sunset (except rental real estate, generally).

IRC § 179, TCJA § 13101

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QUALIFIED BUSINESS INCOME DEDUCTION

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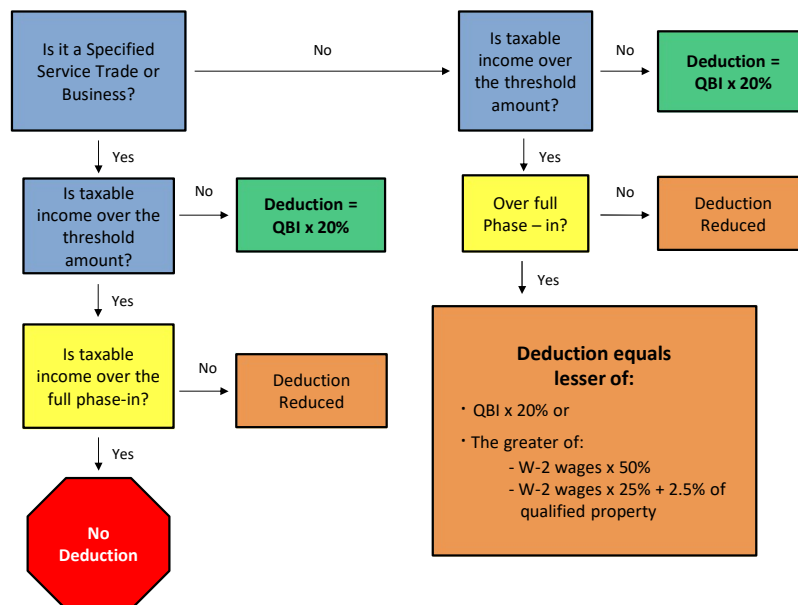
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Qualified Business Income Deduction

- Deduction equals 20% of Qualified Business Income
- Generally available to owners of pass-through businesses
- Limited by the business owner's taxable income
 - Limited for Specified Service Trades or Businesses (SSTB)
 - Limited by wages paid and capital investment

Qualified Business Income Deduction



Qualified Business Income Deduction

SUNSET: IRC § 199A(i) Termination.

This section shall not apply to taxable years beginning after December 31, 2025.

**199A SUNSET ELIMINATES
THE LONG-STANDING TAX ADVANTAGE
WHICH SMALL BUSINESS ENJOYS**

Qualified Business Income Deduction

Top Pass-through Rate	2013-2017	39.6%		78% of total corporate rate, including double taxation (39.6/50.5)
Top Pass-through Rate (199A limitations don't apply)	2018-2025	29.6%	$37\% \times (1-20\%) = 29.6\%$	74% of corporate rate, including double taxation (29.6/39.8)
Top Pass-through Rate (199A limitations apply)	2018-2025	37%		93% of corporate rate, including double taxation (37/39.8)
Top Pass-through Rate (if sunset occurs)	2026-?	39.6%		99% of corporate rate, including double taxation (39.6/39.8)
Corporate Tax Rate – single layer (basically)	1993-2017	35%		
Corporate Tax Rate – double tax (including taxes on dividends)	2013-2017	50.5%	$35\% + 23.8\% \times (1-.35)$	
Corporate Tax Rate – single layer (does not sunset under TCJA)	2018-?	21%		
Corporate Tax Rate – double tax (including taxes on dividends)	2018-?	39.8%	$21\% + 23.8\% \times (1-.21)$	

Sunset Motivated Roth Conversions Bracket Management

Roth Conversions *2017 Tax Reform Refresher*

TAX REFORM PERMINANTLY REPEALED
THE ABILITY TO RECHARACTERIZE
A ROTH CONVERSION

However, it is still possible to
recharacterize a Roth contribution.

Mathematics of Roth IRA Conversions

	Traditional IRA	Roth IRA	Buy Insurance
Current IRA Balance	\$ 1,000,000	\$ 1,000,000	\$ 1,000,000
Less: Income Taxes @ 40%	-	(400,000)	(400,000)
Net Balance	\$ 1,000,000	\$ 600,000	\$ 600,000
Growth Until Death	200.00%	200.00%	200.00%
IRA Balance @ Death	\$ 2,000,000	\$ 1,200,000	\$ 1,200,000
Less: Income Taxes @ 40%	(800,000)	-	-
Net to Family	\$ 1,200,000	\$ 1,200,000	\$ 1,200,000

Mathematics of Roth IRA Conversions

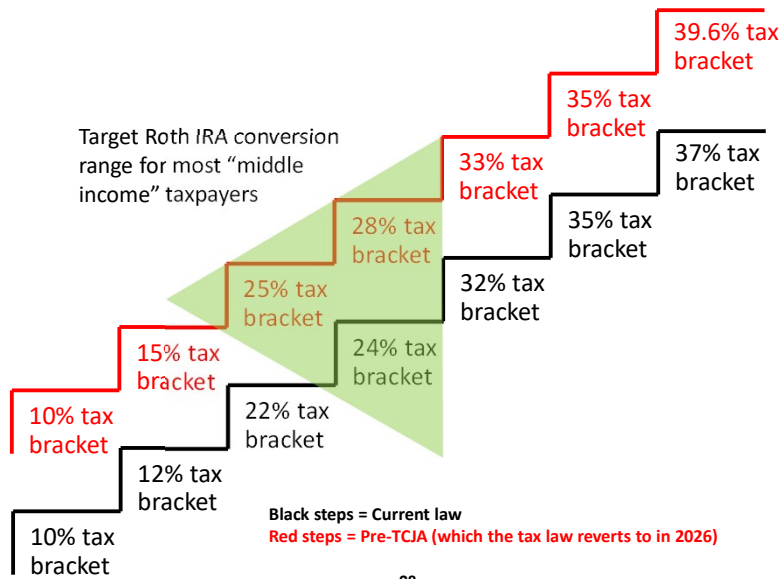
Reasons for converting to a Roth IRA

1. The taxpayer have special favorable tax attributes that need to be consumed such as charitable deduction carry-forwards, investment tax credits, NOLs, etc....
2. The client expect the converted amount to grow significantly
3. Current marginal income tax rate is likely lower than at distribution
4. Cash outside the qualified account is available to pay the income tax due to the conversion
5. The funds converted are not required for living expenses, or otherwise, for a long period
6. The client expects their spouse to outlive them and will require the funds for living expenses
7. The client expects to owe estate tax

Mathematics of Roth IRA Conversions

- The key to successful Roth IRA conversions is often to keep as much of the conversion income as possible in the current marginal tax bracket
 - However, there are times when it may make sense to convert more and go into higher tax brackets
 - Need to take into consideration the 3.8% Medicare “surtax”
 - Need to take into consideration phase-outs of tax-benefits
 - Need to take into consideration the impact of AMT

Mathematics of Roth Conversions



Estate Tax Considerations

- The same amount GST exemption must be allocated for a Traditional IRA or a Roth IRA – the Roth is much more efficient

		Traditional IRA	Roth IRA
Value of Assets		\$ 1,000,000	\$ 1,000,000
Less: Income Tax	37%	(370,000)	-
Net to Trust		\$ 630,000	\$ 1,000,000
GST Exemption Allocated		\$ 1,000,000	\$ 1,000,000

Estate Tax Considerations

- “Missing” IRC § 691(c) deduction
 - To prevent double-taxation, a beneficiary can claim an income tax deduction for estate taxes paid on IRD
 - However, the deduction is equal to the amount of federal estate tax paid
 - The deduction state estate tax paid is “missing”

Estate Tax Considerations

“Missing” IRC § 691(c) deduction example

	Traditional	
	IRA	Roth IRA
IRA balance	\$ 1,000,000	\$ 1,000,000
Less: Federal and state income taxes on Roth IRA conversion (40%)	-	(400,000)
Taxable Estate	\$ 1,000,000	\$ 600,000
Federal estate tax (40%)	\$ 400,000	\$ 240,000
State death tax (10%)	100,000	60,000
Total estate taxes	\$ 500,000	\$ 300,000
Post-death traditional IRA balance	\$ 1,000,000	
Less: IRC §691(c) deduction	(400,000)	
Post-death traditional IRA balance subject to income tax	\$ 600,000	
Federal and state income taxes on IRA distributions (40%)	\$ 240,000	\$ -
Net IRA balance to beneficiaries	\$ 260,000	\$ 300,000

Reconciliation: \$100,000 state death tax x 40% post-death income tax rate = \$40,000 (double-tax component) *OR*
 \$400,000 income tax on conversion x 10% state death tax rate = \$40,000 (estate tax savings)

Estate Tax Considerations

- “Fading” IRC § 691(c) deduction
 - The deduction is calculated on the date of death value
 - Post-death appreciation of pre-tax assets is not offset
 - This results in the relative amount of the deduction “fading” over time

Frozen-in-Time

Estate Tax Considerations

- “Fading” IRC § 691(c) deduction example

	No Planning	Roth IRA Conversion at Death
Traditional IRA balance at death	\$ 1,000,000	\$ 1,000,000
Less: IRC §691(c) deduction	-	(450,000)
Taxable portion of Roth IRA conversion	\$ 1,000,000	\$ 550,000
Federal and state income taxes on Roth IRA conversion (40%)	\$ -	\$ 220,000
IRA balance available for future distributions	<u>\$ 1,000,000</u>	<u>\$ 780,000</u>
Total future IRA distributions	\$ 2,000,000	\$ 1,560,000
Less: IRC §691(c) deduction	(450,000)	-
Less: Amounts not subject to income tax	-	(1,560,000)
Taxable portion of future IRA distributions	<u>\$ 1,550,000</u>	<u>\$ -</u>
Federal and state income taxes on future IRA distributions (40%)	\$ 620,000	\$ -
After-tax total future IRA distributions	<u>\$ 1,380,000</u>	<u>\$ 1,560,000</u>

Reconciliation: \$1,560,000 - \$1,380,000 = \$180,000 *OR* \$620,000 future income tax liability - \$440,000 future value of income tax liability on Roth IRA conversion (i.e. \$220,000 x 2).

Estate & Gift Taxes

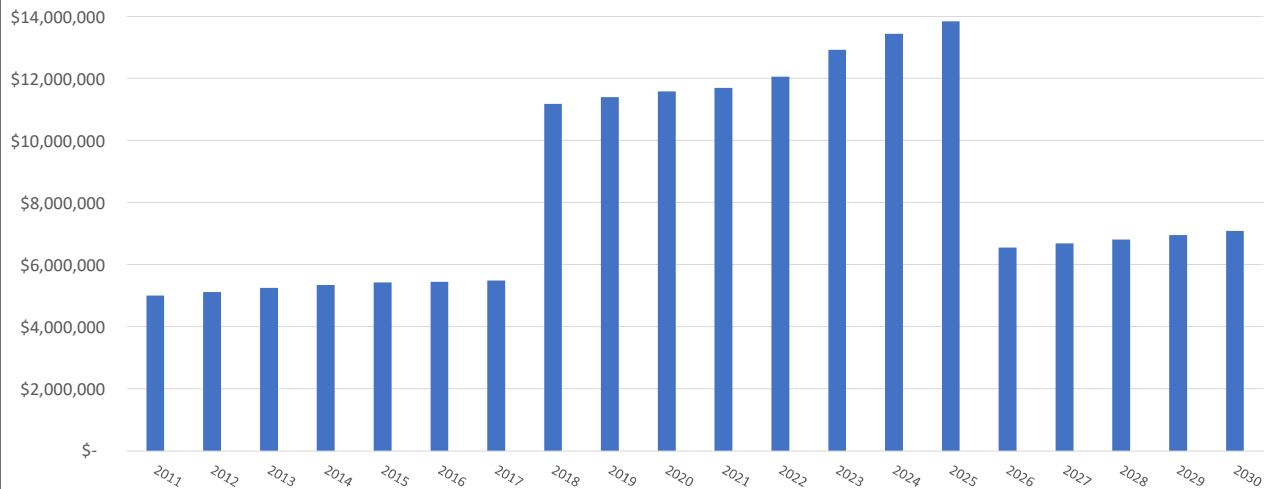
Tax Reform Review – Critical Changes

- Estate & GST tax
 - The TJCA “Doubled” the exemption from 2018 to 2025 (\$12.92M in 2023)
 - Sunsets December 31, 2025
 - **NO CLAW BACK FOR THOSE WHO GIFT BEFORE SUNSET, BUT DIE AFTER SUNSET**
 - Step-up in basis retained at death



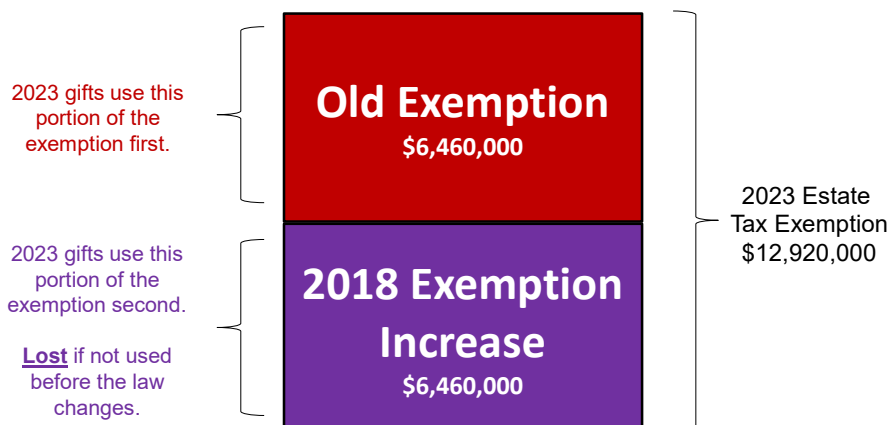
Estate & GST Taxes

Estate Tax Exemption - Past & Projected



Estate & Gift Taxes

Exemption Reduction Math: "Use It or Lose It"



Basis Basics

- Donee's basis for computing gain is the same as the donor's basis
- Donee's basis for computing loss is the lesser of—
 - Donor's basis, or
 - FMV of property on date of gift (Reg. § 1.1015-1(a))

Basis Basics

- The basis calculated in the previous slides is increased by all or a portion of the federal gift tax paid with respect to the gift.
- The increase is the amount of gift tax attributable to the net appreciation in the value of the gift

$$= \frac{\text{Basis increase} \times (\text{gift tax paid}) \times (\text{net appreciation})}{\text{amount of gift}}$$

Basis Basics

- Basis is generally FMV on date of decedent's death or, if elected, the alternate valuation date (IRC § 1014(a))
- Appreciated assets receive a "step-up" in basis at death – saves income tax when the property is sold by "heirs"
- Depreciated assets receive a "step-down" in basis – deprives "heirs" of the income tax benefit of claiming a loss when the property is sold
 - Less common than stepped-up basis because taxpayers have an incentive to realize losses during life

What is the Value of a Step-up?

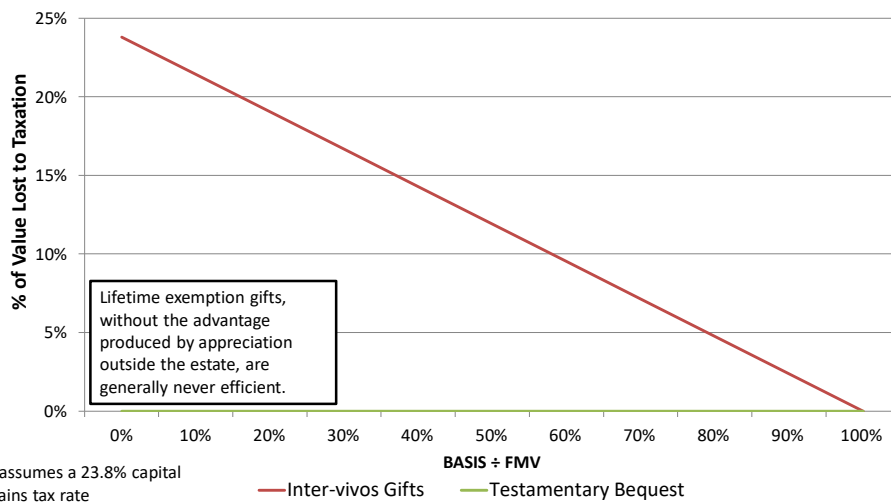
Tax savings

- Federal Capital Gains Tax
- Federal Net Investment Income Tax
- State Capital Gains Tax



Basis Basics

Lifetime Exemption Gifting / Asset Value Constant / Grantor Lives 3+ Years

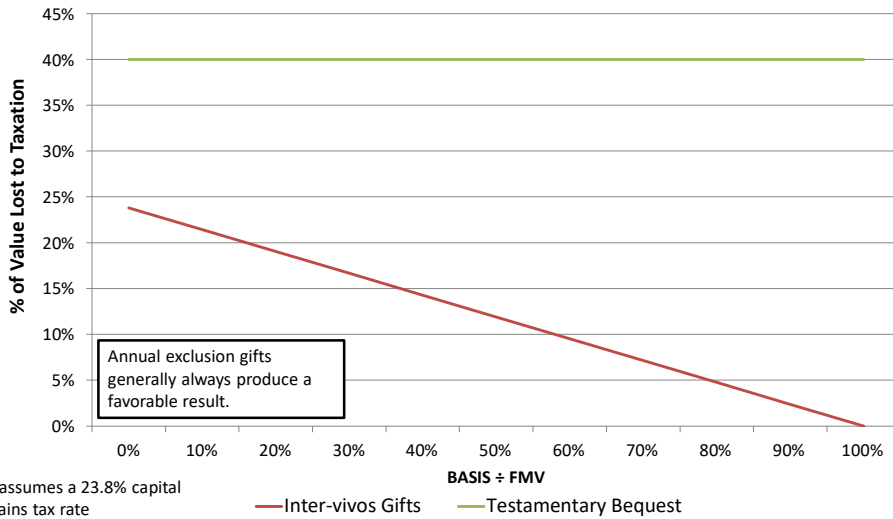


*assumes a 23.8% capital gains tax rate

— Inter-vivos Gifts — Testamentary Bequest

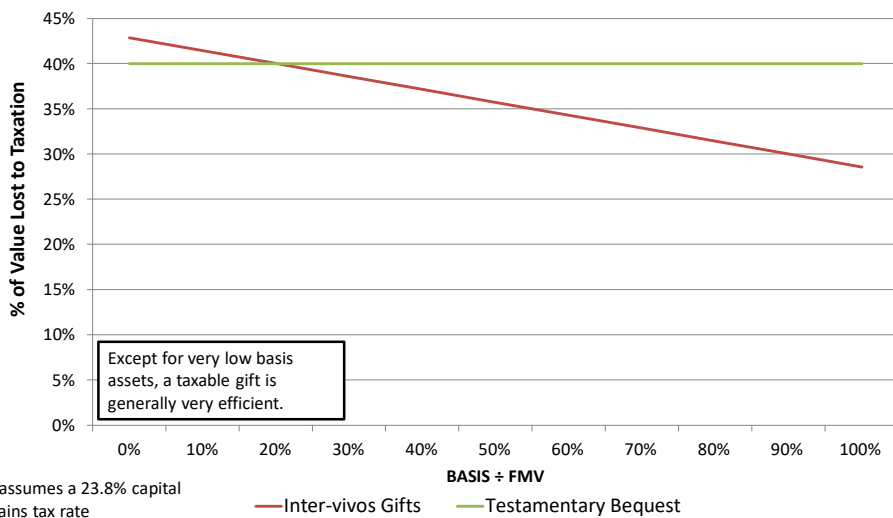
Basis Basics

Annual Exclusion Gifting / Asset Value Constant / Grantor Lives 3+ Years



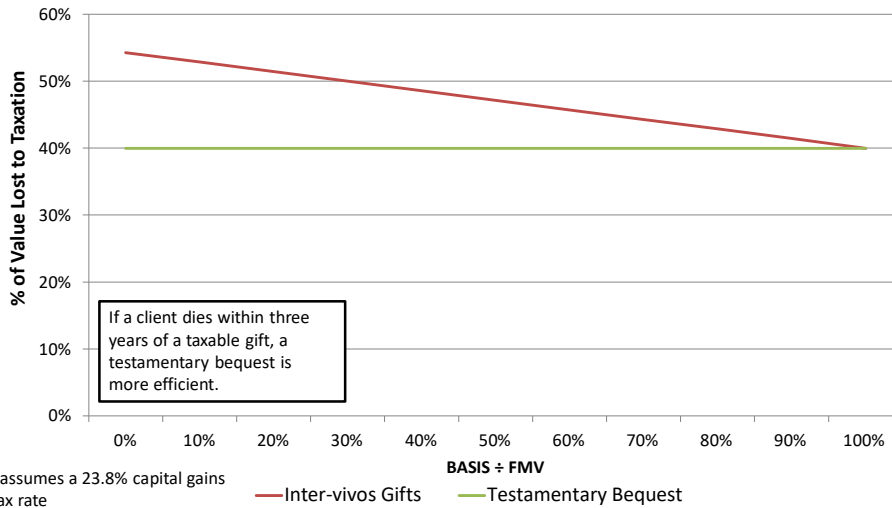
Basis Basics

Gift Tax Paid / Asset Value Constant / Grantor Lives 3+ Years



Basis Basics

Gift Tax Paid / Asset Value Constant / Grantor Dies within 3 Years



If a client dies within three years of a taxable gift, a testamentary bequest is more efficient.

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Single Client Age 92 – Gift versus Death Analysis Simple Breakeven

Size of Estate	\$ 25,000,000	\$ 25,000,000	\$ 25,000,000
Size of Gift	\$ 10,000,000	\$ 10,000,000	\$ 10,000,000
Basis of Gift	\$ 1,000,000	\$ 6,000,000	\$ 10,000,000
Built-in Gain	\$ 9,000,000	\$ 4,000,000	0
Built-in Gain taxed @ 25%	\$ 2,250,000	\$ 1,000,000	0
Appreciation needed to overcome value of step-up	\$ 5,625,000 ¹	\$ 2,500,000 ²	0 ³
% of Appreciation	56.25%	25%	N/A

1. $\$2,250,000 / 40\% = \$5,625,000$ 2. $\$1,000,000 / 40\% = \$2,500,000$ 3. 40% Estate tax exceeds 25% Income tax

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Single Client Age 92 – Gift versus Death Analysis *Interrelated Breakeven*

Size of Estate	\$ 25,000,000	\$ 25,000,000	\$ 25,000,000
Size of Gift	\$ 10,000,000	\$ 10,000,000	\$ 10,000,000
Basis of Gift	\$ 1,000,000	\$ 6,000,000	\$ 10,000,000
Built-in Gain	\$ 9,000,000	\$ 4,000,000	0
Built-in Gain taxed @ 25%	\$ 2,250,000	\$ 1,000,000	0
Appreciation needed to overcome value of step-up	\$ 15,000,000 ¹	\$ 6,666,667 ²	0 ³
% of Appreciation	150.00%	66.67%	N/A

1. $\$2,250,000 / (40\% - 25\%) = \$15,000,000$ 2. $\$1,000,000 / (40\% - 25\%) = \$6,666,667$ 3. 40% Estate tax exceeds 25% Income tax

Simplified Sunset Case Study

- Client is single
- Net worth: \$20,000,000
- Overall basis: \$10,000,000 (1/2)
- Assume net worth is stagnant over the analysis period (25'-26')
- Estate tax rate: 40% (fed only)
- Capital gains tax rate: 30% (fed+state)
- 2025 estate tax exclusion: \$14,000,000
- 2026 estate tax exclusion: \$7,500,000

2025 Funding -> 2025 Death

Option 1 - Fund Intervivos Trust		Option 2 - Do Nothing	
Gift	\$ 14,000,000	Gift	\$ -
Built-in Gain	7,000,000		
Future Income Tax Liability	2,100,000		
Assets at Death	6,000,000	Assets at Death	20,000,000
+ Prior Gifts	14,000,000	+ Prior Gifts	-
- BEA	<u>(14,000,000)</u>	- BEA	<u>(14,000,000)</u>
Taxable Estate	6,000,000	Taxable Estate	6,000,000
Estate Tax	2,400,000	Estate Tax	2,400,000
Total Tax Liability	\$ 4,500,000	Total Tax Liability	\$ 2,400,000

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2025 Funding -> 2026 Death

Option 1 - Fund Intervivos Trust		Option 2 - Do Nothing	
Gift	\$ 14,000,000	Gift	\$ -
Built-in Gain	7,000,000		
Future Income Tax Liability	2,100,000		
Assets at Death	6,000,000	Assets at Death	20,000,000
+ Prior Gifts	14,000,000	+ Prior Gifts	-
- BEA (clawback adj)	<u>(14,000,000)</u>	- BEA	<u>(7,500,000)</u>
Taxable Estate	6,000,000	Taxable Estate	12,500,000
Estate Tax	2,400,000	Estate Tax	5,000,000
Total Tax Liability	\$ 4,500,000	Total Tax Liability	\$ 5,000,000

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Trust Gifting for Sunset

- Consider the significant impact of income tax basis and recognize capturing the disappearing exemption has cost
- Prepare to fund now, but delay actual funding to an opportune time (i.e. fall of 2025 under current law)

CONCLUSION