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TAX WITH SAX: Q4 MAJOR UPDATES

December 8, 2021

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Before making any decision or taking any action, you should consult a professional adviser who has been provided with all pertinent facts relevant to your particular situation.

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HOUSEKEEPING ITEMS

Meet Our Presenters

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Today’s Agenda

- An overview of provisions of the Build Back Better Act, and how to best plan for potential tax changes
- IRS’s new guidance surrounding PPP forgiveness
- An overview of where we are today with gifting and estate planning
- States' transition to entity level elections

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Poll #1

Year-End Income Tax Planning

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Income Tax Planning Matrix

	Accelerate Timing	Defer Timing
Gross Income/Gains	• Elect out of Installment Method • Change Method of Accounting • Harvest Gains	• 1031 Exchange • Opportunity Zones • Change Method of Accounting • Deferred Compensation
Expenses/Losses	• Cost Segregation Study • Recurring Item Exception • Harvest Losses • Accelerate Capital Expenditures • De Minimis Election	• Age Payables • Delay Capital Expenditures

Income Tax Planning

- Section 163(j) (Interest Expense)
  - Interest Expense – Deductible up to 30% of ATI
  - 2021 Small Business Exception - $26MM
  - Tax Shelters Not Eligible (35% of Losses to Limited Partners or Limited Entrepreneurs)
- Section 199A (QBI)
  - United States and Puerto Rico Sourced Income
  - Specified Service Business – Phase Out for “High Earners”
  - Not a Specified Service Business – Deduction is Lesser of:
    - Qualified Business Income x 20% OR the Greater of:
      - W-2 Wages x 50%
      - W-2 Wages x 25% + 2.5% of Unadjusted Basis of Qualified Property

Income Tax Planning

<u>Review Methods of Accounting</u>

- Cash vs. Accrual
  - Cash Method – Small Business Rule
    - 2021 Tax Year – Under $26MM
    - 2022 Tax Year – Under $27MM
  - Cash Method – Timing of Receipts and Disbursements
    - Postponement of Billings
    - Acceleration of Deductible Expenditures
  - Accrual Method
    - Recurring Item Exception
    - Unrecorded Liabilities

Income Tax Planning

Depreciation and Capital Expenditures

- Section 179
  - Maximum Expense - $1,050,000
  - Phase Out Begins - $2,620,000
  - Review State Rules for Non-Conformity
- Bonus Depreciation
  - Property with Recovery Period of 20 Years or Less
    - 2021 Tax Year – 100% Deduction
    - 2022 Tax Year – 100% Deduction
    - 2023 and Beyond – Annual 20% Downward Adjustment
- De Minimis Safe Harbor Election
  - Annual Election
  - $2,500 Safe Harbor (w/o Applicable Financial Statement)
  - $5,000 Safe Harbor (with Applicable Financial Statement)

Income Tax Planning

Basis and At-Risk Limitation

- Review Pass-Through Entity Basis
- Partnership
  - Conversion to Partnership Tax Basis Capital Reporting (Review 2020 Computation)
  - Exempt Income Increase Basis, etc.
  - Understand Client Liabilities
    - Recourse
    - Qualified Non-Recourse
    - Non-Recourse
- S Corporation
  - Exempt Income Increase Basis, etc.
  - Proper Classification of Shareholder Loans

Income Tax Planning

Passive Activity Loss Limitation

- Real Estate Professional
  - 750 “Real Estate” Hours
  - Greater than half of All Service Hours Rendered During the Year
- Non-Passive vs. Passive
  - Keep Track of Your Service Hours by Activity

Build Back Better Overview

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Build Back Better – Overview

Net Investment Income Tax (NIIT)

- NIIT on Trade or Business Income
  - Married Filing Jointly (MFJ) – Taxable Income > $500,000
  - Non-MFJ – Taxable Income > $400,000
  - Non-Grantor Trust or Estate – Taxable Income > $13,050
- Limit on Excess Business Losses
  - Net Business Loss Disallowed
  - Carried Forward
- Surcharge on High Income Individuals, Estate and Trusts
  - MFJ – 5% on Excess of AGI over $10,000,000 + 3% on Excess of AGI over $25,000,000
  - Non-Grantor Trust or Estate – 5% on Excess of AGI over $200,000 + 3% on Excess of AGI over $500,000

Build Back Better – Overview (cont'd)

Corporate Alternative Minimum Tax (AMT)

- 15% of Adjusted Financial Statement Income (AFSI)
- AFSI add/less Modifications
- For Tax Years Beginning after December 31, 2022
- For Corporations that Report Over $1B in Profits to Shareholders

Excise Tax on Repurchase of Corporate Stock

- Tax = 1% of Value of Repurchase
- For Repurchases after December 31, 2022
- For Stock Traded on an Established Securities Market

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Poll #2

Paycheck Protection Program Updates

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Paycheck Protection Program: IRS Guidance

Paycheck Protection Program (PPP) Loan Forgiveness

- PPP First Draw
- PPP Second Draw

Significant Unanswered Question

- Timing of Tax Basis Recognition
  - Division N, Sec. 276 of the Consolidated Appropriations Act provided that borrowers would receive tax basis for the forgiven funds
  - Question was when would the borrowers receive basis?
- We now have an answer due to the three Revenue Procedures issued in November 2021

Paycheck Protection Program: IRS Guidance

Rev. Proc. 2021-48

- Taxpayers may treat the tax-exempt income associated with forgiven PPP loans as received or accrued:
  - As eligible expenses are paid or incurred; or
  - When the PPP loan forgiveness application is filed; or
  - When PPP loan forgiveness is granted
- Also included guidance for filing amended returns where partial forgiveness is achieved, as well as timing surrounding the recognition of gross receipts

Rev. Proc. 2021-49

- Provides support for the treatment of tax-exempt income from forgiven PPP loans, grant proceeds and/or subsidized payment of certain principal, interest and fees for partnerships and consolidated groups
  - **Partnerships**: IRC Sec. 704(b) allocations and IRC Sec. 705 tax basis adjustments
  - **Consolidated Groups**: IRC Sec. 1502 subsidiary basis adjustments

Paycheck Protection Program: IRS Guidance

Rev. Proc. 2021-50

- Allows partnerships that are subject to the centralized partnership audit regime that apply the provisions of Rev. Proc. 2021-48 and Rev. Proc. 2021-49 to file amended returns for taxable years ending after March 27, 2020.
- Amended returns must be filed, and the corresponding Schedules K-1 must be furnished, on or before December 31, 2021.

Estate and Gift Taxes

Estate / Gift Taxes: Current Situation

- 2021 Exemption is $11.7 million per person ($23.4 mil per couple)
- Appears that 2022 Exemption will be $12.06 million per person ($24.12 mil per couple)
- Exemption is the aggregate amount that can be given away during lifetime and at death
- Under current law, this exemption will be automatically reduced in 2026

What to do NOW

- If planning made sense before, it probably still makes sense now
  - Asset protection from creditors for beneficiaries
  - Exemption still dropping effective 2026 unless Congress agrees to change
- Build Back Better includes provisions that will change fiduciary income tax rates
  - Surcharge of 5% on income over $200k and 8% on income over $500k
  - Charitable contributions can only be deducted if trust instrument includes specific powers
  - Different opportunities must be considered in the drafting process

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Poll #3

States’ Transition to Entity Level Elections

Multistate Partnership-Level Tax Elections:

Benefits and Pitfalls

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States’ Transition to Entity Level Elections

- Over the last two years, states have moved to allow pass-through entities to elect to be taxed at the entity level (i.e. the entity-level tax regime)
  - The typical multistate M.O. is that one or two states start a trend, then that trend catches on and flourishes nationally
  - This regime is intended to help the state’s residents avoid the $10,000 state and local tax deduction limitation enacted by the Tax Cuts and Jobs Act (TCJA)
  - The legislation varies across states (as usual), and in most cases, the operative provisions are not well thought-out; leaving a host of questions and issues

States’ Transition to Entity Level Elections

- From a big picture perspective - As of now (2021), 23 states tax pass-throughs at the entity level
  - Of the 23 states, 4 states tax pass-throughs at the entity level as standard practice: CT, DC, NH, and TN
  - There is not much to discuss here as these states have taxed pass-throughs at the entity level for quite some time
  - The most recent mandatory entity-level tax (a full change in taxing regime) was enacted by Connecticut starting in tax year 2018
- The key focus here is states that have enacted elective entity level taxes in order to circumvent the TCJA SALT cap (these regime changes have occurred within the last 2 years)

Elective PTE Taxes

- As of this year (2021), 19 states have enacted an elective pass-through entity taxing regime (hereinafter “PTE”) to circumvent the $10,000 SALT cap enacted by TCJA.

The states are as follow:

- Alabama, Arkansas, Arizona, **California**, Colorado, Georgia, Idaho, Illinois, Louisiana, Massachusetts, Maryland, Minnesota, **New Jersey**, New York, Oklahoma, Oregon, Rhode Island, South Carolina, and Wisconsin.

Elective PTE Taxes

Let's look at three states, their rules, and potential pitfalls:

- New Jersey
- New York
- California

Elective PTE Taxes

- Before we start, the 7 key issues to consider with respect to the PTE election regime (for all states) are:
  - What are the enactment start and end dates?
  - What is an eligible entity (that may make the election)?
  - What is an eligible owner (that may participate)?
  - How do you make the election?
  - What is the tax base?
  - What are the credit and withholding rules?
  - What are the unintended consequences?

Elective PTE Taxes – New Jersey

Enactment Date:

- Elective PTE tax regime available for tax years 2020 and forward

Eligible Entity:

- An entity taxed as a partnership (including LLCs) or an “S” Corporation
  - Must have at least one member who is liable for NJ tax
  - Single member LLCs and sole proprietorships may not elect to pay the PTE tax
  - Election can be made by an officer or member of the entity with authority to make the election for all members (does not appear to only require consent by each member, partner or shareholder nor do the provisions appear to allow a partner or member to elect out)

Elective PTE Taxes – New Jersey

Eligible owners and participation:

- The tax must be calculated on every member’s share of distributive proceeds
- Even exempt organizations appear includable (must file a claim for refund)

Elective PTE Taxes – New Jersey

How to make the election:

- The election is made by the eligible entity or via consent of all partners
- The annual election has to be made electronically before the original due date of the eligible entity's return
- The election can not be retroactive
- The election can only be revoked electronically on or before the original due date of the eligible entity's return (15th day of the third month following close of the tax year)
- Elections can be made for tax years starting on or after 1/1/2020

Elective PTE Taxes – New Jersey

What is the tax base?:

- Qualified net income is the sum of the pro rata share or distributive share of income, subject to New Jersey personal income tax, of each partner, member, or shareholder.
- It appears that for tax year 2021 returns, New Jersey has corrected the forms to properly apply the BAIT to a partner's distributive share of income subject to New Jersey personal income tax. In tax year 2020, NJ guidance was erroneous in that it asserted that the BAIT is imposed on federal income (without consideration to federal/state differences)
- This means post-apportioned New Jersey income

Elective PTE Taxes – New Jersey

What are the credit and withholding rules?:

- The credit appears refundable
- Regular withholding is still required
    - NJ doesn't offer any withholding exemptions under any circumstance

Elective PTE Taxes – New Jersey

What are the unintended consequences?:

- The tax ranges from 5.675% to 10.96%, however, this is not based on each partner's share of NJ income, this is based on the Partnership's NJ income. As such, a partner that may only be in the 6.52% NJ tax bracket will pay BAIT at the highest rate if the partnership's income exceeds $5M
- Partnership must still withhold on partner's income at a rate of 6.37% - total cashflow hit to partner just for NJ is 17.33%
  - Under certain circumstances (e.g. COP to MB state sourcing) a partner included in the PTE regime for CA and NJ may have nearly 34% of tied up (assuming the facts fall in line to create 100% sourcing to both states)

Elective PTE Taxes – New York

Enactment Date:

- Elective PTE tax regime available for tax years 2021 and forward

Eligible Entity:

- An entity taxed as a partnership (including LLCs) or an “S” Corporation
  - Cannot include a PTP
  - Election can be made by an authorized person on behalf of an eligible partnership or S corporation
  - A partnership can make the election even if it has partners that are not eligible for a PTET credit (see next slide)

Elective PTE Taxes – New York

Eligible owners and participation:

- Eligible participants are partners, members, or shareholders that are Article 22 taxpayers (i.e. they are subject to the New York personal income tax)
- A partner or member that is a Single Member LLC can be included if the sole owner is an Article 22 taxpayer (i.e. you can “look through” the entity)
- All other participants must be direct members, partners, or shareholders (i.e. a partnership can not participate even if its partners are Article 22 taxpayers)

Elective PTE Taxes – New York

How to make the election:

- Must annually elect to pay PTET for tax years beginning 1/1/2021
- The election must be made online (Business Online Service account required), annually, and is irrevocable
- The election for tax year 2021 was due by 10/15/2021 (if you haven't made it yet, then you can't elect PTET for tax year 2021)
- The election for tax year 2022 is due between 1/1/2022 and 3/15/2022

Elective PTE Taxes – New York

What is the tax base?:

- Generally, the PTET is imposed on the entity's income that will flow through to a direct partner, member, or shareholder for New York personal income tax purposes
- There is a difference in computation of taxable income between a partnership and an S corporation, at a high-level
  - An S corporation will aggregate all amounts of income and deductions (without regard to limitations – capital losses, PAL, basis limitations, etc.) that will flow to Article 22 taxpayers then apportion the net income using Article 9-A rules (corporate income tax rules)
  - A partnership must include items of income and deductions as above, however, items attributable to residents will no be apportioned, and items attributable to non-residents will be apportioned
- See TSB-M-21(1)(C), (1)I for more detailed information

Elective PTE Taxes – New York

What are the credit and withholding rules?:

- The credit appears refundable
- Regular withholding is still required
  - New York does offer a withholding exemption for owners that consent to be taxed – this may help alleviate some of the cashflow issues caused by this regime

Elective PTE Taxes – New York

What are the unintended consequences?:

- The tax ranges from 6.85% to 10.90%, however, this is <u>not based on each partner's share of NY income</u>, this is based on the <u>Partnership's</u> NY income. As such, a partner that may only be in the 6.85% NY tax bracket will pay PTET at the highest rate if the partnership's income exceeds $25M (the rate is 10.30% for income over $5M)
- Partnership must still withhold on partner's income
    - As previously mentioned, the withholding impact may be mitigated by executing a withholding exemption certificate

Elective PTE Taxes – California

Enactment Date:

- Elective PTE tax regime available for tax years 2021, 2022, 2023, 2024, and 2025

Eligible Entity:

- An entity taxed as a partnership or an “S” Corporation
- Cannot be a:
  - publicly traded partnership,
  - a unitary entity permitted or required to be in a combined group
  - an entity that has a partnership as a partner, member, or shareholder
- Must only have partners, member or shareholders that are (its members must be exclusively corporations or taxpayers):
  - Individuals, trusts, estates, fiduciaries, disregarded entities, or corporations

What about a partnership that has a partner that is a “S” Corporation?

Elective PTE Taxes - California

Eligible owners and participation:

- Individuals, trusts, estates, fiduciaries
- Eligible owners must elect to participate – <u>only owners that elect to participate are included</u> – owners that don't want to participate can be excluded from the PTE computation

Elective PTE Taxes - California

How to make the election:

- Make the election on an original timely filed return (doctrine of elections, non revocable).
- For tax year 2022, an estimated payment must be made by 6/15 in order to be able to make a valid election on the tax year 2022 return (due in 2023).
  - Greater of $1,000 or 50% of prior year's PTE tax – remainder is due on or before original due date of return
- Election is binding on entity and owners

Elective PTE Taxes - California

What is the tax base?:

- Qualified net income is the sum of the pro rata share or distributive share of income, subject to California personal income tax, of each consenting partner, member, or shareholder
- This means post-apportioned California income, including all applicable federal/state differences

Elective PTE Taxes - California

What are the credit and withholding rules?:

- The credit is non-refundable and has a 5-year carryover provision
- The credit cannot offset tentative minimum tax
- Regular withholding is still required

Elective PTE Taxes - California

What are the unintended consequences?:

- Any amount of credit that does not offset TMT becomes a carryover – taxpayers may still have a California tax liability (e.g. 150K of PTE credits, 100K of regular tax, $70K of TMT, PTE credit can only offset $30K of excess tax and $120K is a carryover)
- What happens to my carryover credit when the partnership no longer has a California filing obligation (i.e. no nexus, or no CA apportionment (short term service contract)?
- Partner's free cashflow is going to be impacted – must pay into PTE tax at 9.3% and also pay into regular withholding at 7% - there is a possibility to request withholding exemption (Form 588 – this may not apply in all cases – requires approval from FTB)
- 16.3% of partner's money is tied up with the state – 9.3% of partner's money (converted into a nonrefundable credit) may never be recovered due to the first bullet or may expire worthless due to lack of nexus or California sales factor in future years
- Ordering rule? There is none. Which credit gets applied first? The nonrefundable credit or the regular withholding? Generally, apply the credit first.

Elective PTE Taxes – Considerations

Can I just make this election if I feel like it?:

- No! Every state's rules must be taken into consideration
- This election requires consideration of every partner, member, or shareholder's tax and cashflow position
- The determination for this election may be easy if your client has few partners
- For partnerships with numerous partners (50+), it may never be fee effective to do the analysis
    - How much is a client willing to pay for us to evaluate the impact to 50+, 100+, or 1,000+ partners
- Be careful of nonrefundable credits! What's the cost of potentially lost credit versus benefit of circumvention of the federal SALT cap

Elective PTE Taxes – Key Takeaway

- Many issues in the SALT world require detailed analysis before making a decision (e.g. nexus, unitary combination, structuring, business versus nonbusiness income, water's edge election, etc.)
- This rule is exemplified in the PTE taxing regime – you can absolutely not make this decision without engaging in tax impact modeling work – especially not for more complex clients
- Keep in that some issues discussed here today are fluid as some state legislatures are aware of various issues (glitches) and may make corrections via further legislation
- The partner, member, or shareholders tax position outside of entity issues must become a central focus for the analysis
- Cash-flow issues also take center state

Other Misc. Items – Summary

- **Washington Capital Gains Tax** – effective 1/1/22 – capital gains tax equal to 7% of a Washington resident's adjusted long-term capital gains (deduction for the first $250K of capital gains)
- **Possible federal SALT cap expansion** – Senate democrats still debating magnitude of expansion – Bob Mendez (NJ) pushing for large increase to the cap, Bernie Sanders (VT) pushing to limit the benefit – the final expansion may likely impact our consideration of elective PTE tax
- **North Carolina** – Roy Cooper signed Senate Bill 105 which includes several changes to the state's tax regime. Changes include corporate tax phase out, franchise tax limits, reductions to the personal income tax, update to various conformity provisions, and <u>adoption of a PTE elective tax (effective 1/1/2022)</u>
- **California** – starting on 1/1/2022, California marketplace facilitators must also collect electronic waste recycling fees, battery fees, lumber products assessments, and the tire fee on behalf of marketplace sellers
  - A "marketplace facilitator" is generally defined as a person who contracts with marketplace sellers to facilitate the sale of the marketplace seller's products through a marketplace operated by the person

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Poll #4

OPEN QUESTIONS

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