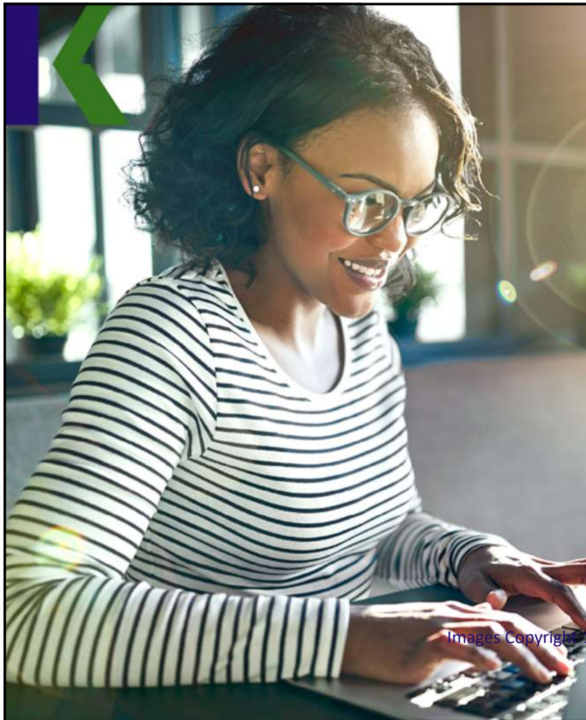

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Key Tax Planning Concepts and Issues

(KTP)

KAPLAN

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Unit 1

Introduction to Tax Planning Concepts

Learning Objectives

When you have completed this unit, you will be able to accomplish the following.

- Explain the relationship of tax planning to tax practice for a CPA.
- Outline the key issues a CPA must be aware of when undertaking a tax planning engagement.

Introduction to Tax Planning Concepts

- Theory Underlying Tax Planning
- Specific Examples of Transactions Implementing Planning Concepts
- Knowing when a Line Is Being Crossed

Warning on Examples and Text

- Don’t attempt to interpret non-IRS examples.
- IRS examples – Use them to fill in the blanks otherwise in the regulations (the courts do look at these).
- The same issues apply to other research.
  - Official source materials are what you start from.
  - Editorial materials are already interpretive—*so don’t attempt to interpret them or you will get it wrong*.

Knowledge Level for Planning

- Planning demands a solid understanding of basic tax compliance principles; this is the next step.
- Remember, planning eventually leads back to a tax return.
- You can only do planning if you understand the compliance reporting position.
- Keep up with tax law changes.

Tax Law Changes

- Inflation Reduction Act
- Energy-efficient home improvement tax credits.
- Electric vehicle tax credits.
- Residential Clean Energy Credit
- Pass-through tax break limits.
- Certain provisions for Corporations
- Premium tax credit eligibility expansion.

Unit 2

Tax Planning Concepts – The Theory

Learning Objectives

When you have completed this unit, you will be able to accomplish the following.

- Describe the key tax planning concepts that CPAs use in tax practice.
- Explain the impact of time value of money on tax planning concepts.
- Apply a cost/benefit analysis to a tax planning proposition.

Tax Planning in General

- Reducing the client's exposure to taxes on a present value basis forms the basis of tax planning.
- But it's more than taxes—tax plans must be integrated into:
  - The client's financial planning goals, which integrate into…
  - The client's life goals.

Tax Planning in General Example

Tax Minimization Maximization Strategy

Harry wants the absolute largest tax minimization possible, as he is upset about paying taxes. Harry is an executive with a major organization, taking home a $5,000,000 annual salary. He has $40,000,000 in securities and a house worth $15,000,000. Harry insists that he wants the absolutely largest tax reduction possible, as he doesn't want the government to get one more dollar from him going forward if at all possible.

Well, the good news is that achieving Harry's stated goal is easy. Harry just needs to immediately quit his job and then turn over the securities and his home to a charity. The plan eliminates Harry's exposure to additional income taxes, he will no longer face property taxes on his home, and there is no longer any concern about estate taxes being imposed when Harry dies.

The plan has met Harry's stated goal, though Harry may starve in the near future if he is crazy enough to follow this plan that maximized his stated goal.

However, it is unlikely that Harry, despite his insistence to the contrary, really has a goal of pure tax minimization (Harry is not crazy). Rather, there are some constraints on what should be done to minimize tax.

Tax Planning in General Example

Hidden Client Constraints

Harry has always been a major donor to charities in the area. Harry both sees this as a solemn duty and also, frankly, enjoys the attention he gains from making these donations.

Harry also is taking care of his elderly parents, regularly sending them money each month. They are likely going to need long-term care in the near future. Harry expects to pay for such fees for his parents, as they do not have sufficient resources to be able to pay for such care. Harry does not believe it is acceptable that his parents would need to depend on public assistance.

Any tax minimization strategy would have to take into account that Harry, in addition to not starving and having a place to live, will also need to have sufficient free funds to continue his charitable gifting at his current level and be able to provide for whatever level of assistance his parents may need.

Tax Planning in General Example

Proper Planning

A proper plan for Harry looks first at his overall life goals—that is, he feels strongly that he has a duty to provide funds to help good causes and that, as a son, he has a duty to support his elderly parents. Additional inquiries of Harry will likely uncover other life goals he may have, such as seeing his children through college, taking care of any grandchildren, and perhaps being able to spend more time with his family and less time at the office.

A proper financial plan to integrate with those goals would be the next logical step in the process. This plan would involve looking at investment strategies Harry may wish to undertake to achieve those life goals, insurance needs Harry may have, and various other financial goals that Harry would like to achieve. Most of this planning does not involve tax planning and the majority, and perhaps all, will not be undertaken by the adviser.

Tax Minimization vs. Tax Planning

- Tax minimization is *not* the same as tax planning.
- Tax minimization is simply getting taxes down to a lower level than they otherwise would be.
  - May not result in greater after-tax earnings
  - May not be compatible with client's financial or life plan
- Tax planning is using tools (including minimization as appropriate) to achieve the client's financial and life goals.

Tax Minimization vs. Tax Planning Example

Higher Taxes – The Appropriate Plan for the Client

Natalia has an option to purchase an interest in an oil drilling venture. The money she invests in the first year will be fully deductible on her return as intangible drilling costs and, under the special passive activity rules applicable to oil and gas working interests, she will be able to claim the deduction even though she would not have any significant participation in the activity.

However, Natalie is highly risk averse and concerned about losing her investment or not having easy access to the funds for a long time. While she has tried similar investments in the past, she has been very nervous all the time she was holding the investment, so much so that she had many sleepless nights until she was able to extract the funds from the investment.

In the past, she finally pulled the trigger on disposing of these investments after seeing the price of oil drop, selling into a depressed and more than somewhat limited market for such investments.

Even though purchasing the interest in the oil drilling venture has clear tax benefits and would, without question, dramatically reduce her tax for the current year, pushing Natalia to purchase this investment most likely would not represent proper tax planning.

Rather, retaining her money and investing in more liquid, if less tax beneficial, investments would be by far the most appropriate course to enable Natalia to meet her life goals.

Tax Planning vs. Tax Minimization

- Beginning planners tend to think planning is minimization and skip learning about the client's preferences, needs, and goals.
    - Failing to communicate risks of strategy does lead to claims against the CPA.
    - This is true even if the underlying research is good.
- Ultimately, we *advise*, the client *decides*.

Tax Planning vs. Tax Compliance

- Solid background in compliance is where CPAs start in tax practice—and it's not unnecessary training.
    - AI remains challenged by tax compliance despite decades of predictions that it is taking over soon.
    - It's not a 100% rules-based system—and what rules there are take decades to actually determine.

Tax Planning vs. Tax Compliance Example

Applying Compliance Concepts to a Potential Planning Engagement

Marie's firm is considering advising a client about the potential benefits of investing in a qualified opportunity zone and she has been assigned the job of determining the impact on the client's tax returns for the current year (when the client has just incurred a $250,000 capital gain) and future years (where it is expected the investment will be sold in 12 years for five times the original investment).

Marie has to apply her tax compliance knowledge to provide the information requested to be used by the partner advising the client for tax planning. This planning can only be done if someone (Marie, in this case) is able to apply the rules applicable to reinvestments in qualified opportunity zones.

Based on her knowledge from preparing returns, Mary knows that reinvested gain would not be taxed, so she needs to prepare with and without calculation of tax due for the year of the gain, holding all other facts the same except for those things that would change due to the reinvestment.

Similarly, Marie would need to recognize the years when basis adjustments would take place under the compliance rules as the taxpayer holds this investment, as well as the computations necessary for the year when the remaining deferred gain not offset by basis increases would be subject to tax.

She also needs to recognize the treatment in the year of sale, including understanding how long the investment must be held to obtain various tax benefits.

Tax Planning vs. Tax Compliance

- Tax compliance work gives the CPA knowledge of the client's situation and facts (tax, financial, and personal)—the starting point for planning.
- Planning is helping lead the client to a fact pattern that will end up with a specific return to be filed.

Tax Planning vs. Tax Compliance Example

Entity Selection Planning

Sarah and Rick, both California residents, are planning to start a business together. They may wish to bring in new investors in later years who will provide money only, so they will need to be able to have different types of equity holders who have different rights. They also dislike paying taxes and fees and have let you know this fact.

An entity selection decision almost always involves significant tax and non-tax issues. For instance, selecting a corporate legal structure likely will have a different impact on protecting Sarah and Rick's assets from the claims of creditors than using a limited liability company—but this is not an area that is tax related, but rather a legal issue.

Similarly, using an LLC vs. a pure partnership certainly is likely to provide greater liability protection for Sarah and Rick than using a standard partnership structure—but the partnership structure would avoid California's tax on LLC, which will cost the enterprise $800 a year at a minimum for the right to be an LLC in the Golden State.

As well, Sarah and Rick may be deciding between different types of businesses to actually enter, though all may be related to a broad area in which they have expertise. Some of those businesses might be eligible to be treated as §1202 businesses if they operate as a C corporation, while others might clearly not qualify—and some areas may not be clear. Thus, the tax might impact exactly what type of business they enter, but care has to be taken not to enter a significantly less profitable area just to gain a tax advantage.

Thus, this area of planning requires the CPA to think far beyond the tax issues to a much greater extent than is normally true in compliance engagements.

Another area that Sarah and Rick may look at is whether the investor is a nonresident alien and the investor chooses to be a shareholder—S corp structure will not work here.

Tax Planning vs. Tax Compliance

- The law: not under the CPA's control, but the CPA uses his/her expertise to:
  - Interpret what sources we have
  - Help predict ultimate result if IRS looks at the position
- The facts in the future: what is subject to control to help achieve the expected results
- Communication of what the client is expected to do is *crucial* to the success of any plan.

Tax Planning vs. Tax Compliance Example

The Lost Qualified Retirement Plan

Wendy, aged 50, came and talked with Linda, her CPA, about ways she might be able to reduce her taxes and save for her retirement. Wendy operates a sole proprietorship with one much younger employee. She is a professional whose income has been increasing reliably over the years and felt comfortable that stream of income would continue into the future.

Wendy had heard about simplified employee pension plans (SEPs) and, in fact, had an article on implementing such a program with her that described how to adopt and fund such a plan and what to contribute for her employees.

Linda suggested Wendy might want to consider instead adopting a defined benefit plan, noting that significantly larger contributions could be made to the plan due to Wendy's age than to a SEP, and there would be a much lower cost added by her other employee. Linda had assured Wendy that just like the SEP, the contribution to the plan could be made after year end, though due one month earlier due to the minimum funding standard that would apply to the plan.

Linda and Wendy met with a retirement plan design adviser who gave Wendy the expected contributions that would be due under the plan. As they were leaving, Linda told Wendy as they shook hands at the end of that meeting that a decision would be needed before year end so the plan could be adopted.

Tax Planning vs. Tax Compliance Example

Wendy wasn't sure which way she wanted to go, since she was concerned about the larger contribution to the defined benefit plan and how her assistant might react if she felt short-changed by the contribution. She continued to think about the issue following their meeting in June.

Linda did not hear back from Wendy before year end and assumed she had rejected the defined benefit plan. On January 10, she got a call from Wendy asking for the name of that plan consultant because she had decided to move forward with the defined benefit plan. When Linda told Wendy she was too late to adopt the plan for the prior year, Wendy said Linda must be in error—her article on the SEP said she had until the due date of her return to create the plan.

Linda told her that was only true for the SEP and she had told Wendy at their meeting she had to decide by December. Wendy did not recall being told that and the letter Linda had sent her did not say anything about that. At best, Linda now has an upset client.

Tax Avoidance (Objective of Tax Planning) vs. Tax Evasion

- Tax avoidance vs. tax evasion
- Section 7201
- Statute of Limitations Section 6531
- *Cole v. Commissioner*, T.C. Memo 2010-31 (T.C. 22-2-2010)

Time Value of Money

- Money received/paid a year from now worth less than money received/paid today
- Key concept in tax and financial planning
- Also difficult for most clients to understand

Photo by Jon Tyson on Unsplash

Simple Example

Money today	$ 12,000
Interest rate	7.00%
Interest for one year	840
Money one year from today	$ 12,840

If the tax is paid one year later, the taxpayer can pocket the $840. If the tax is paid today, the government gets the $840.

Simple Example

Money due one year from today	$ 12,000
Interest rate	7.00%
Interest for one year	785
Money needed today to pay later	$ 11,215

The same is true viewing the issue as being able to earn additional funds to pay the tax.

Time Value of Money Example

Time Value of Money

Al has the option to receive $10,000 today or receive $11,000 two years from today. The party paying Al is willing to go whichever way Al wishes but is not willing to change the amount that the party would pay today or the amount to be paid in two years.

For Al to decide which option makes the most sense, Al would need to determine the return he would expect to receive over two years if he had $10,000 to invest today. Assume Al expects he would earn 6% annually on the funds.

In that case, his lost earnings for year 1 if he didn't take immediate payment would be $600 ($10,000 times the 6% rate). For year 2, he would expect to earn 6% on the $10,000 again, but he'd also be able to earn 6% on the $600 of earnings from year 1, giving him total earnings for the year of $636. Thus, at the end of two years, Al would have $10,000+$600+$636, or $11,236. Since that is $236 more than what he is being offered to be paid if he waits two years, Al would opt for immediate payment.

Time Value of Money Example

Net Present Value Concept

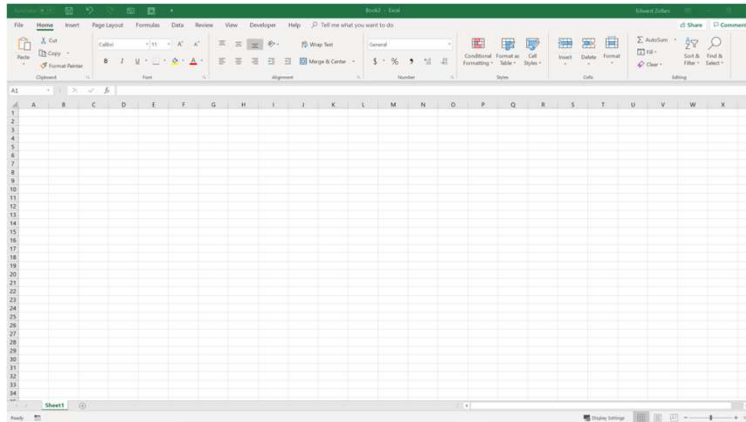
This time the math is slightly more complicated, but not so much as to be impossible to understand. The amount that money would be expected to grow is using a compounded 6% growth rate (since the 6% in year 2 would be earned on the original principal plus the 6% earned in year 1). So, the first year's earning factor would be 1.06 (1 for the principal and 0.06 for the interest at 6%). For the second year, we'd multiply that 1.06 by another 1.06.

If you remember dealing with exponents in math, you'll note that that is 1.062. If we added a third year, we'd get another 1.06, so now we are at 1.063. Or, more generally, our factor is (1 + interest rate) raised to the number of years.

Since we know that times our beginning amount gives us the value at the future, if we know the future value, we divide by that factor to get what number we'd have to start with in order to earn our way to the future number. In this case, we'd divide $11,000 (our future value) by 1.062 (or 1.1236) to arrive at our present value of $9,789.96.

This means that if Al is offered more than $9,789.96, he should take the offer, while if the offer is less than what he would receive, this would not allow him to build the funds to the $11,000 he would otherwise receive without the early payment.

Time Value of Money



Time Value of Money

- Excel provides tools for analyzing the tax plan, including tools for time value and other financial calculations.
- NPV function = NPV(rate, value1, [value2], ...)
- PV function = PV(rate, nper, pmt, [fv], [type])
- XNPV function = XNPV(rate, values, dates)

Time Value of Money

Cash Flow Table	
1/1/2019	-
4/15/2025	2,500
4/15/2028	4,000
4/15/2029	1,000

Discount rate	7%

Present Value	$4,264.82

=XNPV(E2,B3:B6,A3:A6)

Broad Tax Planning Methods

- Tax deferral—Delaying the time when the tax will be paid, but not aimed at changing the amount paid. The time value of money concept is key to why this method is used.
- Tax conversion/rate shifting—Arranging the situation in a fashion to convert the income to a tax-favored type of income that is subject to lower tax rates.

Tax Deferral Example

Paying for Deductions Before Year End

Jannelle's Bakery looks to make use of a simple deferral strategy. Since the bakery's gross receipts are less than $25 million (gross receipts test), the bakery qualifies to use the cash basis of accounting for tax purposes and does use that method.

At December 31, Jannelle goes through her mail and discovers utility bills that are due for payment the first week of January. By making those payments by December 31, she obtains the benefit of the tax deductions in the current year rather than the following year. If her rates are the same both years, she'll still pay the same amount of tax over the two-year period, but she made more of the payment in the second year than she would have had she waited to pay them on the due date as she normally does.

Sharp readers will note that the tax savings is not the only present value item in play here—by paying the utility bill earlier, Jannelle is giving up the ability to earn money (or pay off debt and avoid paying interest expense) for the period from December 31 until the date the item would have been paid. In this case, it's likely the cost to Jannelle of lost earnings for one week on those payments would be less than what she'd gain from retaining the tax for the full year.

But if a client goes overboard on this technique, not only do they risk IRS scrutiny (overly aggressive prepayments misstate income, leading to disallowance of the deduction, with taxes, penalties, and interest assessed), but they also can cost themselves more than the value of being able to delay the tax payment.

Tax Deferral Examples

- Qualified retirement plans/IRAs/SEPs
- §1031 exchange of real estate
- Purchase of nonqualified annuities
- Year-end payment of deductible expenses

Tax Rate Shifting/Conversion

- One key planning method is moving income to more tax-favored categories such as the following:
  - Long-term capital gains
  - Tax-exempt income
  - Qualified business income (§199A)
  - Different tax year with lower rates
- But lower rates often come with “strings” attached.

Tax Rate Shifting/Conversion Examples

- Acquisition of rental real estate
- Purchase of growth stocks
- Structuring accumulation trust to avoid state income taxes
- Roth IRA contributions
- §1202 stock

Tax Rate Shifting/Conversion Example

Municipal Bond Investments

Dylan has been investing her funds in high-quality corporate bonds but is concerned with what she perceives to be the high taxes she has been paying. She looks into the issue on the internet and discovers that if she buys municipal bonds issued by her state or municipalities in her state, she will not pay tax to either the IRS or her state taxing agency on this income.

Dylan goes out and buys municipal bonds to obtain the zero taxes due on them. Much to her dismay, she discovers that bonds of the same quality as her corporate bonds have a significantly lower interest return to her.

What Dylan should do is determine the after-tax return of both the corporate bonds and the municipal bonds of similar quality and only then determine which type of bond makes the most sense for her to invest in.

Skills Needed for Tax Planning

- Apply the tax law to facts.
  - Not simply using a "cookbook" approach
  - Understand primary sources and work with them
  - Secondary sources are a map to find the key primary sources
  - Must keep current on tax law developments (read the daily updates from tax services)

Skills Needed for Tax Planning

- Communication skills
  - Must be able to communicate with both
    - Parties with various skill levels with regard to tax
    - Make the plan understandable to the client
  - Must also be able to listen and take in information in areas outside tax—and not dismiss them as "unimportant"
  - Must communicate properly with the client to ensure the objectives of the client are met

Example A – Communication Problem

J owns J Gardening LLC. This is a disregarded entity. On November 30, 2022, J Gardening LLC bought $1,200,000 of gardening equipment. The CPA decided to use the Section 179 depreciation deduction to give J a large deduction. The CPA does not realize that J wants to buy a house and he needs to show income that he can afford to pay for the house. The $1,200,000 depreciation puts him below the affordability threshold for his home, as J Gardening is J's only source of Income.

The advice is not in line with the client's goal.

Example B – Communication Problem

Veniti, Inc., has retained earnings of $3,000,000 on its balance sheet at December 31, 2022. In the board meeting minutes, the board had documented that it will allocate these funds to their working capital and equipment as they move to expand into another market sector. The CPA, who has not discussed with the client to understand the client's goals, focuses on how to advise the client on dividend distribution in an equitable way to avoid additional taxes on excess retained earnings.

This advice is not in line with the client's goals.

Skills Needed for Tax Planning

- Objectivity in application
    - Must avoid confirmation bias
        - Data that supports our bias given too much weight
        - Ignore or downplay data that goes against the answer we want
    - Be careful of "marketing mode" where benefits are accentuated and risks given little coverage

Example – Objectivity Problem

Missing Reversal of Case Supporting the Taxpayer's Position

Holly's client, Project A, Inc., wants to be able to write off certain expenditures immediately rather than having to capitalize them as part of an intangible asset, which would be recovered over 15 years. Holly is not certain about the proper treatment, but she knows that her client strongly believes that they should be able to write this expense off.

Holly does some research and comes up initially with two court decisions in separate U.S. District Courts that generally apply to this type of expenditure, as well as an article from the Tax Adviser from 6 years ago that discusses this issue.

One of the District Court decisions decided the expense had to be amortized. The other case, tried in the U.S. District Court that would have jurisdiction over the client's case if they took their case to the U.S. District Court, came to the opposite conclusion, allowing the current deduction. The article was written after both cases had been issued, so Holly was interested in the conclusions expressed in that article.

Example – Objectivity Problem

That article noted that the first District Court case had been reversed on appeal to a Circuit Court of Appeals. While it is not the circuit that would have jurisdiction over Holly's client, Holly felt this really helped her case. The article also noted the contrary District Court case she had found, noting it had been decided in the way the Appeals Court panel had suggested the law should be read.

Based on this information, Holly informed her client that the amount could be deducted. She also concluded that this represented substantial authority, so no disclosure was needed on the tax return if this position was needed and she did not advise the client to make such a disclosure.

Example – Objectivity Problem

However, what Holly had not discovered was that five years ago, the IRS had announced *non-acquiescence* with the result the appeals panel had arrived at. As well, the District Court case that had been decided in favor of the position Holly had advised her client to take had also been reversed on appeal—and that Circuit Court of Appeals is the one that would have jurisdiction over Holly's client's tax matters if the matter went to Tax Court or the U.S. District Court.

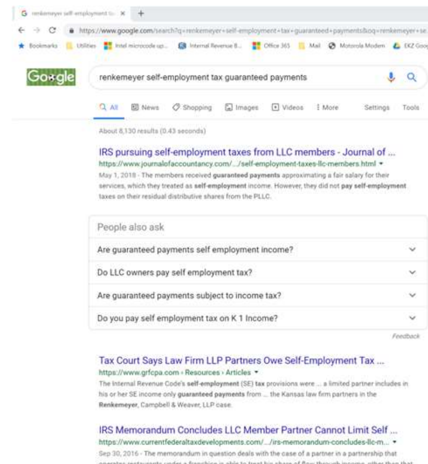
Holly had been victimized by stopping her research once the evidence she found supported the position she knew her client preferred. The article served to put Holly on notice that different courts had arrived at different conclusions and it had been written many years before. Holly failed to consider whether additional developments might have taken place since the article was written.

Skills Needed for Tax Planning

- Importance of a citator
  - Must check status of items you are relying on
  - Not all citators are created equal (prefer a *Shepardizing* citator if you have access to one)
  - In a pinch, can use Google as a quick and dirty way to see if there is new material on your issue
    - Should check it since plaintiff's counsel will, but…
    - Remember this is not what Google designed their system to do

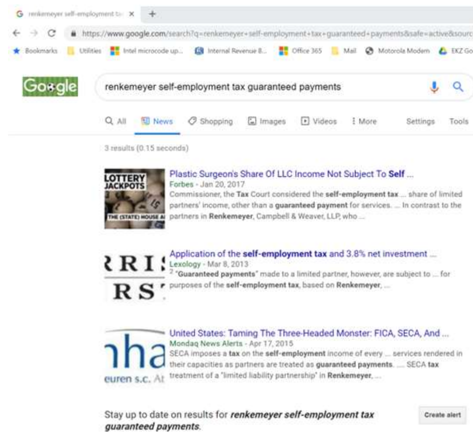
Skills Needed for Tax Planning

- Note what was uncovered searching for “Renkemeyer self-employment tax guaranteed payments.”
- The first article describes the *Castiglia* case, a key follow-on case to *Renkemeyer*.



Skills Needed for Tax Planning

- Switching to news also brings up the *Hardy* case, another key post-Renkemeyer case.
- Note the ability to create an alert on this search when new items appear.



Skills Needed for Tax Planning

- Objectivity also necessary to keep CPA from being blinded when client wants to go too far
- Case of CPA who was convicted of aiding and abetting tax evasion, sentenced to 6 months in prison

Skills Needed for Tax Planning

- CPA's problem arose with loans client claimed he received from fund he was managing
  - Big 4 firm had audited the fund, gave clean opinion
  - But CPA became aware there was no written documentation of the loan (Is reliance on audit now reasonable?)
  - Client "borrowed" over $18 million
  - CPA did try to get the right answer, but…

Now On to Actual Planning Issues…

- The next part of today's session will look at actual planning examples that have application to clients today.
- Consider these from the planning perspective—and look at how to expand out the concepts to other areas.
- Remember, this is editorial material.
  - It is not authority for a position.
  - The rules here change *daily*.

Unit 3

Deferral Planning in Action

KAPLAN

Learning Objectives

When you have completed this unit, you will be able to accomplish the following.

- Explain how qualified deferred compensation works as a tax planning strategy.
- Explain how non-qualified deferred compensation (NQDC) works as a tax planning strategy.
- Advise clients on year-end deduction strategies.
- Apply the provisions that apply to §1031 exchanges.

Qualified Deferred Compensation Plan: Retirement Plans

- Such plans are the textbook example of deferral planning.
  - We take ordinary income today (wages, self-employment income, etc.) and remove it from tax.
  - The payor gets a current deduction, even though the recipient does not pick up income (even if parties are related).
  - Eventually, the funds are subjected to tax when they leave the plan, taxed again as ordinary income.

Qualified Retirement Plans

- Only known benefit is time value of money
  - Rates may be different at retirement—but this isn't knowable when distribution may be decades away
  - Time value impacts:
    - Eventual payment of tax on earnings plus
    - Tax on amounts earned inside the plan (not subject to tax until distributed)

Individual Retirement Accounts

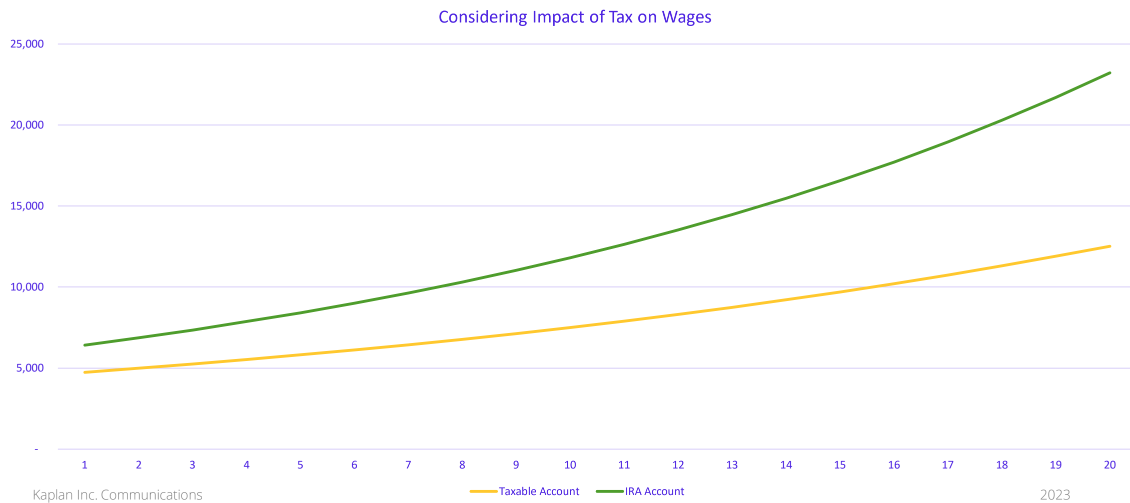
- Basic starting point for retirement account planning
- Open to anyone with earned income (though contribution may not be deductible)
- Note, it may be what's used even if other options are possible—if client isn't willing to defer more than $6,000 ($12,000 married), it's tough to justify other options
- Remember the $1,000 "catch-up" contribution

IRA vs. Taxable – Single $6,000 Contribution

IRA vs. Taxable

- The chart accounts merely for tax-free growth assuming a 7% return and 25% tax rate.
- But to be truly comparable, we need to reduce the $6,000 by the tax due on it ($1,500), since that also won't be paid if the contribution is deductible.
- That leads to the following chart.

IRA vs. Taxable – Consider Tax on Wages



Manual Example

	IRA		Remaining Taxable		
	Earnings	Balance	Earnings	Tax	Balance
Deductible Amount Contributed		14,000		4,200	9,800
Year 1	700	14,700	490	123	10,167
Year 2	735	15,435	508	127	10,548
Year 3	772	16,207	527	132	10,943
Year 4	810	17,017	547	137	11,353
Year 5	851	17,868	568	142	11,779
Year 6	893	18,761	589	147	12,221
Year 7	938	19,699	611	153	12,679
Year 8	985	20,684	634	159	13,154
Year 9	1,034	21,718	658	165	13,647
Year 10	1,086	22,804	682	171	14,158

Business-Related Retirement Plans

- If a client has his/her own business, much more can be done.
- The "catch" is that rules do require providing benefits to "rank and file."
- But often the cost of the rank and file can be offset by
  - Retirement plan design options,
  - Tax subsidy for any employer payments, and
  - Additional tax benefits to the owner vs. IRA.

Business-Related Retirement Plans

- Defined contribution plans
  - Primarily see profit sharing plans today (§401(k) plans are profit sharing plans with an optional provision)
  - Contributions go into specific accounts for each participant, subject to limits on maximum allowed
  - Participant gets both the ups and downs of investment performance in the plan

Business-Related Retirement Plans

- Defined contribution plans
  - Maximum employer contribution is 25% of covered compensation (§404)
  - Maximum allocated to single employee limited to lesser of:
    - 100% of compensation or
    - $61,000 for 2022, $58,000 for 2021 (§415)
  - For those over age 50 in plan allowing deferrals, can also have $6,500 catch-up contribution

Business-Related Retirement Plans

- Defined contribution plans
  - Use various “fancy” allocations to skew benefits toward favored employees (generally owners)
  - Cross-tested plans look to ultimate expected benefit (favors older employees)
  - New comparability plans combine this with dividing employees into groups to be tested

Business-Related Retirement Plans

- Defined contribution plans
  - Plan design undertaken by plan consultant who needs:
    - Employee census
    - What owners want to contribute to their own accounts
  - CPA involved in analyzing the overall cost/benefit issues of the plan, considering tax benefits and costs

Business-Related Retirement Plans

- Defined benefit plans
  - Promise a specific benefit to employee at retirement date
    - May be based on pay over lifetime (traditional)
    - Now see ones based on assumed rate of return on deemed contribution (cash balance)
  - Contribution limits based on what's needed to fund the expected benefits

Business-Related Retirement Plans

- Defined benefit plans
  - Maximum benefit for an employee is the lesser of:
    - $245,000 (for 2022) or
    - 100% of average compensation over high 3 years
  - Funding can be either via:
    - Trust – Employer directly responsible for investment performance
    - Insurance – Shifts risk to insurer, at a cost

Business-Related Retirement Plans

- Which plan type?
  - Defined contribution plans the most popular
    - No required contribution for profit sharing plan
    - No risk of “overfunding,” so fewer issues to track
  - Defined benefit plans work in the right context
    - Allow much greater contribution if owner is older
    - Generally want a steady stream of income

Business-Related Retirement Plans

- SECURE Act made various changes to employer plans:
  - Allows adoption up to extended due date
  - Requires limited coverage of long-term part-time employees in some §401(k) plans
  - Simplifies setting up multiple employer plans

Required Minimum Distribution Rules

- Reversal for retirement plans – When the money comes out
- Congress made these changes with the SECURE Act:
  - Minor impact – Will push required beginning date (RBD) back 18 months
  - Larger impact – Eliminates most stretch planning; inherited balances generally have to be paid out within 10 years

Required Minimum Distribution Rules

- Required minimum distributions begin at age 72, not 70½. If the beneficiary turned 70½ in 2022, the required minimum distribution remains due no later than April 1, 2023. If the beneficiary is currently receiving distributions because of the familiar 70½ rule, distributions continue. Those that turned 70½ in 2020 or later may wait until age 72 to begin receiving distributions.
- Payout over participant's lifetime
- Standard table assumes a 10-year-younger beneficiary
- If beneficiary is spouse and spouse is more than 10 years younger, can use spouse's actual age for computing RMD

Inherited Account

- Death before required beginning date
    - Five-year rule (entire balance out by end of fifth year following year of death)
    - One-year rule (balance paid over lifetime of *designated beneficiary* beginning in year after death of participant)
    - Note: The SECURE Act removes the 1-year rule for most beneficiaries and extends the 5-year rule to 10 years.

Inherited Account

- Inherited IRAs *cannot be rolled over*.
  - A rollover is a distribution to the beneficiary followed by depositing in another (or the same) IRA within 60 days.
  - A beneficiary can do a trustee-to-trustee transfer (which is confusingly referred to as a direct rollover by the IRS).
  - But once funds leave an inherited IRA, they are out for good.

Inherited Account

- Death after entering pay status
  - Paid over life expectancy of *designated beneficiary*
  - *Designated beneficiary*
    - Beneficiary of the account with shortest life expectancy
    - Determined on September 30 the year after year of death

Inherited Account

- Death after entering pay status
  - If no designated beneficiary, use life expectancy of decedent at date of death

Inherited Account Example

Inherited IRA After Original Owner Entered Pay Status

Harry dies in March 2018 after beginning minimum distributions. He has named a trust that does not qualify for look-through status as the sole beneficiary of his IRA. The minimum distribution for 2018 will be based on Harry's single life for his age on his 2018 birthday (even if that birthday was after the date of his death).

For future years, the minimum distribution will be reduced by 1 each year.

Harry names his brother Jack as the beneficiary of the IRA. Harry's life expectancy based on his 2018 birthday is 10, while Jack's life expectancy based on his age upon his birthday in 2019 is 14. The 14 will be used for 2019 as the factor to determine the minimum required distribution to Jack. The 14 will be reduced by 1 each year for future distributions. But if Harry had not taken his minimum distribution for 2018 before he died, that distribution (which will be taken by Jack) will be based on the 10-year factor tied to Harry's life before switching to Jack's life expectancy in the following year.

Spouse as Beneficiary

- Spouse has choices that aren't available to others
  - Can use the standard options discussed earlier
  - Can also treat an IRA as the spouse's own account
  - Spouse can roll over to own IRA from employer retirement account

Spouse as Beneficiary

- If don't treat as own account, is a death benefit (so no premature distribution tax), so need to take care if spouse under age 59½
- If treat as spouse's own, get own RMD rules, including the 10-year-younger beneficiary

Major SECURE Act Changes

- General rule for deaths after 2019 for non-spousal distributions is pay within 10 years
- Exceptions:
  - Minor child of decedent (only until age of majority)
  - Beneficiary no more than 10 years younger
  - Disabled beneficiary

Major SECURE Act Changes

- Beginning in 2020, the act generally allows contributions to traditional IRAs in the year a person turns 70½ and beyond. Subject to transition rules, required minimum distribution rules focus on age 72 rather than 70½.

Non-Qualified Deferred Compensation Plan (NQDC)

- An NQDC allows a service provider such as an employee to earn compensation such as salaries, bonuses, and other compensation in a year and then defer receiving that income in a later year. This also allows a deferment of the tax on that income. The deferral can result in a lower tax liability when the income is paid, as oftentimes the payment is received when the employee leaves the workforce.

NQDC – Section 409A Conditions

- The plan must be in writing.
- The plan document(s) specifies, at the time an amount is deferred, the amount to be paid, the payment schedule, and the triggering event that will result in payment. Permissible triggering events include:
  - a fixed date,
  - separation from service (e.g., retirement), and
  - a change in ownership or control of the company, disability, death, or an unforeseen emergency.
- Other events, such as the need to pay tuition for a child, a change in the financial condition of the company, or a heavy tax bill, are not permissible triggering events.
- The employee makes an irrevocable election to defer compensation before the year in which the compensation is earned. However, a special deferral election rule applies to commission payments.

NQDC – Impact on Employee

- Withholding tax deferral but FICA
- No restriction in amount
- Increase investment opportunities
- Distribution is based on specific dates
- Not protected by ERISA

NQDC Example

Mendek, Inc., has an NQDC with its key employee, Jesse Mendek. The NQDC is for $12M and it states that Jesse Mendek will receive these funds and any growth related to the funds on June 30, 2023. Jesse is fine with this, as he anticipates that he will retire by then. Jesse decided to retire a year earlier based on his doctor's advice. He put in his resignation effective June 30, 2022. He approached Mendek, Inc., and asked for his compensation on his resignation date. The NQDC does not allow this. He will have to wait until June 30, 2023.

NQDC – Impact on Employer

- No ERISA
    - Discriminatory rules do not apply
    - Improve cash flows
    - “Golden handcuff”

Opportunity Zones

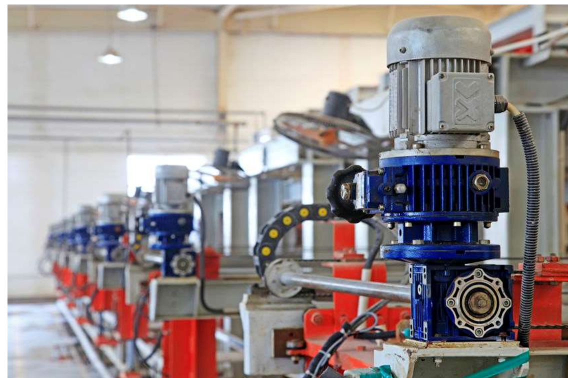
- Final regulations issued
    - Defer recognition by reinvesting
    - Escape tax entirely on gain on the investment itself
    - Only capital gains can be reinvested
    - Additional investments accounted for separately

Opportunity Zones

- Substantially all tangible property in opportunity zone set at 70%
- Note – Does not control substantially all provisions
- Deemed contributions under §752(a) not treated as separate investments

Opportunity Zones

- Partnership
  - Can invest gains on its own
  - If it doesn't, individual partners can (special 180-day rules)
- Can use fund ownership interest as collateral for a loan
- §1231 gain reinvestment special rules



§1031 Exchanges of Real Estate

- Another pure deferral planning option – Pushes gain to following years
  - Must be qualifying property (real property used in trade or business or held for investment)
  - Must meet time period tests if deferred like-kind exchange
    - 45-day identification requirement
    - 180-day/due date receipt requirement

§1031 Exchanges of Real Estate

- Is a clear planning option
  - What appears to be minor misstep eliminates the benefit
  - Professional needed to guide through the steps
  - But those same minor missteps can trip up the adviser

§1031 Exchanges of Real Estate – Exception

The CPA must understand that Section 1031 rules apply differently to certain industries. While many forms of oil and gas interests qualify as real property for U.S. federal income tax purposes, not all oil and gas interests are treated as real property for federal income tax purposes, even if the particular interest is treated as real property under applicable state law.

§351 Tax Free Transfer of Assets to New Corporation

- Shareholders are allowed to transfer assets to a newly formed corporation tax free. The transfer results in tax deferral until the newly transferred assets are disposed.
- Conditions
  - Transfer must be in exchange for stock.
  - Transfer must be made of property.
  - The exchange must result in control as defined under section 368(c).

§351 Tax Free Transfer of Assets to New Corporation

Sec. 368(c) defines control as the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation

§351 Example

- *M1* has three classes of stock. Classes *R and S are voting common stock, and Class T is nonvoting common stock. The shares are owned by X1 and X2 shown in Exhibit A, below. X1 and X2 are unrelated parties. X1 transfers property (with unrealized gain) to M1 in exchange for 50 shares of Class R stock and 120 shares of Class S stock in a value-for-value exchange. X2 does not transfer any property. The stock ownership of M1 after the exchange is shown in Exhibit B, also seen below.*

Example Continued

Table A

	Class R(voting)	Class S(voting)	Class T(non-voting)
X1	70	40	20
X2	30	40	20
Total	100	80	40

Table B

	Class R(voting)	Class S(voting)	Class T(non-voting)
X1	120	160	20
X2	30	40	20
Total	150	200	40

After the exchange, *X1* now owns 80% of the total combined voting power of all classes of stock entitled to vote (Classes *R* and *S*) (280 ÷ 350) and 50% of all other classes of stock (Class *T*). Because the threshold requirement for control under Sec. 351 is not met (*X1* owns only 50% of Class *T* instead of at least 80%), *X1*'s transfer of property to *M1* does not meet the requirements of Sec. 351 and is subject to federal income tax.

§351 Example Continued

After the exchange, *X1* now owns 80% of the total combined voting power of all classes of stock entitled to vote (Classes *R* and *S*) (280 ÷ 350) and 50% of all other classes of stock (Class *T*). Because the threshold requirement for control under Sec. 351 is not met (*X1* owns only 50% of Class *T* instead of at least 80%), *X1*'s transfer of property to *M1* does not meet the requirements of Sec. 351 and is subject to federal income tax.

§351 Property Defined

- Property defined under §351 include
- Installment notes
- Plant and equipment
- Unrealized receivables of a cash basis taxpayer
- Proprietary processes and formula including proprietary information in the nature of a patentable invention.

§351 Exchange Shares for Compensation

- Exchanging stock for compensation- taxable
  - Not always the case
- Nominal property issue

§351 – Violation

- Binding Committing Violating "control immediately after" requirement
- Using Nonqualified Preferred Stock
- Contribution of property in exchange for stock of the recipient's parent.

§351 – Tax Planning

There are certain times that a shareholder may want to opt out of the section 351, this may occur when the transferor decides to recognize gain in the transfer of property if the tax cost is low or if the transferor wants to recognize a loss, as section 351 does not allow recognition of any gain or loss on the transfer of property to the corporation.

§6166-Deferral Estate Taxes on Closely Held Business

- Deferral for 5 years with payments extending out 14 years
- Interest rate is usually 2%
- Must be a closely held company
- Applies to any business structure
- Decedent's ownership at least 20% of the company's value
- Company must be valued at 35% or more of the adjusted gross estate
- In a corporation, shareholders cannot exceed 45
- In a partnership, partners cannot exceed 45

§6166 – Tax Planning

The IRS may deny the valuation of the business. The CPA must ensure that the client appraises the business and the entire estate as soon as possible to ensure that the value of the business qualifies for the section 6166 deferral. The CPA should elect based on executors permission to defer the business interest, then pay the proper amount of taxes due for the nonbusiness estate assets, which are ineligible for the 6166 tax deferral.

Unit 4

Conversion Planning in Action

Learning Objectives

When you have completed this unit, you will be able to accomplish the following.

- Explain how rental real estate is used to convert taxable income to lower rates.
- Advise clients on the importance of after-tax returns for municipal bonds.
- Explain the use of §1202 stock and advise clients on when structuring a new business to qualify for §1202 status is appropriate.

Conversion Planning

- Get income taxed at lower (or zero) tax rate
- Unlike deferral planning, conversion planning reduces total lifetime tax paid
- Why it exists:
    - Incentivize certain types of investments (rentals, long-term capital gains, etc.)
    - Limits on jurisdiction for taxation of income (state trust income tax planning)

Rental Real Estate

- Key conversion factor is depreciation vs. §1031 gains
    - Depreciation reduces ordinary income (maximum 37% rate)
    - §1231 gains generated by such depreciation taxed at lower rate (25% + 3.8%)
- As well, appreciation of real estate taxed at maximum capital gain rate (20% + 3.8%)

Rental Real Estate Example

Rental Property as an Investment

Alexander purchases a residential rental property for $900,000 on January 1. He puts down 20% ($180,000) and finances the rest on a 30-year mortgage with a 5.25% interest rate. He expects to rent the property for $4,500.00 per month. His average cash expenses per month he expects to be $450, which includes the real estate taxes he will owe plus expected repairs.

For simplicity, we will ignore the value of land that would exist in this purchase.

The monthly payment for the mortgage is $3,975.87. The first 12 payments will include $37,558.02 of interest (deductible on Schedule E) and $10,152.38 of principal (non-deductible cash outflow). More than offsetting the non-deductible principal paid on the mortgage is the first 12-month depreciation of $25,090.91.

Cash Flow for the First Year

Cash received	$ 54,000.00
Mortgage paid	(47,710.40)
Cash expense	(5,400.00)
Positive cash flow	$ 889.60

Tax Reporting for the First Year

Rental income	$	54,000.00
Depreciation		25,090.91
Interest		37,558.02
Other expenses		5,400.00
Total deductions		68,048.93
Loss	$	(14,048.93)

Rental Real Estate Example

Sale at the End of Year 2

Assume Alexander sells the property for $1,000,000 at the end of the second year. Again, he will have 11½ months of depreciation (half month convention for year of sale) and the interest for the year on the mortgage will be $37,012.00. All other items are the same as the prior year.

The Schedule E for the year will look like this:

Rental Real Estate Example

Rental income	$ 54,000.00
Depreciation	25,090.91
Interest	37,012.00
Other expenses	5,400.00
Total deduction	67,502.91
Loss	$ (13,502.91)

113 Kaplan Inc. Communications 2023

Rental Real Estate Example

Assume the entire passive loss carries into this year, so we have a total ordinary loss of $27,551.84. Assuming our client is in the maximum tax bracket, that will reduce the taxes for $10,194.18.

The gain on sale is computed as follows:

114 Kaplan Inc. Communications 2023

Rental Real Estate Example

Sales Price	$ 1,000,000.00
Original Cost	900,000.00
Less depreciation	50,181.82
Adjusted Basis	849,818.18
Gain on sale	$ 150,181.82
Taxed at maximum 25%	$ 50,181.82
Taxed at maximum 20%	$ 100,000.00
25% Tax	$ 12,545.46
20% Tax	20,000.00
Total Tax	$ 32,545.46

Rental Real Estate

- The net investment income tax (at 3.8%) has to be considered as well in any calculation unless:
  - the taxpayer is a real estate professional *and*
  - the rental sold was also a trade or business.

Total Tax and Net Cash Flow Example

EXAMPLE

Total Tax and Net Cash Flow

The overall net tax paid on the investment in the rental is shown below:

Tax on Sale	$ 32,545.46
Savings on losses	(27,551.84)
NII Tax	4,659.94
Total Tax	$ 9,653.55

The cash flow is summarized as follows:

Year 1/2 Cash Flow	$ 1,779.20
Sales price	1,000,000.00
Less mortgage	(699,149.22)
Down payment	(180,000.00)
Net cash flow	$ 122,629.98

Thus, the effective net tax rate is $9,653.55 divided by $122,629.98, or 7.87%.

Compare with Sale of Stock Example

Tax on Leveraged Stock Investment

In this case, the interest paid of $74,570.02 would be investment interest. As well, there is no incoming cash flow to give Alexander the cash to pay the interest.

The gain on sale is fairly straightforward—we have a $1,000,000 sales price and a $900,000 basis, thus a capital gain of $100,000. But don't multiply that by 23.8% just yet because that $74,570.02 is only deductible if a client has net investment income—but net investment income does not include long-term capital gains or qualified dividends unless the taxpayer agrees to waive the special capital gain rates.

Assuming the client does not have large amounts of interest income to absorb the $74,570.02 of interest paid, it is likely that $74,570.02 of the capital gain will have to be taxed at regular rates. That means we have a gain taxable at 23.8% of $25,429.98 and a tax of $6,052.34.

While that is less than the tax on the rental, that doesn't mean the rate on net cash flow is lower—again, no money came in to pay the interest, so the interest is a pure cash drain.

Compare with Sale of Stock Example

Here is the net cash flow:

Sales price	$ 1,000,000.00
Less debt	(720,000.00)
Down payment	(180,000.00)
Interest paid	(74,570.02)
Net cash flow	$ 25,429.98

Note that the net cash flow is the taxable gain less the interest paid, so our effective rate on positive cash flow is 23.8%. And, as well, Alexander has significantly less cash after taxes.

Depreciation for Real Estate

- Lives
  - Residential – 27.5 years
  - Commercial (anything not residential) – 39 years
- 80% income test to determine if real estate is residential
- Note that transient use is *not* considered residential use

Residential Real Estate Test Example

Residential Real Estate

Stephanie purchases a property that has 30 units that provides living units. She rents these units out on day-to-day agreements and units have an average rental period for each tenant of 2.5 days. The longest period of rental for a single unit during the year was 2 weeks.

Stephanie's property is used primarily on a transient basis. Thus, this property is non-residential real estate and must be depreciated over 39 years.

Personal Use Residential Example

Personal Use

Dennis buys a duplex. He rents out one of the units and makes the other unit his personal residence. The prior owner rented both units and obtained $45,000 a year for each unit in rent. Dennis is able to get the $45,000 in rent on the unit he does rent.

For purposes of the 80% test for residential real property, we deem that the unit Dennis has made his principal residence is rented at $45,000. When we add the $45,000 received from the tenant for the other unit, that means 100% of the gross rental income is from dwelling units.

Business Use

Assume the property has five units in it, one of which is designed to be a retail store. Dennis still uses one as his personal residence and the four other units (3 residential and 1 commercial) are all leased at annual rents of $45,000.

With the assumed $45,000 rental of Dennis's residence, the 80% test is met and the building is considered to be residential real estate.

Cash Flow and Rentals

- Cash flow is quite often very different from taxable income reported in rentals.
- Remember, over time, reported income will generally equal net cash flows, but the *timing* of reporting will be different.
- Always consider the risk of debt for leveraging (remember 2008 and real estate).

§1231 Gains – Not Quite Capital Gains

- Rental real estate property will generally not be capital gain property, but rather §1231 property.
- Normally, it works like this:
  - Net §1231 gain for year – All such transactions are capital
  - Net §1231 loss for year – All such transactions are ordinary
- But be aware of the 5-year §1231 loss recapture we'll discuss.

Dispositions in General

- Common area of confusion for clients in dealing with real property is treatment of debt
- Debt taxpayer that gets paid off or for which the buyer assumes responsibility for is part of the sales price, enters into the computation of gain
- Thus, taxpayer could be paying tax on a gain that is greater than cash received

Rental Debt Example

Debt Paid Off as Part of the Sale

Kelsea has a rental property that she is going to sell. At the time of the sale, the property is worth $750,000 and the unpaid balance of the mortgage on the property is $500,000 at the date of sale.

While the buyer comes to the closing with $750,000, Kelsea will not receive $500,000 of those proceeds because that amount will have to be used to pay off the mortgage on the property so that the buyer can obtain clear title. Thus, at closing, Kelsea would only receive $250,000 (for simplicity, we are ignoring other closing costs involved in the transaction).

Despite only receiving $250,000 from the sale, Kelsea is treated as realizing $750,000 from the sale of the property. If Kelsea's adjusted basis in the property is less than $500,000, she will recognize gain that is greater than the $250,000 in cash she receives at closing.

Dispositions in General

- Cancellation of debt income vs. sales price
  - If recourse debt not fully satisfied in sale, either:
    - Taxpayer will need to pay off the debt (eventually) or
    - Will be cancellation of debt income (ordinary)
  - If nonrecourse debt, excess debt is part of sale price if:
    - Property foreclosed (including deed in lieu of foreclosure) or
    - Short sale to which lender agrees is entered into

Debt and Disposition Example

Foreclosure of Property – Recourse Debt

Jillian has a rental property that is being foreclosed. The balance on the mortgage at the time of the foreclosure is $800,000 and the fair market value of the property securing the debt is $600,000. When the property is foreclosed upon by the lender, Jillian is treated as having disposed of the property in a taxable transaction with sales proceeds of $600,000.

If the lender chooses not to pursue collection of the remaining $200,000 balance due on the debt, Jillian would have ordinary income from the discharge of indebtedness of $200,000. The $200,000 would not be part of the proceeds of the sale. Jillian may be able to exclude some or all of the $200,000 from income if she can meet one of the conditions found in IRC §108 that provides certain discharges of debt are treated as not currently taxable.

Debt and Disposition Example

Foreclosure of Property – Nonrecourse Debt

If the debt on Jillian's property was nonrecourse, the entire $800,000 would have been treated as an amount realized from the disposition and used to compute the gain or loss on sale under IRC §1001. The fact that the property was only worth $600,000 is not relevant because the debt was nonrecourse in nature.

§1231 Generally

- Assets used in trade or business are not capital assets
- If held for more than 1 year, become §1231 assets subject to §1231 rules
- If not held for 1 year, ordinary gain/loss rules apply

§1231 Generally Example

Holding Period

Lewis bought a rental that qualified as a trade or business on January 10, 20X1. On November 20, 20X1, he sold the property and generated a $40,000 gain. The gain is not a capital gain, as the property was excluded as trade or business property under IRC §1221(a)(2). The gain is also not a §1231 gain because Lewis had not held the property for more than one year, so it failed to meet the definition of §1231 property per IRC §1231(b)(1).

The gain on disposition is an ordinary gain.

§1231 Generally

- First compute all §1231 gains and losses (including those from passthroughs).
- Determine net §1231 gain/loss:
  - If net §1231 gain, then all transactions capital (subject to recapture rule if prior net losses claimed)
  - If net §1231 loss, then all transactions ordinary (and a new five-year loss recapture period begins)

§1231 Generally Example

Net §1231 Gains

Shawn has two rentals that qualify as trade or businesses. He sells both rentals during the year. For the first rental, Shawn has a $250,000 gain on disposition, while for the second rental, Shawn has a net loss of $150,000. Shawn has no other §1231 gains or losses for the year.

Shawn's §1231 gains exceed his §1231 losses by $100,000 ($250,000 – $150,000). Since that results in a net gain, the transactions generate a long-term capital gain and a long-term capital loss.

Net §1231 Losses

Assume that Shawn instead had only incurred a $50,000 gain on the sale of the first rental. In this case, his §1231 losses would exceed his §1231 gains by $100,000. In this case, both transactions would be excluded from capital gain/loss treatment, resulting in an ordinary gain on the sale of the first rental and an ordinary loss on the sale of the second rental.

Non-Recaptured Net §1231 Losses

- Special rules that turn net §1231 gains into losses up to amount of non-recaptured §1231 losses
- Non-recaptured §1231 losses are:
  - Amount of net §1231 losses from prior 5 years, less
  - Portion of such losses already used to convert net §1231 gains to ordinary income treatment

Non-Recaptured §1231 Losses Example

EXAMPLE

Non-Recaptured Section 1231 Losses

Kelly had the following net §1231 gains and losses over the past five years:

Year	Gain/Loss
20X1	25000
20X2	-20000
20X3	5000
20X4	-10000
20X5	15000

In 20X6, Kelly incurs a net §1231 gain of $25,000. The non-recaptured §1231 gain for 20X6 is $10,000. That is computed by taking the $20,000 loss from 20X2 and the $10,000 loss from 20X4 and reducing the $30,000 total (but not below zero) by gains incurred in the years after the losses ($5,000 and $15,000) that were treated as ordinary gains under this rule.

The $25,000 gain in 20X1 does not enter into this calculation because it was incurred prior the first loss year.

Thus, $10,000 of Kelly's 20X6 §1231 gains will be treated as ordinary gains. The remaining §1231 gains will be treated as capital gains under the general rule of §1231 found at §1231(a)(1).

Trade or Business and Rentals

- For years, hadn't worried much about this—just treated all rentals as business items for §1231 purposes
- Only really matters if:
  - Have unrecaptured net §1231 losses (if a capital asset, those rules wouldn't apply)
  - Sell rental at a loss (it would be capital, subject to the net $3,000 loss cap)

Trade or Business and Rentals

- Supreme Court refused to give a simple definition (*Groetzinger v. Commissioner*, 480 U.S. 23), but must test for:
  - Involvement with continuity and regularity and
  - Primary purpose is income or profit
- Does not affect "above-the-line" deduction (§212 expenses related to a rental are allowed in computing AGI per §62(a)(4))

Trade or Business and Rentals

- Cases holding non-triple-net leases are generally rentals.
  - *Fackler v. Commissioner,* 133 F.2d 509 (1943)
  - *Hazard v. Commissioner*, 7 TC 372 (1946)
- However, the Second Circuit disagrees it's this easy—*Grier v. United States*, 120 F.Supp. 395 (1954), *affd*, CA2 218 F. 2d 603 (1955).

Outside Second Circuit Example

EXAMPLE

Rental Located Outside Second Circuit Jurisdiction

Adam owns a residential rental property. He has leased it on one year leases to various tenants over the past five years. While most months Adam just has to collect the rent from tenants, he does take care of arranging for any repairs or maintenance that might be necessary on the property. When the property goes vacant, he also places ads for a new tenant and makes the decision on which tenant to lease the property to.

In the view of the Tax Court, found in the *Hazard* case, Adam has a sufficient level of activity to be in the trade or business of renting the property.

Outside Second Circuit Example

EXAMPLE

Management Company

In 20X8 Adam engages the services of a management company to take over the tasks he had been handling for the rental. Although Adam does not directly meet the continuity and regularity tests, Adam's agent (the management company) does. Thus the overall undertaking would still meet the test to be a trade or business under the *Hazard* test.

Inside Second Circuit Example

EXAMPLE

Rental Undertaking Where the Second Circuit Has Jurisdiction

Assume the same facts as the first example for a rental trade or business—Adam does not hire a management company. As well, Adam has had the same tenant for the seven years he has held the property. Adam lives in New York state (subject to the jurisdiction of the Second Circuit Court of Appeals) and the rental is also in New York.

In this case, there is a high likelihood Adam would be found not to be in the trade or business of renting property based on the Second Circuit's *Grier* precedent.

Rentals as a Trade or Business

- Triple-net leases are generally not a trade or business (Rev. Rul. 73-522).
- However, if there are multiple triple-net leases, then there may be a trade or business (*Central States Pension Fund v. Personnel, Inc.,* 974 F.2d 789 (7th Cir. 1992)).

Triple-Net Leases Example

EXAMPLE

Triple-Net Lease and Trade or Business Status

Ella owns a single office building that she leases to a local accounting firm. The lease is triple-net lease—that is, the accounting firm is required to pay for all repairs, maintenance and property taxes. Ella only pays the mortgage on the building and collects the monthly rent.

The activities related to the building are not sufficiently continuous and regular for the rental to be treated as a trade or business. Rather, this is simply an investment activity entered into for a profit.

Triple-Net Leases Example

EXAMPLE

Multiple Office Buildings

Assume Ella owns 30 high rise office complexes in 12 states, each of which have a large number of individual tenants. While the tenants are still responsible for their share of the property taxes on their building, as well as a share of common area repairs along with repairs to their own unit, Ella now must spend full time managing the operation of all of these buildings, including significant time handling the basic accounting to determine each tenant's share of common costs and constantly having to market empty units to new tenants and determine if a potential tenant is credit-worthy enough to allow to enter into a lease for an empty unit.

Under the logic found in the *Central States* case, Ella appears to have a trade or business even though each lease is technically a triple-net lease. This situation is markedly different from the situation of a taxpayer with a single triple-net lease.

§1250 Property

- Generally, old §1250 required recapture of depreciation on real property in excess of straight-line
- For property acquired after 1986, that hasn't happened because real property is depreciated on straight-line basis
- But watch out for ACRS real property (1981–1986)
    - Old §1250 rule did not apply
    - If used accelerated depreciation, was subject to §1245 recapture rules (always ordinary income)

§1250 Unrecaptured Gain

- Congress eventually decided that §1250 was too much of a good thing.
- Now, *§1250 Unrecaptured Gain* is subject to a maximum rate of 25% rather than 20%.
- Is the reduction of basis in the real property due to depreciation that is not otherwise taxed as ordinary income?

§1250 Unrecaptured Gain Example

EXAMPLE

Computing Amount of Potential Unrecaptured §1250 Gain

Mark has a commercial building he acquired a number of years ago. He purchased the building for $1,000,000 and has claimed $480,000 of depreciation to date on the building. The building is sold for $1,400,000.

Mark has an overall gain of $880,000 ($1,400,000 – ($1,000,000 - $480,000)). Of this gain, $480,000 potentially may be treated as unrecaptured 1250 gain since it represents the depreciation claimed on the building since inception. The remaining $400,000, assuming it is treated as capital gain after application of the rules of §1231, would be subject to the same maximum capital gain rates as regular long-term capital gains.

§199A and Rentals – It Gets Complicated

- §199A treatment is another *potential* conversion possibility for rentals, but it can cut both ways:
  - If the rental shows an operating profit and is a trade or business, get effectively a rate that is 80% of ordinary rate
  - If rental shows an operating loss, then get hit with lower benefit for losses
- The problem is with the treatment of §1231 gains.

Income Taxed at Capital Gain Rates

- Any income taxed at capital gain rates is *not* qualified business income for §199A.
- That includes §1231 gains taxed as capital gains.
- Note that often this is the only net income a rental will show, with all other items netting to a potentially significant loss.

Safe Harbor: Rentals & §199A

- Notice 2019-07, 1/18/19
  - Issued at same time as §199A final regulations
  - Tests rental “enterprises” for qualification

Photo by Nick Karvounis on Unsplash

Safe Harbor: Rentals & §199A

- Notice 2019-07, 1/18/19
  - Requirements:
    - Books and records
    - 250-hour rule for taxpayer/agents
    - Contemporaneous documentation (not for 2018)

Photo by Nick Karvounis on Unsplash

Safe Harbor: Rentals & §199A

- Notice 2019-07, 1/18/19
  - List of activities that count
  - Does not count certain activities
  - Excluded:
    - §280A rentals
    - Triple-net leases

Photo by Nick Karvounis on Unsplash

Impact of §199A on Rentals Example

EXAMPLE

Negative Impact of Rental as a Trade or Business

Bruce has rented a property for the past five years, generating $42,000 of passive activity loss carryover. All five years were after 2018. When he sells the rental, he generates a $100,000 gain. Overall, the rental generated a net $58,000 of taxable income over the period Bruce held it.

However, for purposes of §199A, only the $42,000 loss is taken into consideration in computing qualified business income under IRC §199A if the rental is a trade or business. Assuming Bruce has $100,000 of qualified business income from a separate activity, he will see a net reduction of his deduction under §199A from $20,000 to $11,600 (20% of $58,000 rather than 20% of $100,000). The $8,400 reduction is 20% of released passive loss on the rental.

Impact of §199A on Rentals Example

EXAMPLE

Trade or Business Rental Sold at a Loss

Assume Bruce had sold the rental at a net loss of $10,000. In this case, he still would have released the $42,000 of passive loss carryover, all of which would reduce qualified business income. But if Bruce has a net §1231 loss (often the case, since most taxpayers don't have multiple significant §1231 gains and losses in the same year), then the $10,000 loss on the disposal of the rental will also reduce qualified business income.

In this case, Bruce's negative qualified business income from the rental would rise to $52,000. His deduction under §199A, assuming the other qualified business income remains the same, would now drop to $9,600 (the $100,000 QBI from the other activity now reduced by the negative $52,000 QBI from the rental).

Municipal Bonds – An Issue of Returns

- Municipal bonds are tax free—generally have a lower return relative to the risk in the bond
- As well, have issue with alternative minimum tax for private activity bonds (less of an issue after TCJA)
- Often negatively impacts other tax benefits through inclusion in various calculations of *modified adjusted gross income*
- Also have to consider "double tax free" bond issue

Financial Planning Issue – After-Tax Return

- Look at return *after taxes* to compare taxable vs. tax-exempt bonds

Financial Planning Issue – After-Tax Return

$$\text{taxable return} = \frac{\text{tax exempt return}}{(1 - \text{federal marginal tax rate})}$$

Financial Planning Issue – After-Tax Return Example

EXAMPLE

Tax-Exempt Bonds Rate of Return Planning

Mark is looking at two investments in interest paying securities. One is a municipal bond that pays 3.6% while the other is a corporate bond paying 5%. Mark lives in a state without an income tax and Mark expects to be in the highest federal marginal tax bracket. The two bonds have similar levels of risk in Mark's view, so he's interested in the returns.

In this case, if Mark buys the taxable bond, its higher initial yield must be reduced by the impact of the 37% tax Mark expects to pay on that interest. Thus, Mark can only keep 63% yield (1-0.37), or 3.15%. In this case, the municipal bond with a similar level of risk paying 3.6% gives the better after-tax return to Mark.

Financial Planning Issue – After-Tax Return Example

EXAMPLE

Lower marginal Rate

Mark retires and his income declines so that now he expects to be in the 25% marginal tax bracket for federal purposes. While the corporate bond pays the same 5%, the tax Mark expects to pay on the interest has gone down, so Mark expects to keep 75% of the yield (1 – 0.25). Thus, the after-tax yield of the taxable bond is now at 3.75% (75% of 5%), which is greater than the yield on the tax free bond.

Now that Mark's marginal rate has declined, the corporate bonds provide the greater after- tax return.

Financial Planning Issue – After-Tax Return Example

EXAMPLE

Excessive Tax Avoidance

Sara has complained for years about the money the government has stolen from her in taxes, so in her retirement she has invested her savings entirely in tax free municipal bonds. She has the same facts as Mark, looking at choosing between the 3.6% municipal bond or the 5% corporate bond. Her investment portfolio is very significant, so she would generate over $100,000 in income from investing in either set of bonds.

Sara selects the municipal bond since she knows that will eliminate her taxes entirely. While this is correct, it also represents a far from optimal result in terms of rate of return, ignoring the additional risk she takes on by having such a highly non-diversified portfolio.

A much better option would be for Sara to invest in the taxable bonds up until her taxable income from those bonds push her to the beginning of a tax bracket where the after-tax return of the corporate bonds drops below that of the municipal bonds.

Communicating the Issue to Clients

- Remember that clients are not accountants.
- While Excel is great at computing the benefits, most clients react negatively to large tables of numbers.
- But clients react positively to charts that pull out the key numbers.

Communicating with Clients Example

EXAMPLE

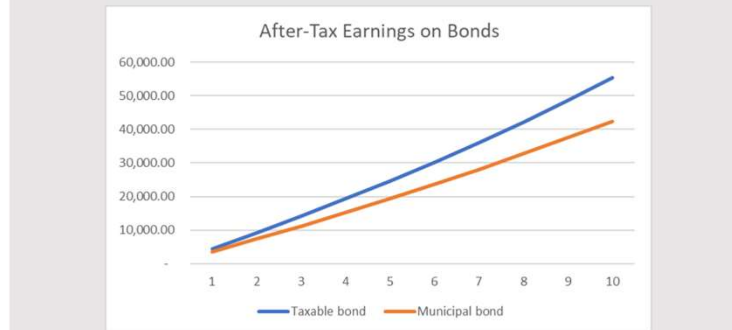
Analysis of Cost of Excessive Investment in Municipal Bonds

Let's take Sara, who has managed to push her marginal tax rate down to 10% with the bonds. What is the cost of doing this?

As accountants we would like a presentation like this:

Year	1	2	3	4	5	6	7	8	9	10
Taxable Bond										
Invested Cash	100,000.00	104,500.00	109,202.50	114,116.62	119,251.87	124,618.20	130,226.02	136,086.19	142,210.07	148,609.52
Interest paid	5,000.00	5,225.00	5,460.13	5,705.83	5,962.59	6,230.91	6,511.30	6,804.31	7,110.50	7,430.48
Tax	500.00	522.50	546.01	570.58	596.26	623.09	651.13	680.43	711.05	743.05
Net cash after tax	4,500.00	4,702.50	4,914.12	5,135.25	5,366.33	5,607.82	5,860.17	6,123.88	6,399.45	6,687.43
Cumulative cash	104,500.00	109,202.50	114,116.62	119,251.87	124,618.20	130,226.02	136,086.19	142,210.07	148,609.52	155,296.95
Tax Exempt Bond										
Invested Cash	100,000.00	103,600.00	107,329.60	111,193.47	115,196.43	119,343.50	123,639.87	128,090.91	132,702.18	137,479.46
Interest paid	3,600.00	3,729.60	3,863.87	4,002.96	4,147.07	4,296.37	4,451.04	4,611.27	4,777.28	4,949.26
Tax	-	-	-	-	-	-	-	-	-	-
Net cash after tax	3,600.00	3,729.60	3,863.87	4,002.96	4,147.07	4,296.37	4,451.04	4,611.27	4,777.28	4,949.26
Cumulative cash	103,600.00	107,329.60	111,193.47	115,196.43	119,343.50	123,639.87	128,090.91	132,702.18	137,479.46	142,428.72

Communicating with Clients Example


However, Sara's eyes glaze over with comments asking how we can read that tiny print (we CPAs like getting it all on one sheet of paper as well).

But the chart below is a lot easier for Sara to grasp immediately, even if the CPA in you objects that it doesn't show the details you think are necessary to understand the issue

Back Door Taxation – Modified AGI

- Congress loves to phase out benefits as income rises.
- They use *modified adjusted gross income* to pick up items otherwise not subject to tax in computing phaseouts.
  - There is no one definition of modified AGI for IRC.
  - But inclusion of tax-exempt income is fairly standard.

Back Door Taxation – Modified AGI

- Tax-exempt income negatively impacts the following:
  - Social Security benefits subject to tax
  - Refundable healthcare credit
  - Excess investment income for qualifying for EITC
  - AMT impact of *private activity bond* interest
  - Out-of-state bonds subjected to tax by taxpayer's state of residence

§1202 Stock – General Utilities Returns?

- Prior to 1986, most closely held business entities were C corporations.
  - They had access to an additional set of low brackets.
  - Dividends were rarely paid in practice.
  - Old §336 eliminated gain inside the corporation on the sale of assets.

General Utilities Example

EXAMPLE

Application of General Utilities Doctrine

From 1970-1979 Kelly owned 100% of the stock of Ascot Widgets. Over those 10 years Kelly took out salary and the company had income left in that just happened to be taxed at the lowest corporate rates. Thus Ascot Widget's income before taxes and taxes for those years looked like this.

Here is the net after-tax earnings for Kelly with the C corporation, along with comparison with what after tax income would have looked like had the entity been set up as an S corporation and either paid out the $25,000 as salary or let it show up on Kelly's K-1.

Year	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Income before taxes	25,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000
Tax on first $25,000	22%	22%	22%	22%	22%	20%	20%	20%	20%	17%
Federal income tax	5,500	5,500	5,500	5,500	5,500	5,000	5,000	5,000	5,000	4,250
Net after taxes	19,500	19,500	19,500	19,500	19,500	20,000	20,000	20,000	20,000	20,750
Individual tax rate										
Paid as salary	70%	70%	50%	50%	50%	50%	50%	50%	50%	50%
Passed through S corporation	70%	70%	70%	70%	70%	70%	70%	70%	70%	70%
Available at individual level										
Paid as salary	7,500	7,500	12,500	12,500	12,500	12,500	12,500	12,500	12,500	12,500
Passed through S corporation	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500

In those years the top individual income tax rate was 70%. Beginning in 1972 Congress created a special 50% maximum tax bracket that applied to earned income.

As should be clear, operating her company as a C corporation saved Kelly a lot of taxes over the ten years, assuming the corporation had a use for $25,000 of capital each year (as most do).

General Utilities Example

EXAMPLE

Sale of Ascot Widgets Under Old §366

A buyer offered Kelly $5,000,000 for the assets of Ascot Widgets on January 1, 1980, an offer she accepted. Let us assume, for simplicity, that Kelly has no basis in her stock. Ascot Widgets immediately adopts a formal plan of liquidation and then sells its asset (the amounts paid were entirely for the valuable goodwill, customer lists and other intangibles that Ascot held) for $5,000,000. The company, not having any liabilities, then redeems Kelly's shares for $5,000,000. In fact, Kelly had a $5,000,000 capital gain on the redemption of her shares. In 1980 Kelly would have excluded 60% of the gain under the law that existed prior to the Tax Reform Act of 1986. Thus, she would have paid tax on 40% of the gain at a maximum rate of 70%- or a 28% tax rate on long term capital gains.

Below we compare the total taxes paid by Kelly and Ascot Widgets as a C corporation vs. the tax that would have been paid had she operated the corporation as an S corporation an either passed out the $25,000 as flow through income or additional salary.

		S Corporation	
	C Corporation	K-1 Income	Salary
Total taxes 1970-1979	51,750	175,000	135,000
1980 tax on sale (28% rate)	1,400,000	1,400,000	1,400,000
Total taxes 1970-1980	1,451,750	1,575,000	1,535,000

General Utilities Example

While the tax paid was identical on the sale of the assets, a substantial tax savings was generated in the years the business operated.

But, we also have to account for the tax Kelly would pay on the assets (all cash we'll assume for simplicity) remained trapped in the corporation each year. Over the ten years Kelly had after-tax earnings of $198,250, assuming that was also sent out to Kelly in the sale, it would have been taxed as additional gain on sale, triggering a tax of $55,010. But even adding that to the $51,170 only results in tax on the operational year earnings of $107,260, still less than either of the results from the C corporation—and over half of that tax didn't have to be paid until the end of the ten years.

After General Utilities – The Debacle Example

EXAMPLE

Sale of Assets After General Utilities Repeal

Let's assume that the sale of the company took place after the repeal of General Utilities. Now if the corporation's assets were sold, the gain on sale of intangibles inside the corporation would have been subject to a 34% maximum corporate tax rate, for a total tax of $1,700,000 paid by the corporation.

The cash available to redeem Kelly's shares would have been reduced by the tax paid, resulting in a gain on disposition of her shares of $3,300,000 which would now be subject to personal tax.

Note the change in results this time in the table below:

		S Corporation	
	C Corporation	K-1 Income	Salary
Total taxes operating years	-	115,000	115,000
Inside tax	1,700,000	-	-
1988 tax on sale (28% rate)	924,000	1,400,000	1,400,000
Total taxes paid	2,624,000	1,515,000	1,515,000

The advantage the C corporation previously had is now dwarfed by the massive impact of the double tax in the year of sale. Thus, following the repeal of the *General Utilities* doctrine in the Tax Reform Act of 1986 C corporations converted to S status in large numbers and few closely held C corporation would be formed in the succeeding decades.

Tax Cuts and Jobs Act Impact

- §199A does not give passthroughs a similar cut to what C corporations received at the top bracket.
- So, annual tax costs of operating as a passthrough are often higher than for a C corporation.
- But if double tax is still there, it's an issue.
- However, §1202 quietly chipped away and, in some cases, eliminated the double tax on the sale of certain businesses.

Tax Cuts and Jobs Act Impact

- Provides for:
  - Varying rate of exclusion of gain on sale of qualifying stock
  - Eventually becomes a 100% exclusion for stock issued post September 27, 2010
  - Capped at $10 million per taxpayer

§199A – The Rules

- Definition of qualified small-business stock
  - Anti-evasion rules to prevent back door redemption of prior shareholders
  - Active business requirement and bar on certain businesses (much of this list will be familiar as it was borrowed from a good part of §199A's SSTB rules)
  - Qualified small business (*must be a C corporation)*
  - Exclusion amounts

§199A – The Rules Example

EXAMPLE

Ascot Widgets and §1202 Gains

Let's have Kelly begin Ascot Widgets in 2011. At the time Kelly acquires her shares for full control of the brand new Ascot has nowhere near $50,000,000 of total assets (remember we assume she has no basis when she sells).

Here is our table of the operating years from 2011-2021 using maximum rates in place at the time:

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Income before taxes	25,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000
Tax on first $25,000	15%	15%	15%	15%	15%	15%	15%	21%	21%	21%
Federal income tax	3,750	3,750	3,750	3,750	3,750	3,750	3,750	5,250	5,250	5,250
Net after taxes	21,250	21,250	21,250	21,250	21,250	21,250	21,250	19,750	19,750	19,750
Individual tax rate										
Paid as salary	43.4%	43.4%	43.4%	43.4%	43.4%	43.4%	43.4%	41.2%	41.2%	41.2%
Passed through S corporation	39.6%	39.6%	39.6%	39.6%	39.6%	39.6%	39.6%	29.6%	29.6%	29.6%
Available at individual level										
Paid as salary	14,150	14,150	14,150	14,150	14,150	14,150	14,150	14,700	14,700	14,700
Passed through S corporation	15,100	15,100	15,100	15,100	15,100	15,100	15,100	17,600	17,600	17,600

The salary rate from 2011-2020 includes an additional 3.8% to account for the Medicare tax and additional Medicare tax on such salary. The pass-through rate for 2018-2020 assumes that Kelly gets a 20% deduction under §199A for the flow through income reported on her personal return.

§199A – The Rules Example

EXAMPLE

Sale of Ascot Widgets under 100% Exclusion of §1202 Stock Gain

Again we have a sale of the assets for $5,000,000 by the corporation, followed by a redemption of Kelly's stock. In this case the situation has now swung back in favor of the C corporation if a 100% §1202 exclusion applies when the stock is disposed of.

		S Corporation	
	C Corporation	K-1 Income	Salary
Total taxes operating years	42,000	106,850	158,500
Inside tax (at 21%)	1,050,000	-	-
2021 tax on sale (20%)	-	1,000,000	1,000,000
Total taxes paid	1,092,000	1,106,850	1,158,500

Elective Rollover Provision

- §1045 allows rollover of gain into new QSBS
- Useful mainly for:
  - Stock held:
    - More than 6 months but
    - Less then 5 years (no 100% exclusion) *or*
  - Pre-100% exclusion stock
- Making the election

Unit 5

Combination Planning in Action

Learning Objectives

When you have completed this unit, you will be able to accomplish the following.

- Describe how to balance brackets by using year-end control of deductions and/or income.
- Identify opportunities to handle both types of planning.
- Identify tax planning techniques post Tax Cuts and Jobs Act of 2017.

Year-End Planning/Balancing Brackets

- Standard part of CPA's life is the year-end meeting
- Often looking at actions to take prior to year end to affect date of:
  - Recognition of an item of income
  - Triggering of a deduction for tax purposes
- Done to do one or both:
  - Defer tax
  - Balance tax brackets

Unbalanced Income Example

EXAMPLE

Reducing Tax in First Year, Tax Disaster the Second

In the example with Wilma, the out of balance year was the first year in the bad scenario. But, in our push to lower the current year's tax we do need to take care that we don't shove so much income into the following year, that we create a tax disaster that is only slightly offset by time value of money concepts.

This time Wilma has $100,000 she is going to get in 2022, $200,000 in 2023 and then $100,000 she could get before the end of December if pushes her customer hard to pay, but likely won't come to her until 2023 if she follows her normal billing and collection practices. Figuring it's always best to delay the payment of tax, Wilma does not push to get paid by the end of the year.

Here is the tax result:

Delayed income disaster	2022	2023	Total
Taxable Income	100,000	300,000	400,000
Tax	18,175	80,194	98,369

Wilma initially feels good about the situation when she picks up her 2022 return—look how little she paid. But she has real sticker shock when she picks up her 2023 return.

Even using present value calculation to take into account the payment of the tax later. Assuming a 5% discount rate and, for simplicity, that the taxes are paid at the end of each year this scenario has taxes with a net present value of $87,030.53 at the beginning of 2022, vs. $81,933.96 if the income is split evenly.

Temporary Benefit Issue Example

EXAMPLE

Pay on Time, Expense Immediately

AM Trucking, Inc. was excited about the ability to immediately write off their equipment under the new bonus depreciation regime at the end of 2017. It was even better, since they could finance the purchase with little cash down and get an immediate write-off against their taxes. They were able to buy $3,000,000 of tractors late in the year, putting down $300,000.

However, during the following few years they found they hit a problem—they were paying back principal on the loans they had taken out and their accountant informed they could not take a deduction for these large payments. The only way to avoid paying tax on income in excess of the cash flow or, even better, not pay more tax than last year, is to buy another $3,000,000 worth of equipment, again borrowing $2,700,000.

They continue this, but when the economy slows down and it no longer makes sense to buy new equipment because they have no need for it, credit has become more difficult to obtain, and their cash flow has been extremely tight, they don't acquire equipment. Although they paid a significant on loan payments, much of it now represented non-deductible principal.

Now they feel they have not been properly advised, since they now owe tax with no cash available to pay the tax and when the business is deep in a down cycle.

Balancing Income – RMD Example

EXAMPLE

First Year Minimum Required Distribution

Robert hit his required beginning date this year. He will be required to take an initial distribution of $25,000 from his IRA by April 1 of the following year, but if he does so he will need to take his second distribution (which we will assume will also be $25,000) by the end of the following year. Assume Robert has no basis in his IRA account.

Robert is single and has taxable income of $95,000 before taking any IRA distributions. We will use 2022 tax brackets for these computations. Robert has a single filing status.

In 2022, $95,000 of taxable income places Robert in the 24% marginal tax bracket. The 32% bracket begins at taxable income of $170,050.

If Robert takes the first distribution by the end of 2022, his tax for the two years is projected to look like this:

First Distribution by 12/31	2022	2023	Total
Taxable Income	120,000	120,000	240,000
Tax	22,636	22,636	45,272

If, instead, Robert delays the distribution until after the first of the year, his tax for the tax year is projected to look like this:

First Distribution after 12/31	2022	2023	Total
Taxable Income	95,000	145,000	240,000
Tax	16,636	28,636	45,272

While the tax is identical, the majority of the tax is not paid until the following year. Thus, present value concepts would lead us to recommend that Robert save up the $6,000 he saves in 2022 and pay it over with his 2023 return.

Balancing Income – RMD Example

EXAMPLE

Taxable Income of $135,000 Before IRA Distribution

Assume Robert's taxable income before the IRA distribution is $135,000 for each year. Now there is a bump in tax if Robert allows the first distribution to spill into 2023.

Here are the tax computations when Bob takes his first distribution by the end of 2022:

First Distribution by 12/31	2022	2023	Total
Taxable Income	160,000	160,000	320,000
Tax	32,236	32,236	64,472

Compare this to the computation when Robert pushes the entire distribution into 2023:

First Distribution after 12/31	2022	2023	Total
Taxable Income	135,000	185,000	320,000
Tax	26,236	39,432	65,668

Note that Robert pays $1,196 of additional tax if he delays the distribution. Robert would need to earn over 20% from holding the $6,000 for an extra year to pay for that increase in tax. Given that rate of return is rather high, the time value of money benefit may not be enough to justify paying the extra tax.

Prepayment of Expenses – 12-Month Rule

- Generally have to capitalize payment if receive benefit beyond year end (Reg. §1.263(a)-4(d))
- Cannot simply prepay, even if on the cash basis, and deduct:
  - Next 3 years' rent
  - Next 2 years' insurance

Prepayment of Expenses Example

EXAMPLE

Improper Strategy for Paying Cash Basis Expenses

Natasha has an accounting firm which is having an exceptionally good year due to being paid substantial fees to assist a long time client in the sale of her business. While those fees were good news, Natasha knows that they won't recur in the future and, in fact, her revenues are likely to be substantially lower in the near future until she is able to replace the work she used to perform for the business that was sold.

Natasha decides to contact her tax research provider and comes to an agreement where she will pay the vendor a fee equal to five times the amount of her upcoming one year renewal payment in November. That payment will give her five years worth of access to the online research materials. She plans to claim the full deduction on her tax return in the current year to offset those extra high fees.

Natasha's plan will not work—under Reg. §1.263(a)-4(d)(3)(i) Natasha must capitalize the entire amount she paid for the five years of access and amortize the amount paid over the 60 months she has access to the materials.

Prepayment of Expenses Example

EXAMPLES

Prepaid Insurance Capitalization (Example 1 from Reg. §1.263(a)-4(d)(3(ii))

N corporation, an accrual method taxpayer, pays $10,000 to an insurer to obtain three years of coverage under a property and casualty insurance policy. The $10,000 is a prepaid expense and must be capitalized.

Prepaid Rent Capitalization (Example 2 from Reg. §1.263(a)-4(d)(3(ii))

X corporation, a cash method taxpayer, enters into a 24-month lease of office space. At the time of the lease signing, X prepays $240,000. No other amounts are due under the lease. The $240,000 is a prepaid expense and must be capitalized.

12-Month Rule for Intangibles

- Generally don't have to capitalize if right or benefit does not extend beyond the earlier of:
  - 12 months after first date realizes a benefit *or*
  - End of the taxable year immediately after the year of payment
- Must look at renewals in determining time period

12-Month Rule Example

EXAMPLE

Prepaid for One Year Term Beginning After Year End

Lauren pays for the liability insurance for her unincorporated business on November 1. She files on the calendar year for tax purposes. The policy covers a one year period beginning on February 1 of the following year.

Although the policy covers no more than 12 months, because the coverage does not begin until February of the following year, the benefit that Lauren receives from the payment extends past the end of the tax year following the year she paid the premium.

Thus, Lauren does not qualify for the 12-month rule allowing immediate expensing of the payment under Reg. §1.263(a)-4(f). She will not be able to claim any deduction for the year of payment, and will only be able to deduct 10/12 of the premium on her return for the following year.

12-Month Rule Example

EXAMPLE

Contract for 13 Months When Benefit First Received

Assume Lauren's insurance coverage had expired on November 1. She decided to convert to a calendar year policy and paid for 14 months of coverage on November 1. Although only 12 months remains on the contract at year end, so the benefits do not extend beyond the end of the following tax year, 12/14 of the amount paid must be capitalized at year end and deducted in the following year.

In this case, Lauren violated the requirement that there be no more than 12 months covered by the contract based on the first day she received benefits. In this case, she received benefits over 14 months, so the majority of the payment must be capitalized.

Roth Conversions

- Roth IRA conversions
  - Distribute from regular, roll to Roth
  - Direct custodian-to-custodian transfer to Roth from regular IRA
  - Have custodian simply move to Roth account

Roth Conversions

- Roth IRA conversions
  - Math of the Roth IRA
    - Perfect balance situation (a matter of indifference)
      - Put $6,500 in regular IRA
      - Put $4,550 in Roth IRA ($6,500 less $1,950 tax)

Regular IRA Distributions

Year	Beginning Balance	Earnings	Distribute 1/10	Ending Balance	Tax	After Tax
1	25,153	1,585	(2,515)	24,223	755	1,760
2	24,223	1,507	(2,691)	23,039	807	1,884
3	23,039	1,411	(2,880)	21,570	864	2,016
4	21,570	1,294	(3,081)	19,783	924	2,157
5	19,783	1,154	(3,297)	17,640	989	2,308
6	17,640	988	(3,528)	15,100	1,058	2,470
7	15,100	793	(3,775)	12,118	1,133	2,642
8	12,118	566	(4,039)	8,645	1,212	2,827
9	8,645	303	(4,323)	4,625	1,297	3,026
10	4,625	0	(4,625)	0	1,388	3,237

Roth IRA Distributions

Year	Beginning Balance	Earnings	Distribute 1/10	Ending Balance	Tax	After Tax
1	17,607	1,109	(1,761)	16,955	0	1,761
2	16,955	1,055	(1,884)	16,126	0	1,884
3	16,126	988	(2,016)	15,098	0	2,016
4	15,098	906	(2,157)	13,847	0	2,157
5	13,847	808	(2,308)	12,347	0	2,308
6	12,347	691	(2,469)	10,569	0	2,469
7	10,569	555	(2,642)	8,482	0	2,642
8	8,482	396	(2,827)	6,051	0	2,827
9	6,051	212	(3,026)	3,237	0	3,026
10	3,237	0	(3,237)	0	0	3,237

Roth Conversions

- Roth IRA conversions
  - Math of the Roth IRA
    - Economically larger contributions (effectively putting the tax amount into the Roth)

Roth IRA – More Goes In

Year	Beginning Balance	Earnings	Distribute 1/10	Ending Balance	Tax	After Tax
1	25,153	1,585	(2,515)	24,223	0	2,515
2	24,223	1,507	(2,691)	23,039	0	2,691
3	23,039	1,411	(2,880)	21,570	0	2,880
4	21,570	1,294	(3,081)	19,783	0	3,081
5	19,783	1,154	(3,297)	17,640	0	3,297
6	17,640	988	(3,528)	15,100	0	3,528
7	15,100	793	(3,775)	12,118	0	3,775
8	12,118	566	(4,039)	8,645	0	4,039
9	8,645	303	(4,323)	4,625	0	4,323
10	4,625	0	(4,625)	0	0	4,625

Roth Conversions

- Roth IRA conversions
  - Math of the Roth IRA
    - Distributions and the Roth IRA

Traditional IRA RMDs

Age	Beginning Balance	Earnings	RMD Factor	Distribute RMD	Ending Balance
72	500,000	33,723	27.4	(18,248)	515,502
73	515,502	34,723	26.5	(19,453)	530,799
74	530,799	35,705	25.6	(20,734)	545,796
75	545,796	36,659	24.7	(22,097)	560,382
76	560,382	37,579	23.8	(23,545)	574,440
77	574,440	38,455	22.9	(25,085)	587,833
78	587,833	39,278	22.0	(26,720)	600,413
79	600,413	40,046	21.2	(28,321)	612,159
80	612,159	40,740	20.3	(30,156)	622,763
81	622,763	41,358	19.5	(31,937)	632,204
82	632,204	41,888	18.7	(33,808)	640,303
83	640,303	42,317	17.9	(35,771)	646,867
84	646,867	42,633	17.1	(37,828)	651,689
85	651,689	42,820	16.3	(39,981)	654,544
86	654,544	42,862	15.5	(42,229)	655,192
87	655,192	42,765	14.8	(44,270)	653,702
88	653,702	42,514	14.1	(46,362)	649,868
89	649,868	42,096	13.4	(48,498)	643,480
90	643,480	41,497	12.7	(50,668)	634,321
91	634,321	40,702	12.0	(52,860)	622,175
92	622,175	39,732	11.4	(54,577)	607,342

Roth IRA – No RMDs

Age	Beginning Balance	Earnings	RMD Factor	Distribute RMD	Ending Balance
72	500,000	35,000	None	0	535,000
73	535,000	37,450	None	0	572,450
74	572,450	40,072	None	0	612,522
75	612,522	42,877	None	0	655,399
76	655,399	45,878	None	0	701,277
77	701,277	49,089	None	0	750,366
78	750,366	52,526	None	0	802,892
79	802,892	56,202	None	0	859,094
80	859,094	60,137	None	0	919,231
81	919,231	64,346	None	0	983,577
82	983,577	68,850	None	0	1,052,427
83	1,052,427	73,670	None	0	1,126,097
84	1,126,097	78,827	None	0	1,204,924
85	1,204,924	84,345	None	0	1,289,269
86	1,289,269	90,249	None	0	1,379,518
87	1,379,518	96,566	None	0	1,476,084
88	1,476,084	103,326	None	0	1,579,410
89	1,579,410	110,559	None	0	1,689,969
90	1,689,969	118,298	None	0	1,808,267
91	1,808,267	126,579	None	0	1,934,846
92	1,934,846	135,439	None	0	2,070,285

Roth IRA – No RMDs, Lower Start

Age	Beginning Balance	Earnings	RMD Factor	Distribute RMD	Ending Balance
72	350,000	24,500	None	0	374,500
73	374,500	26,215	None	0	400,715
74	400,715	28,050	None	0	428,765
75	428,765	30,014	None	0	458,779
76	458,779	32,115	None	0	490,894
77	490,894	34,363	None	0	525,257
78	525,257	36,768	None	0	562,025
79	562,025	39,342	None	0	601,367
80	601,367	42,096	None	0	643,463
81	643,463	45,042	None	0	688,505
82	688,505	48,195	None	0	736,700
83	736,700	51,569	None	0	788,269
84	788,269	55,179	None	0	843,448
85	843,448	59,041	None	0	902,489
86	902,489	63,174	None	0	965,663
87	965,663	67,596	None	0	1,033,259
88	1,033,259	72,328	None	0	1,105,587
89	1,105,587	77,391	None	0	1,182,978
90	1,182,978	82,808	None	0	1,265,786
91	1,265,786	88,605	None	0	1,354,391
92	1,354,391	94,807	None	0	1,449,198

Roth Conversions

- Roth IRA conversions
  - Conversion of Roth IRA to traditional IRAs
    - Math looks great in many cases but…
    - Paying the up-front tax is a tough pill for most clients to swallow
  - Back door Roth IRA conversion – IRS is OK with it???

Back Door Roth IRA Conversion Example

EXAMPLE

Back Door Roth IRA Contribution

Troy and Tory are married and have adjusted gross income of $380,000. They are both covered by qualified retirement plans. Neither currently has a traditional IRA. Both are currently age 40. They are interested in making additional retirement contributions, but their research on the internet has indicated they can only make a nondeductible traditional IRA contribution.

You advise them that this is true, but can get rid of the tax on the earnings which would normally apply to a traditional IRA with basis if we do a "back door" Roth conversion. After Troy and Tory make a contribution of $6,000 each to their traditional IRAs, the balance is then converted to a Roth IRA after waiting few days.

Assuming the IRA have not had earnings over that time period, the conversion will take place without tax. They will have converted 100% of their traditional IRAs and, as such, will be able to use 100% of that basis in computing the taxable portion of the conversion. Since basis = cash out balance at this point, no tax is due. Thus, they will have moved $12,000 into Roth IRAs by using the back door technique.

SECURE Act Reverses 2017 Tax Cuts and Jobs Act / Kiddie Tax

- Covered individuals
- Definition of unearned income
- Planning options
  - Paying earned income
  - Growth stocks until age out
  - Investing in tax-deferred investments
  - Use up the kiddie tax base each year

Opportunities for Planning

- Sale of a business
- Employment contract negotiation
- Divorce (with one HUGE caveat)
- Business formation

Tax Planning – Post TCJA

- Capital gains
  - Long-term capital gains
- Charitable
  - Bunching
  - Appreciated property
- Section 199A
  - Aggregation

Tax Planning – Post TCJA Example – Aggregation

A taxpayer has exceeded the threshold limit of QBI of $200 each from two trades or businesses *A* and *B*. *A* has $100 of W-2 wages, and *B* has $40 of W-2 wages. Neither *A* nor *B* owns any qualified property. If the QBI deduction is calculated separately for *A* and *B*, *A* would have a QBI deduction of $40, since 50% of W-2 wages ($50) exceeds 20% of QBI ($40). *B* would receive a QBI deduction of $20, since 50% of W-2 wages ($20) is less than 20% of QBI ($40). Thus, the total QBI deduction for both *A* and *B* is $60 ($40 for *A* + $20 for *B*). If *A* and *B* were aggregated, the total QBI of the combined trade or business would be $400, and the total W-2 wages would be $140. The QBI deduction for the aggregated group would be $70, since 50% of the W-2 wages ($70) is lower than 20% of the QBI of the combined group ($80). Aggregation of *A* and *B* results in a net increase to the QBI deduction of $20 over not aggregating the businesses.

Tax Planning – Post TCJA

- Bonus depreciation
  - The new law increases the bonus depreciation percentage from 50% to 100% for qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023.
- Section 179
  - For tax years beginning after 2017, the TCJA increased the maximum Section 179 expense deduction from $500,000 to $1 million. The phaseout limit increased from $2 million to $2.5 million. These amounts are indexed for inflation for tax years beginning after 2018.

Unit 6

Tax Planning Based on the SECURE Act of 2019, CARES Act of 2020, and CAA of 2021

Learning Objectives

When you have completed this unit, you will be able to accomplish the following.

- Describe additional tax planning strategies related to the SECURE Act.
- Explain tax planning strategies related to the CARES Act.
- Explain tax planning strategies related to the CAA.

Retirement Planning

- The threshold for the retirement plans has increased. This increase has been reflected in an earlier chapter.
- The conversion of a traditional IRA to a Roth IRA has been in existence before the SECURE Act. Additional provisions provide for tax planning opportunities for IRA Roth conversions.
- The SECURE Act now ensures that most nonspouse beneficiaries of inherited IRAs and qualified plans must distribute the account balance within 10 years. In the case of a traditional IRA, most distributions will occur perhaps in the prime of the receiver’s life, thus piling up more taxes for them.

Retirement Planning

- Tax Planning
  - Consider
    - Lower current tax rates
    - Pandemic year 2020 and any future lower income years
    - Reduction in taxes to beneficiary on inherited IRA

Health Savings Accounts (HSA/Flexible Spending Accounts [FSA])

- HSAs/FSAs are pretax deductions. The annual deduction for the family in 2022 is $7,300 (single $3,650).
- There is a catch-up of $1,000 for individuals age 55 and above.
- The CARES Act expanded on various items that qualify as medical deductions. It permanently reinstates over-the-counter medical products as eligible expenses for FSAs, certain Health Reimbursement Accounts (HRAs) and HSAs without a prescription.
- HSAs are no longer “use it or lose it.”
- The CAA allows the entire balance of unused funds to be carried from 2020 to 2021 and 2021 to 2022.
- Carryover flexibility applies to health and dependent care FSAs.

Health Savings Accounts (HSA/Flexible Spending Accounts [FSA])

- Tax Planning
  - Advantage of FSA/HSA
  - Not impacted based on underspending in 2020 and 2021 years

Charitable Donations

In 2020, the CARES Act increased the threshold of cash donations to 100% of AGI from the 60% deduction. Even though there is an increase in the threshold, the client may not benefit from this CARES Act provision because of the increase in the standard deduction amount from the TCJA. The standard deduction is indexed for inflation.

Charitable Donations

Tax Planning

- If a client itemizes, the client should consider setting up a donor-advised fund as a tax planning strategy. The donor-advised fund allows the client to bunch donations in one year and take a standard deduction in another year.

Coronavirus-Related Distribution

- There are special rules for distributions made to an individual:
  - who is diagnosed with COVID-19,
  - whose spouse is diagnosed with COVID-19,
  - whose dependent is diagnosed with COVID-19, or
  - who experienced changes in financial circumstances as a result of COVID-19, such as
    - reduction in hours,
    - layoff,
    - furlough, or
    - losing childcare.
- Distributions made up to 100% are not subject to the 10% early withdrawal nor 20% withholding.
- Income can be spread over 3 years from the year of receipt of lump sum.
- Recontributing is allowed but not required. The recontribution must be made within a period of 3 years from the date of distribution.

Coronavirus-Related Distribution Example

S is a qualifying individual. S received $60,000 qualifying distributions. S can choose to report the entire $60,000 in the year of receipt (2020) or report $20,000 each year (2020, 2021, and 2022).

Coronavirus-Related Distribution

Tax Planning

- The CPA should advise the client on when to include the qualifying distribution as income.
- The client may have a lower income in 2020 as a result of the pandemic.

Net Operating Loss (NOL)

- Under the CARES Act:
  - An NOL from a tax year beginning in 2018, 2019, or 2020 can be carried back 5 years.
  - Carryback is not required for 2018, 2019, and 2020 NOLs.
  - Taxpayers that carry back NOLs must use the entire five-year carryback period.
  - The provision expires for tax years beginning in 2021.
  - NOLs generated in 2018, 2019, and 2020 are subject to the TCJA 80%-of-income limitation if carried forward to a year in which the limitation applies (such as tax years beginning after 2020).
  - NOLs generated in 2018, 2019, and 2020 are not subject to the 80%-of-income limitation if claimed completely during the five-year carryback period during 2018, 2019, or 2020.

Net Operating Loss (NOL) Example

- M, Inc., is an accrual-method C corporation. It expects to have $3 million of taxable income in 2019 and $0 taxable income in 2020. M's projections assume it will defer recognizing income associated with a one-time prepayment of $1 million received in 2019 for services to be performed in 2020 under the deferral method based on Section 451(c). If M, based on Rev. Proc. 2004-34, uses the full inclusion method instead, M will have $4 million of taxable income in 2019 (subject to tax at a 21% rate) and a $1 million NOL in 2020 that can be carried back to offset income in 2015 (subject to tax at a 35% rate).
- The tax shifting, which will result in additional tax savings because the tax rate in 2019 is 21% whereas the rate in 2015 is 35%, will result in the following tax savings: $1,000,000 × 35% = 350,000, less $1,000,000 × 21% = $140,000.

Net Operating Loss (NOL)

Tax Planning

- The CPA should work with the client to understand the tax implications of carrying back the NOL to the 5 years to ensure the client has the maximum benefit of the NOL carryback. The NOL carryback provisions are not a requirement but an incentive. Thus, the CPA would need to see if this provision is beneficial to the client.

Excess Business Loss Limitation Delayed

- The CARES Act delayed the effective date of the business loss limitation to the years after December 31, 2020. The American Rescue Plan Act of 2021 extended this provision for one year, through 2026.
- Section 461(l) placed a limitation on the amount of trade or business losses that can be deducted by a taxpayer to $250,000 for a single taxpayer ($500,000 for a joint return) based on the TCJA 2017.

Excess Business Loss Limitation Delayed

Tax Planning

- The CPA can file an amended return to create a tax refund for 2018 and 2019. If an NOL is created as a result of this amendment, the NOL rules apply under the CARES Act and the taxpayer can therefore carry back the NOL over a period of 5 years.

C Corporation Alternative Minimum Tax (AMT) Credits

- When AMT was repealed under the TCJA, C Corporations were allowed to claim the refundable credits over a period of 4 tax years beginning in 2018, 2019, 2020, and 2021.
- The CARES Act provides that the C corporations can claim the credits:
  - fully in tax years beginning in 2018 and 2019 or
  - choose to claim 50% in 2018 and the balance in 2019.
    - To claim the full credit in 2018, the taxpayer must either file an amended return for 2018 or file for a tentative refund on Form 1139.

C Corporation Alternative Minimum Tax (AMT) Credits

Tax Planning

- The CPA should confirm if claiming the credit will work best for the client at 50% for 2018 or 100% for 2018 by assessing income levels and the client's objective.

Exclusion of Student Loan Repayment

- The CARES Act allows employers to make student loans up to $5,250 between 03/27/20–12/31/20.
- The payment is not taxable to the employee and is deductible to the employer under IRC 127.
- The CAA expanded eligible expenses to include loan repayment assistance.
- The threshold still remains at $5,250. The CAA extends the payment to year 2025. The American Rescue Plan Act of 2021 provides that gross income does not include income from the debt discharge after 2020 and before 2026.
- The loans do not need to be related to the employee's employment with the employer and may have been incurred prior to the employment relationship.

Exclusion of Student Loan Repayment

- The employer’s program must obtain expense substantiation and:
  - not discriminate in favor of highly compensated employees and perform nondiscrimination testing;
  - pay no more than 5% of amounts to individuals who are shareholders or owners;
  - have a written plan document describing the group of eligible employees, the types of benefits offered, and a statement that employees cannot choose between the benefit and cash compensation; and
  - provide notice to employees that the benefit exists.

Exclusion of Student Loan Repayment

- Tax Planning
  - Many employers are business owners; this option is in addition to the deductible amount of student loan interest on personal tax returns.
  - An additional benefit to employers is that this provision helps to retain staff. The cost of employing new staff cannot be overemphasized.
  - Staff retention is an additional way to reduce cost.

Bonus Depreciation on Qualified Improvement Property (QIP)

- Tax Planning
  - The CPA can advise the client to file an amended return to take advantage of the increased depreciation expense or can file a Form 3115 to change the accounting method. An increased depreciation deduction reduces the client's tax liability and can lead to a refund.

Bonus Depreciation on Qualified Improvement Property (QIP)

- The CARES Act includes a provision for qualified improvement property (QIP), which was left out in the TCJA.
- The CARES Act now allows QIP to qualify for 15-year depreciation and therefore also be eligible for 100% first-year bonus depreciation.
- The change is retroactive to QIP placed in service on or after January 1, 2018.
- QIP is defined as a Section 1250 property relating to an internal structural improvement of nonresidential property. Exclusions apply.

UNIT 7

Other Tax Planning Opportunities

KAPLAN

Learning Objectives

When you have completed this unit, you will be able to accomplish the following.

- Identify additional tax planning opportunities beyond deferral and conversion.
- Recall various CPA's responsibility in these tax planning opportunities.

§1244 Small Business Stock

- A section 1244 stock is a stock market loss that allows stock owners to claim losses from the sales of shares in small companies as regular losses rather than capital losses. Individual stock owners can claim losses of up to $50,000, and couples may claim up to $100,000 (this is unlike capital losses, which are subject to an annual deduction limit of only $3,000).

§1244 Small Business Stock

To qualify as a small business stock the following conditions must be met:

- The corporation must be a domestic corporation
- Dollar threshold
- The stock must be issued in exchange for cash or other property (other than stock and securities)
- Shareholders must have bought and paid for the stocks themselves
- The stock can be either common or preferred, provided the preferred stock was issued after July 18, 1984
- The corporation must meet the gross receipts test

§1244 Small Business Stock

Tax Planning

- To benefit from the Section 1244 stock treatment, the CPA should ensure that any stock purchased falls within the requirements of section 1244 stock.

Choice of Entity

Type of Entity can determine the tax liability of a client.

- Sole proprietorship
- Partnership
- Limited Liability Company
- S Corp
- C Corp

Choice of Entity: Tax Planning

Tax Planning

As much as possible, the CPA should assist the client in choosing their business structure. In doing so, the CPA should listen to the objective of the client.

For example,

If Jason is a US citizen and he plans to start a clothing business JY Clothing which he wants to get into the global market, perhaps Australia. To encourage entry into the Australian market, he decides to include an Australian as a shareholder. Although an S Corporation has many tax advantages, JY Clothing will not qualify as an S Corporation because it has a nonresident alien as its shareholder.

Choice of Entity: Passive Activity Losses

- Another planning opportunity for Choice of Entity is the availability passive activity limitations. IRC section 469 states that passive activity losses can only be deducted against passive activity gains. This applies when the taxpayer has a business that is a flow through entity. If the business has a high level of passive activity the better option for the taxpayer is a C Corporation. The passive activity limitation rules do not apply to C Corporation.

Gift Splitting

- Annual exemption 2022, $16,000
- Lifetime unified credit 2022, $12,060,000
- Consent Required for Gift splitting
- Last surviving spouse rule

Gift Splitting-Tax Planning

The CPA should ensure the client is aware of the availability of the gift-splitting provision, the CPA should file the Form 709 on a timely basis. The CPA must also note that if the client and the spouse divorces prior to filing their taxes for the year the gift took place, neither spouse can be remarried for gift splitting to qualify.

Alternative Valuation Date Election

- The election gives relief to estates where the asset value declines from the date of death of the taxpayer to the date of payment of the tax liability If the executor makes this election, the election will apply to all assets of the estate. If the election is made, all assets are valued, either 6 months after death or on the date of disposition, whichever is earlier,
- To qualify for this election, the election must decrease the value of the estate and the estate tax liability.

Alternative Valuation Date Election: Tax Planning

The CPA should assess the value of the decedent's estate to determine if the estate will be in a better position when the alternative valuation election was made. If the estate is in a better position, the CPA can reduce the tax liability.

Deceased Spouse Unused Exemption (DSUE)

IRC section 2010 allows for portability. Portability allows the deceased spouse's unused exemption (DSUE) to pass to the surviving spouse thus increasing the surviving spouses' unified exemption amount.

Deceased Spouse Unused Exemption (DSUE): Tax Planning

- Portability of the DSUE is not automatic. The CPA should ensure that the estate tax return is timely and properly filed when the first spouse passes away. If the election is not made, the estate loses the DSUE when the surviving spouse dies.
- Note last surviving spouse rule

Unit 8

Tax Practice and Professional Standards

KAPLAN

Learning Objectives

When you have completed this unit, you will be able to accomplish the following.

- Describe the relevant professional standards that apply to tax advice and signing returns.
- Identify and explain penalties that may apply to clients when the IRS challenges a strategy.

Signing and Advice Standards

	Internal Revenue Code		Circular 230	AICPA SSTS
	§6662 (Taxpayer)	§6694 (Preparer)		
More Likely Than Not	Tax Shelter	Tax Shelter	Tax Shelter	Tax Shelter (See Note)**
Substantial Authority	No Disclosure	No Disclosure	No Disclosure	See Note**
Realistic Possibility				No Disclosure*
Reasonable Basis	Disclosed	Disclosed	Disclosed	Disclosed
Not Frivolous	**No longer available under any applicable standard**			

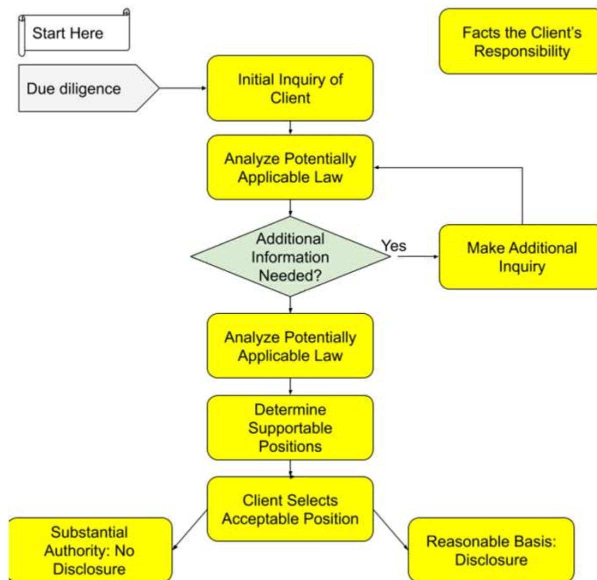
* Only if no higher taxing authority standard

** Effective federal income tax return standard

Return Position Standards

- Substantial authority (no disclosure needed)
- More likely than not (tax shelters)
- Realistic possibility of success (AICPA 1 in 3—NOT available for federal taxes)
- Reasonable basis (disclosure required; cannot sign if do not meet at least this standard)
- Not frivolous (removed from the rules in 2007—no longer can sign return that only meets this standard)

CPA's Responsibilities



Applicable AICPA SSTSs

- SSTS No. 1 – Tax Return Positions
  - Interpretation 1 – Realistic Possibility Standard
  - Interpretation 2 – Tax Planning
- SSTS No. 7 – Form and Content of Advice to Clients

Accuracy-Related Penalty

- Substantial understatement of tax—20% penalty unless:
  - Substantial authority for position or
  - Reasonable cause for understatement
    - Opinion shopping does not give reasonable basis
    - Reasonable reliance on advice of a professional does

Preparer Penalties (§6694)

- Penalty on the preparer (of return or position)
- Amount of penalty
  - General penalty
  - Willful or reckless conduct
- Returns covered by the penalty

Other Preparer-Related Penalties

- **IRC §6700 – Promoting abusive tax shelters**
  - The penalty is for a promoter of an abusive tax shelter and is generally equal to $1,000 for each organization or sale of an abusive plan or arrangement (or, if lesser, 100% of the income derived from the activity).
- **IRC §6701 – Penalties for aiding and abetting understatement of tax liability**
  - The penalty is $1,000 ($10,000 if the conduct relates to a corporation's tax return) for aiding and abetting in an understatement of a tax liability. Any person subject to the penalty shall be penalized only once for documents relating to the same taxpayer for a single tax period or event.

Other Preparer-Related Penalties

- **IRC §7206 – Fraud and false statements**
  - Guilty of a felony and, upon conviction, a fine of not more than $100,000 ($500,000 in the case of a corporation), imprisonment of not more than 3 years, or both (together with the costs of prosecution).
- **IRC §7207 – Fraudulent returns, statements, or other documents**
  - Guilty of a misdemeanor and, upon conviction, a fine of not more than $10,000 ($50,000 in the case of a corporation), imprisonment of not more than 1 year, or both.

IRC Section 7206 vs. 7207

- There are cases where the tax preparer may want to claim that the act of fraud and false statements falls under IRC Section 7207 instead of IRC Section 7206. Section 7206 is a felony, while IRC Section 7207 is a misdemeanor. In *United States v. Bishop*, 412 U.S. 346 (1973), the court held that the word "willfully" has the same meaning in §§ 7206(1) and 7207, connoting the voluntary, intentional violation of a known legal duty, and the distinction between the statutes is based on the additional misconduct, which is essential to the violation of the felony provision; based on this fact, the district court properly refused the lesser charge.
- CPAs must ensure they are not exposed to any legal action for their negligence and that they are not involved in any fraudulent activity.

Integrity and Objectivity

- ET Section 2.100.001
  - Objectivity is a requirement
  - Freedom from influences that bring into question professional objectivity
- Conflict of interest
  - ET Section 2.110 and Circular 230 §10.29
  - *Appearance* of a conflict *is* a conflict (can't rationalize it away)

Conflict of Interest Example

Joe and Mary are getting divorced. Harry has been the couple's tax adviser for many years, but he primarily worked with Joe. When he would ask Mary about issues, she would respond that she really didn't like to deal with this sort of thing and that Harry would need to ask Joe.

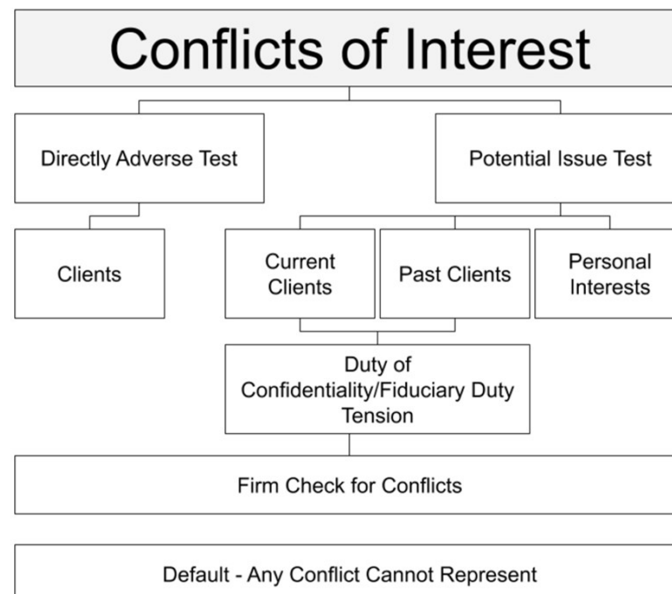
Both Joe and Mary want Harry to continue to be their individual tax advisers, but Joe demands that Harry not talk with Mary about tax matters related to taxation of alimony and the impact of any property settlement, including who will receive their burned out tax shelters that are about to fail. However, Joe does want Harry to tell him how to arrange such items to reduce his tax.

Mary is aware of this restriction and Joe's demands, but she tells Harry she is fine with this limitation. Despite Mary's claim that she is fine with the arrangement, Harry cannot provide the services. In reality, he likely cannot work with either party because even if he has Mary go elsewhere, his prior year responsibilities to her will likely run afoul of Joe's view of what his tax adviser should do in the divorce.

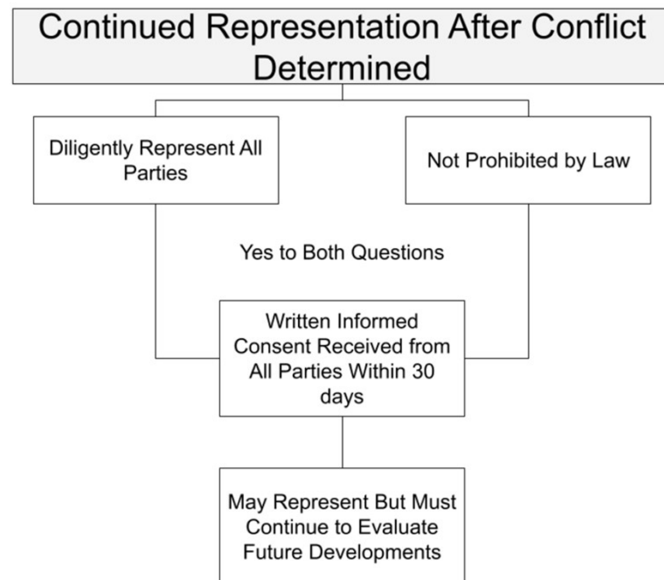
Conflict of Interest

- AICPA has list of specific conflict issues
- Do you have a conflict?
  - Responsibility to another party?
  - Personal interests?
- If yes:
  - Can you perform as if no conflict?
  - Do affected parties consent?

Conflict of Interest Chart



Continued Representation



Reminders

- **Post event evaluation:** Please complete the course evaluation that will be viewable once the session ends. We welcome your feedback!

KAPLAN