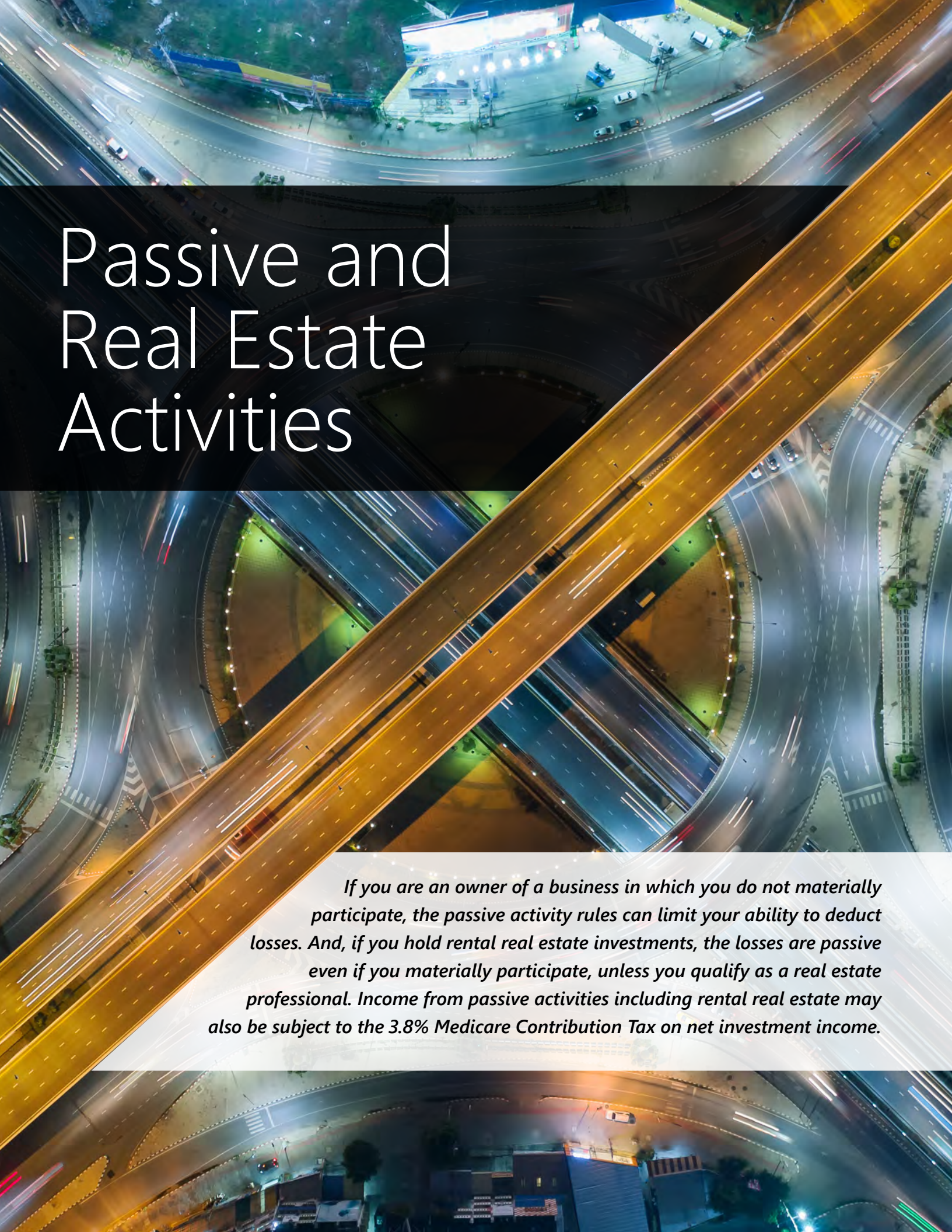

Passive and Real Estate Activities

If you are an owner of a business in which you do not materially participate, the passive activity rules can limit your ability to deduct losses. And, if you hold rental real estate investments, the losses are passive even if you materially participate, unless you qualify as a real estate professional. Income from passive activities including rental real estate may also be subject to the 3.8% Medicare Contribution Tax on net investment income.

What are Passive Losses?

A passive loss is a loss from a business activity in which you do not materially participate. The most common ways you are deemed to materially participate in a business activity, and thereby avoid the passive activity limitation rules, are if:

- You participate more than 500 hours in the activity during the year,
- Your participation constitutes substantially all of the participation in the activity,
- You work more than 100 hours per year in the activity and not less than any other person, including non-owners, or
- You work more than 100 hours per year in each of several activities, totalling more than 500 hours per year in all such activities.

Passive activity losses are deductible only to the extent that you have income from other passive activities to offset the losses, or when you completely dispose of the activity. If you have passive losses that you cannot deduct in the current year, you can carry these losses forward to the following year, subject to the same passive loss rules and limitations.

Taxpayers should keep detailed records as to the time they spend on a particular activity, especially when they participate in several activities. Moreover, there are specific rules as to what kind of work qualifies as participation.

Convert Passive Losses

If you fail the material participation tests and you have passive losses that are subject to a disallowance, there are things that you can do to convert the disallowed losses into tax-saving deductible losses:

Dispose of the activity

Sell any passive activity with current or suspended passive losses through a bona fide sale to an unrelated party. The losses become fully deductible when the activity is sold – including any loss on the disposition (subject to capital loss limitations). Even if you realize a gain on the sale, you can still save taxes as Tax Tip 13 illustrates. But you must also be aware of the phantom income trap discussed in Tax Tip 14.

Tax Tip

13. Use Passive Activity Capital Gains to Release Suspended Ordinary Losses

If you have suspended passive activity losses, you may be able to dispose of a passive activity at a gain and not have to pay any taxes. In fact, you may actually reduce your taxes despite the gain.

As an example, assume you have suspended passive losses of $300,000 from an activity that you have held for more than one year. You dispose of the activity in 2019 and realize a capital gain of $340,000. You would actually save federal taxes of $43,000 as well as receiving the proceeds from the sale.

This very favorable result is due to the fact that the suspended losses reduce your ordinary income at a 37% rate (beginning on January 1, 2018), whereas the long-term capital gain from the sale would be taxed at no more than 20%. The suspended loss would therefore reduce your tax by $111,000 (37% of $300,000), but the capital gain would only increase your tax by $68,000 (20% of $340,000). If you have a net capital loss carryover that you might be able to utilize, your savings would even be greater since the gain could be offset by the carryover loss, giving you the full tax benefit of the loss (but a reduced carryover).

The tax savings would be reduced by the 3.8% Medicare Contribution Tax in the amount of $1,520 (3.8% of $40,000, which is the difference between the $340,000 capital gain and $300,000 ordinary loss).

Increase your participation in loss activities

For an activity that is generating losses, consider increasing your participation to meet one of the tests listed above, if possible, so you will not be subject to a passive loss limitation for the activity in that year.

Increase the hours you participate in real property trades or businesses

If you are engaged in real estate activities, increase your hours to meet the real estate professional test (discussed below). If you are a real estate professional, your real estate losses are no longer treated as passive losses, allowing you to deduct them in full.

Utilize Your Passive Losses

If you have passive losses from activities that you cannot convert into "material participation" activities as discussed above, you should consider taking the following steps to utilize your passive losses:

Decrease your participation in income activities

For an activity in which you materially participate that is generating non-passive income, limit your participation to less than 500 hours, if feasible. Therefore, the activity may become passive and you can use the income to offset your passive losses. However, make sure that you are not still considered active under the other tests. This may result in the additional 3.8% Medicare Contribution Tax to the extent that the income is not fully offset by passive losses. If you or your spouse have been materially participating in the activity for five out of the last ten years, you will be deemed to be materially participating in the current year, even if you do not participate at all in the current year.

Invest in income-producing passive activities

Consider investing in an income-producing trade or business that you will not materially participate in. This creates passive income to you which can be offset until you utilize all of your passive losses from other unrelated passive activities. This may result in the additional 3.8% Medicare Contribution Tax to the extent that the income is not fully offset by passive losses.

Tax Tip

14. The Phantom Income Trap

Income in excess of your net proceeds can be triggered upon the disposition of real estate. This results from prior deductions based on indebtedness. Therefore, you may have deducted losses and/or received cash distributions in prior years that were greater than your actual investment in the property. This is sometimes referred to as negative capital.

Phantom income to the extent of your negative capital can also occur if you dispose of your interest in the pass-through activity, even if the underlying property remains unsold. However, to the extent your prior year's passive losses were suspended, you would have an ordinary loss to offset this income. As Tax Tip 13 demonstrates, this can actually be a tax savings opportunity.

Identify Your Actual Passive Losses

When identifying your net passive losses, take into account the following:

- Investment and trading partnerships, S corporations and LLCs that only generate portfolio income, such as capital gains, interest and dividends, are not passive activities, even if you do not participate in the activity. Therefore, the investment income cannot offset your passive losses.
- Interest expense on money borrowed to fund your investment in a passive activity is treated as an additional passive activity deduction, subject to the same disallowance rules.
- Portfolio income, such as interest and dividends, from a passive activity cannot offset the passive losses from the activity.

Losses from Limited Liability Companies ("LLCs") and Limited Liability Partnerships ("LLPs")

Generally, limited partners of an LLP are presumed to not be materially participating in the business, and thus

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these activities would be considered passive. There is an exception to the presumption of no material participation where an individual holds an interest in a limited partnership as both a limited partner and a general partner. In this case, such person can avoid the passive loss rules with respect to the limited partnership interest.

The courts have addressed whether the rules that apply to limited partnership interests also apply to members of an LLC. Although the IRS does not concur, cases have held that such members are not limited partners for purposes of determining their material participation in these activities. Rather, the facts and circumstances must be examined to ascertain the nature and extent of the participation of the member.

Limitation on Losses for Taxpayers Other Than Corporations

Under the passive activity loss rules contained in IRC Sec. 469, if a taxpayer has a flow-through loss from a passive activity, the passive loss could not offset earned income or ordinary income at the individual taxpayer level. The passive loss rules prevent taxpayers from using losses incurred from income-producing activities in which they are not materially involved. However, if the taxpayer is a real estate professional, the losses derived from real estate activities are not considered passive and are available to offset all categories of income, including earned income or ordinary income.

The TCJA amends and adds to IRC Sec. 461 an additional limitation on a taxpayer's business loss from entities other than C corporations, called an "excess business loss" limitation, effective for taxable years beginning after December 31, 2017. The TCJA defines an excess business loss as the excess of aggregate deductions of the taxpayer attributable to his or her trade or business over the sum of aggregate gross

Tax Tip

15. Defer Your Gain Using the Installment Sale Method

In 2019, you sell a nonresidential building for $2,000,000, net of closing costs, which you bought in 1998 for $600,000 (including subsequent improvements). At the time of the sale, you had accumulated depreciation of $400,000. Therefore your taxable capital gain is $1,800,000 ($2,000,000 less the cost of $600,000 plus the accumulated depreciation of $400,000). You will receive a 20% down payment of $400,000 before the end of the year and receive a mortgage from the buyer for the balance, with the first payment due in January of 2020. By using the installment sale method, you will defer $290,000 of federal tax to future years as the mortgage is paid down by the buyer.

	Full payment in current year	Installment sale method
Taxable gain in year of sale	$ 1,800,000	$ 360,000
Federal tax cost this year	380,000	90,000
Deferred tax		290,000

The taxable gain using the installment sale method is computed by multiplying the down payment of $400,000 by the gross profit ratio of 90%. The gross profit ratio is the taxable gain of $1,800,000 divided by the total proceeds of $2,000,000.

Caution: *You are subject to a tax rate of 25% on the portion of the gain that is attributable to previous non-accelerated depreciation deductions on real property on a "first in first out" ("FIFO") method. Also, this method may not be advantageous when the tax rates of future years' installments are expected to increase.*

Note: *The 3.8% Medicare Contribution Tax on net investment income, which is not reflected in the above illustration, may apply to the gain and related interest.*

income or gain for the taxable year plus a threshold amount of $500,000 for married taxpayer filing jointly or $250,000 for all other taxpayers. The threshold amounts will be adjusted for inflation every year, and this limitation expires after December 31, 2025. Any residual amounts are treated as an NOL carryforward for the taxpayer in the following years in accordance with IRC Sec. 172. The TCJA has amended the NOL carryforward to be indefinite and limits the NOL deduction to 80% of taxable income for a given taxable year. When applying the NOL deduction in subsequent years, the taxpayer will need to follow the ordering rules per IRC Sec. 172.

Passive Activity Credits

Tax credits from passive activities, such as rehabilitation and low-income housing credits, can reduce your regular tax liability. However, for properties placed into service prior to 2008, these credits are limited to the amount of your regular tax attributable to your net passive income, and cannot be used to reduce your AMT. For post-2007 investments, both the qualified Rehabilitation Tax credit as well as the low-income housing credit can offset both regular tax and AMT to the extent of your tax attributable to passive activity income. If you have a net overall passive loss, the disallowed credits are carried forward and can be used to offset your taxes in future years. If you have net passive income but the credits are limited because of the AMT, you can carry the credits forward to offset your regular tax in future years when you are not in the AMT.

Real Estate Activities

Real estate activities are passive by definition, unless you qualify as a real estate professional. Regardless of whether you are a real estate professional or not, there are ways you can defer the tax from the gain on the sale of real estate properties, as discussed below. A separate rule allows you to deduct up to $25,000 of losses each year if you actively participate in a rental real estate activity. This special allowance is reduced, but not below zero, by 50% of the amount by which the taxpayer's AGI exceeds $100,000. It is completely phased out when AGI reaches $150,000.

Real Estate Professional Rules

If you are a real estate professional, you can deduct rental real estate losses in full since you are not subject to the passive loss limitations. To qualify, you must annually:

- Perform more than 50% of your personal services in real property trades or businesses in which you materially participate, and
- Have more than 750 hours of service in these businesses.

In addition, you must materially participate in the rental real estate activity in order for that activity to be considered nonpassive. For example, a real estate broker who owns one or two apartments for rent might be a real estate professional but might not be considered to materially participate in the rental activity.

In the case of a joint return, the real estate professional requirements are satisfied if, and only if, at least one of the spouses separately satisfies both requirements. In regards to the material participation test though, work performed by a taxpayer's spouse in a trade or business is treated as work performed by the taxpayer.

Real estate professionals are not subject to the 3.8% Medicare Contribution Tax on net investment income, including capital gains, from rental real estate activities in which they materially participate.

Observation: *If you fail either test and you have real estate losses, try to increase your hours of service to meet the tests. For purposes of the real estate professional test, a taxpayer can elect to aggregate all of their real estate rental activities to determine material participation. Once the election is made, it continues unless the IRS consents to its revocation.*

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Installment Sale Reporting Benefits

An installment sale can be a very tax-efficient method to defer a gain on the sale of real estate for future years. If you are contemplating a sale of real estate, consider agreeing to receive one or more payments after the year of the sale so that you are eligible to report the gain on the installment sale method. By doing so, you can defer much of the tax to future years.

The installment method allows you to report gain only as you receive principal payments. By simply deferring one payment until next year, you can defer the tax on that portion of the sales price by a full year (see Tax Tip 15). The gain you report in future years retains the same character as when it was sold. Therefore, if property that is sold had a long-term holding period, the gain reported in future years will also be long-term except for the interest element if interest is not stated on the deferred payments. You may also be entitled to interest payments on seller-financed mortgages or loans. The interest payments are taxable as ordinary income when received. You can use the installment sale method even if you owned the property through an entity in which you hold an interest if the entity does not elect out of the instalment method. However, if the face amount of all installment receivables you own at December 31 exceeds $5 million, an interest charge on the deferred tax (assessed as an additional tax) will apply.

Caution: *Even if no payments are received in the year of sale, any recapture income under IRC Secs. 1245, 1250, or 751 is recognized immediately. Furthermore, when the deferred gain on the sale of real estate is attributable to both unrecaptured IRC Sec. 1250 gain (maximum tax rate of 25%) and regular capital gain (maximum tax rate of 20%), the unrecaptured IRC Sec. 1250 gain is reported first upon the receipt of principal payments.*

Like-Kind Exchanges

Previously, IRC Sec. 1031 allowed deferral of gain on like-kind exchanges for assets that included

Tax Tip

16. Like-Kind Exchanges for Vacation Homes

Like-kind exchanges for vacation homes that are converted to rental property are tricky, but can be worthwhile. It is possible for you to do a like-kind exchange if you turn a vacation home into a rental property. For example, if you stop using your vacation home, rent it out for a substantial period of time and then exchange it for other real estate and conduct the rental of that real estate as a business, then you have converted it to an investment property. This conversion could allow for a like-kind exchange. Of course, the timing and facts must support such a conversion. In addition, if the property swapped for is intended to be a new second or primary home, you are not allowed to move in immediately. In 2008 the IRS issued Rev. Proc. 2008-16, which includes a safe-harbor rule under which it said it would not challenge whether a replacement dwelling qualified as investment property for purposes of a like-kind exchange. In order to meet this safe harbor, you must have held the relinquished property for at least 24 months and in each of the two 12-month periods immediately after the exchange: (1) you must rent the dwelling unit to another person for a fair rental for 14 days or more; and (2) your own personal use of the dwelling unit cannot exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental. In addition, after successfully swapping one vacation/investment property for another, you cannot immediately convert it to your primary home and take advantage of the $500,000 primary residence exclusion. If you acquire property in the like-kind exchange and later attempt to sell that property as your principal residence, the exclusion will not apply during the five-year period beginning with the date the property was acquired in the 1031 like-kind exchange.

Your specific fact pattern must support a position in which your vacation property or second home was in fact held for rental, investment, or business use and would therefore qualify for tax-deferred exchange treatment. The more rental, investment, or business use activity, the stronger the facts will be that the property was converted and held for rental or investment. The more you can substantiate that the property was held, treated and reported as rental or investment property, the better your position will be to support tax-deferred exchange treatment.

Caution: *The sale of your principal residence does not qualify for a like-kind exchange.*

Note: *Like-kind exchange reporting is not elective. Consider not engaging in a like-kind exchange if a taxable event is the better approach (e.g., when you have expiring losses, or state tax considerations).*

tangible and intangible personal property. Personal property can include vehicles, furniture, boats and art collectibles. The TCJA limits the deferral of gain on like-kind exchanges completed after December 31, 2017, to only real property not held primarily for resale. Keep in mind only U.S. real property is eligible and real property located outside the U.S. is not eligible. Personal property will no longer be allowed a deferral of gain.

If you exchange real property for property of a like-kind (same nature or character), you do not realize taxable gain at the time of the exchange, except up to the amount of any cash or other boot received (such as unlike property). The like-kind exchange rule gives you the opportunity to defer taxes until you sell the property that you receive in the exchange.

Like-kind exchanges typically are used when selling real estate and can yield substantial tax benefits. Even though the definition of like-kind property allows for a certain amount of flexibility, such as permitting an exchange of land for a building if both are held for investment purposes, specific and complex rules govern like-kind exchanges. These rules include a requirement that you cannot directly receive any cash or other consideration and must identify the replacement property with the qualified intermediary holding the funds within 45 days after the sale.

Pass-Through Tax Treatment

The TCJA made significant changes to the tax treatment of income from pass-through entities for both investment and noninvestment related activities. Under pre-Act law, an individual taxpayer generally was required to apply their individual income tax rate, depending on their tax bracket, to their regular taxable income.

For taxable years beginning after December 31, 2017 and before January 1, 2026, the TCJA allows a deduction of 20% of a taxpayer's domestic qualified business income ("QBI") from a partnership, LLC taxed as a partnership, S corporation or sole proprietorship. The 20% deduction is also allowed for a taxpayer's qualified REIT dividends and qualified publicly traded partnership income. QBI is defined as all domestic business income other than investment income (e.g., dividends other than REIT dividends), investment interest income, short-term capital gains, long-term capital gains, commodities gains and foreign currency gains. QBI does not include reasonable compensation or guaranteed payments made to the taxpayer.

For taxpayers whose taxable income is above the limits mentioned below, the 20% deduction is not allowed if the QBI is earned from a "specified service trade or business." A specified service trade or business is defined, in part, as any trade or business (other than architecture or engineering) involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners.

For specified service businesses, noted above, the 2019 deduction phases out for joint filers with taxable income between $321,400 and $421,400, and for individual filers earning between $160,700 and $210,700.

Taxpayers below this income threshold that are engaged in non-specified service businesses may deduct the 20%. Taxpayers above this income that are engaged in non-specified businesses may still deduct the 20% but are subject to a cap (the "wage limitation test"). The 20% deduction is limited to the greater of (a) 50% of the W-2 wages paid with respect to the qualified trade or business or (b) the sum of 25% of the W-2 wages with respect to the qualified trade or business plus 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property. For this purpose, qualified property is generally defined as tangible property subject to depreciation under IRC Sec. 167, held by a "qualified trade or business" and used in the production of qualified business income

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(land is not included) the depreciable period for which has not ended before the close of the taxable year. The depreciable period with respect to qualified property is the period beginning on the date the property is first placed in service and ending on the later of (1) the date ten years after that date or (2) the last day of the last full year in the applicable recovery period that would apply to the property under IRC Sec. 168 without regard to IRC Sec. 168(g) (which lists applicable recovery periods under ADS). A qualified trade or business is any business other than a specified service trade or business (defined above) or the trade or business of performing services as an employee.

The 20% deduction is not allowed in computing AGI but instead is allowed as a deduction to taxable income.

This provision raised many questions relating to whether real estate rental activity qualifies for the deduction. In response, the IRS issued Notice 2019-07 which provides safe harbor guidelines under which the real estate activities will be treated as a trade or business for QBI deduction purposes. In order to qualify for the safe harbor, the following requirements must be met:

- At least 250 hours of rental services are performed annually for taxable years prior to January 1, 2023. For years after 2022, any three out of five consecutive years must meet the 250-hour requirement.
- Rental services include lease negotiations, tenant application, rental collections, operations, management and supervision of employees, contractors and sub-contractors. However, procuring property, financial management, investment management, time spent traveling to and from the real estate or long-term capital improvements are not considered qualifying rental activities.
- Rental services may be performed by owners and/or employees, agents or independent contractors of the owners.
- Separate books and records must be maintained for each rental activity.
- Contemporaneous records must be maintained beginning in 2019 and should include:
  - Description of services performed
  - Dates and hours of the services performed
  - Who performs the services
- Real estate used as a residence by the owner for any part of the year does not qualify for the safe harbor.
- Triple net leases, where the tenant pays a portion of the taxes, insurance and maintenance, do not qualify for the safe harbor.

Note: *This is a safe harbor. Not meeting the criteria of the safe harbor does not necessarily prevent you from taking the QBI deduction.*

Other Considerations

The TCJA also makes additional changes to tax law beginning January 1, 2018 impacting real estate business owners. Some property owners will receive a new tax advantage with the ability to immediately write off the cost of certain new investments under IRC Sec. 179. Bonus depreciation may also be available. See the chapter on business owner issues and depreciation deductions.

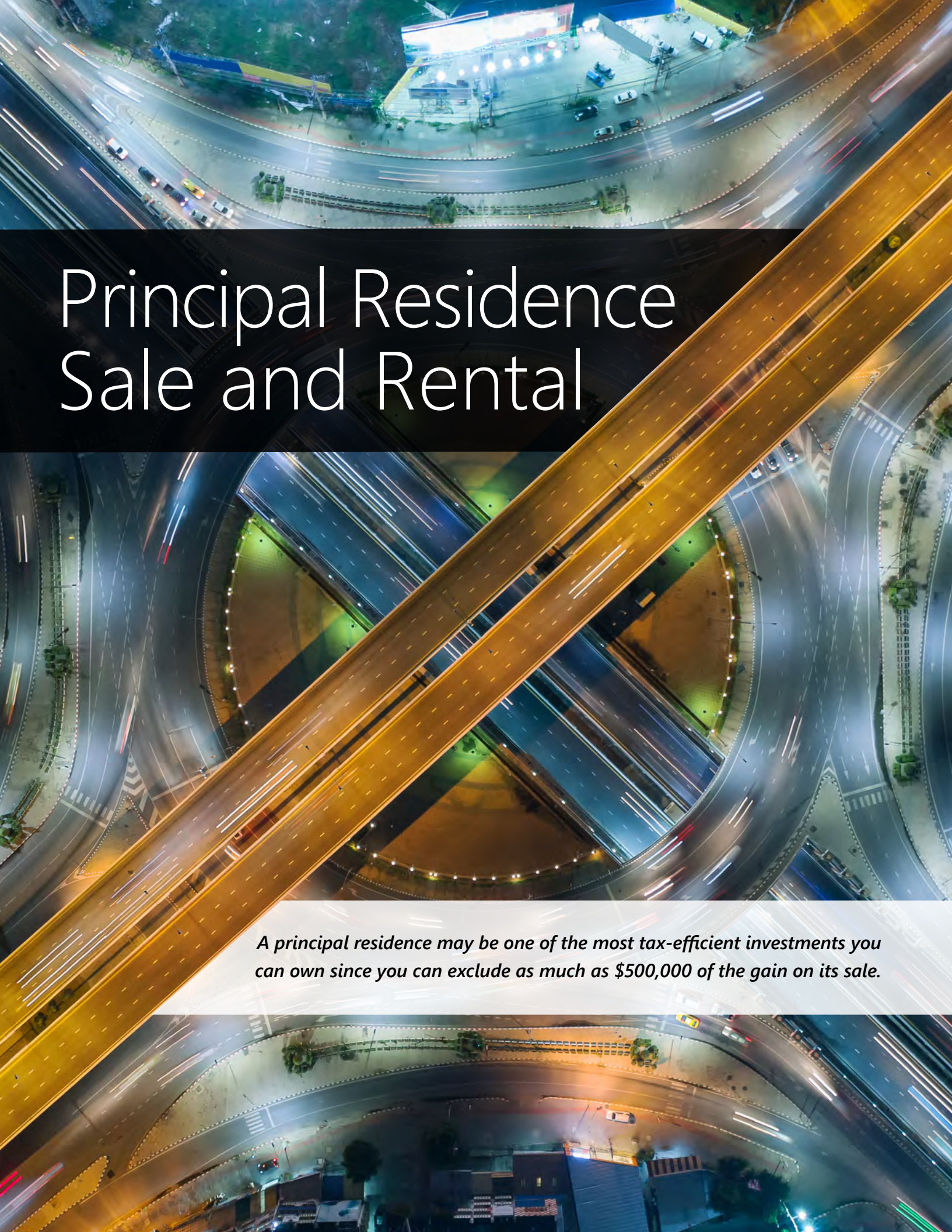
Investment property owners can continue to deduct net interest expense (as explained more fully in the chapter on business owner issues and depreciation deductions), but investment property owners may desire to elect out of the new interest disallowance tax rules. Specifically, the election can be made to exclude from the limitation any real property trade or business as defined under the passive activity rules. The election is made at a time and in a manner as provided by the IRS and, once made, is irrevocable. The new interest limit is effective in 2018 and applies to existing debt.

The interest limit, and the real estate election, applies at the entity level.

The current depreciation rules for real estate continue. However, property owners electing to use the real estate exception to the interest limit must depreciate real property under slightly longer recovery periods of 40 years for non-residential property, 30 years for residential rental property, and 20 years for qualified interior improvements. Property owners will need to take into account the longer depreciation schedules if they elect to use the real estate exception to the interest limit. The depreciation rules are covered in more detail in the chapter on business owner issues and depreciation deductions.

State and local taxes paid with respect to carrying on a trade or business, or in an activity related to the production of income, continue to remain deductible. Accordingly, a rental property owner can deduct property taxes associated with a business asset, such as any type of rental property.

Principal Residence Sale and Rental



A principal residence may be one of the most tax-efficient investments you can own since you can exclude as much as $500,000 of the gain on its sale.

The sale of your principal residence is eligible for an exclusion of capital gain up to $500,000, if you file as married filing jointly and meet the tests listed below (other taxpayers can exclude up to $250,000 of the gain). Any portion of the gain attributable to a home office or rental use is not eligible for the exclusion.

Pass These Tests and Exclude Up to $500,000 of Your Gain

To qualify for the full amount of the exclusion, you must meet all of the following conditions:

- Have owned your principal home for at least two years. Your principal residence can be a house, houseboat, mobile home, cooperative apartment or condominium. The two-year rule may consist of 24 full months or 730 days. If you are filing a joint return, only one spouse need qualify in order to benefit from the exclusion of at least $250,000.
- Have used the home as your principal residence for at least two years, in the aggregate, during the five-year period ending on the sale end date.
- Did not exclude the gain on a home sale within the last two years.
- Did not acquire your home through a like-kind exchange (also known as a 1031 exchange) during the past five years.

With regards to the principal residence, occupancy of the residence is required. Short temporary absences, such as for vacation or other seasonal absences, even if the property is rented during such temporary absences, will be counted as periods of use.

A pro-rata exclusion is allowed if you fail the above tests as a result of a hardship, which includes a change in employment, health reasons, multiple births from the same pregnancy, divorce or legal separation, or other unforeseen circumstances and natural disasters. The pro-rata exclusion is generally equal to a fraction, the numerator of which is the number of months you used and owned the house as your principal residence within the past two years and the denominator is 24.

A reduction of the exclusion is required to the extent that any depreciation was taken after May 6, 1997 in connection with the rental or business use of the residence, unless there was a separate structure for the rental or business use. Regardless, there will be a taxable gain which equals the amount of depreciation previously deducted and it will be taxed at a special 25% capital gain rate.

Do Not Assume You Can Always Sell Your House Tax-Free

Many people mistakenly think that you can defer a gain from the sale of a principal residence if they buy a new home that costs more than the selling price of the old home. That law was repealed many years ago (in 1997, to be exact). Under current law, you will have to pay taxes to the extent that a net gain exceeds the maximum exclusion amount allowed. Here is an example for a married couple filing jointly and meeting all tests:

Net proceeds on sale	**$ 2,000,000**
Tax basis (including capital improvements)	**600,000**
Net gain on sale of home	**1,400,000**
Allowable exclusion	**(500,000)**
Taxable gain	**900,000**
Federal tax at maximum 20% capital gain rate and the 3.8% Medicare Contribution Tax on net investment income	**$ 214,200**

Notes: *This gain may be subject to state income taxes. See the chapter on state tax issues.*

The taxable gain will be subject to the 3.8% Medicare Contribution tax on net investment income. The excludable gain ($250,000/500,000) is not subject to this tax.

No Exclusion Allowed for Nonqualified Use of Property

Beginning with sales or exchanges of your principal residence after December 31, 2008, you will no longer be able to exclude gain allocated to periods of nonqualified use of the property.

Generally, nonqualified use means any period after 2008 where neither you nor your spouse used the property as a principal residence. To figure the portion of the gain that is allocated to the period of nonqualified use, multiply the gain by the following fraction:

Total nonqualified use during period of ownership after 2008, divided by total period of ownership.

A period of nonqualified use does not include:

- Any portion of the five-year period ending on the date of the sale that is after the last date you (or your spouse) use the property as a principal residence.
- Any period (not to exceed an aggregate period of ten years) during which you or your spouse are serving on qualified official extended duty as a member of the uniformed services or foreign services of the United States, or as an employee of the intelligence community.
- Any other period of temporary absence (not to exceed an aggregate period of two years) due to change of employment, health conditions, or such other unforeseen circumstances as may be specified by the IRS.

Special Consideration for Those Who File Joint Returns

If you are married filing jointly, things can get a little more complicated if you want to be eligible for the maximum exclusion of $500,000. While either you or your spouse can meet the two-year ownership test, the following rules apply to the use test and "no exclusion in prior two years" test:

- Both you and your spouse must meet the two-year use test. If only one spouse meets the test, the exclusion is limited to $250,000.
- Both you and your spouse must meet the "no exclusion in prior two years" test. This can be an issue if you sell your home, claimed an exclusion of $250,000, marry a homeowner and then jointly sell that home within two years. If the spouse meeting the test is the homeowner, he or she will still be eligible for the $250,000 exclusion, and the spouse failing the test is not eligible for a pro-rated exclusion, unless the hardship rule applies, as discussed above.

Sale by Surviving Spouse

A surviving spouse who has not remarried and sells a principal residence within two years from the date his or her spouse died can exclude $500,000 of gain rather than $250,000.

Know Your Tax Basis

To minimize your taxable gain, you will want to have the highest tax basis possible, and have the documentation to substantiate the basis calculation. So be sure to maintain accurate records, including information on your original cost (including closing costs) and subsequent capital improvements.

Basis must be reduced by any pre-1988 deferrals of gain (i.e., when the law allowed taxpayers to defer tax by buying a new principal residence costing more than the net proceeds of their principal residence).

Loss on the Sale of Your Home

Based on historical evidence, you would expect your home to appreciate after you purchase it. However, if you only hold it for a short time, or if unusual market conditions prevail, it is possible to lose money on the sale of your principal residence, especially after

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factoring in closing and improvement costs. Since a loss on the sale of a personal residence is not deductible, you do not gain a tax benefit from the loss. But if part of your home was rented or was used for your business, the loss attributable to that portion will be deductible, subject to various limitations, since it is a business loss rather than a personal loss.

Rental of Vacation or Second Home

You should consider the tax consequences if you are planning to rent out your vacation or second home. Proper planning can help you maximize tax savings.

Tax-free rental income

If you rent your vacation home or principal residence for 14 days or less during the year, the rental income is tax-free, regardless of the amount of rent you receive. Even though you do not have to report this income, you are still eligible to deduct the amount of qualifying mortgage interest and real estate taxes as itemized deductions on your 2019 tax return (subject to limitations).

The TCJA reduces the mortgage interest deduction limitation with respect to acquisition indebtedness to $750,000 for debt incurred after December 15, 2017. For tax years beginning after December 31, 2025, the limitation reverts back to $1 million regardless of when the debt was incurred. Interest on home equity loans is suspended for tax years beginning after December 31, 2017 and before January 1, 2026 unless the debt proceeds are used to buy, build or substantially improve the residence that secured the loan. Further, the TCJA allows individual taxpayers to deduct sales, income, or property taxes up to $10,000 ($5,000 for married filing separately) for tax years beginning after December 31, 2017 and beginning before January 1, 2026.

Rental expenses deductible in full

If you personally use your vacation home (including family members) for no more than the greater of 14 days a year or 10% of the total number of days it is actually rented out, the property is considered to be a rental property rather than a personal residence. As rental property, all ordinary and necessary expenses of maintaining the home are deductible against the rental income you receive. However, if your expenses exceed your income, your deductible loss may be limited since the rental activity is considered to be a passive activity. See the chapter on passive and real estate activities for a more detailed discussion.

Rental expenses limited by personal use

If you personally use your vacation home for more than the greater of 14 days or 10% of the total number of days it is rented (or available for rental, under a Tax Court case), it is considered a personal residence and your deductions may be limited, as follows:

- Qualifying mortgage interest and real estate taxes are deductible as rental expenses based on the number of days rented divided by the total number of days in the year.
- The balance of the real estate taxes and mortgage interest are deductible as itemized deductions, subject to the new law under the TCJA.
- Other rental expenses, including depreciation, utilities and repairs, are deductible based on a ratio of the days the property was rented over the total number of days the property was used for rental and personal purposes.
- Expenses directly attributable to the rental activity itself (such as broker commissions on the rental income or advertising costs) are deductible in full.
- Net overall losses from the rental of a personal use residence are not currently allowable but are carried forward and available for use against income from the property in future years, including a gain on the sale.

To the extent that the property qualifies as rental real estate (personal use less than 10% or 14 days) losses may be subject to the passive loss rules. See the chapter on passive and real estate activities for more

information.

Like-Kind Exchanges for Vacation Home

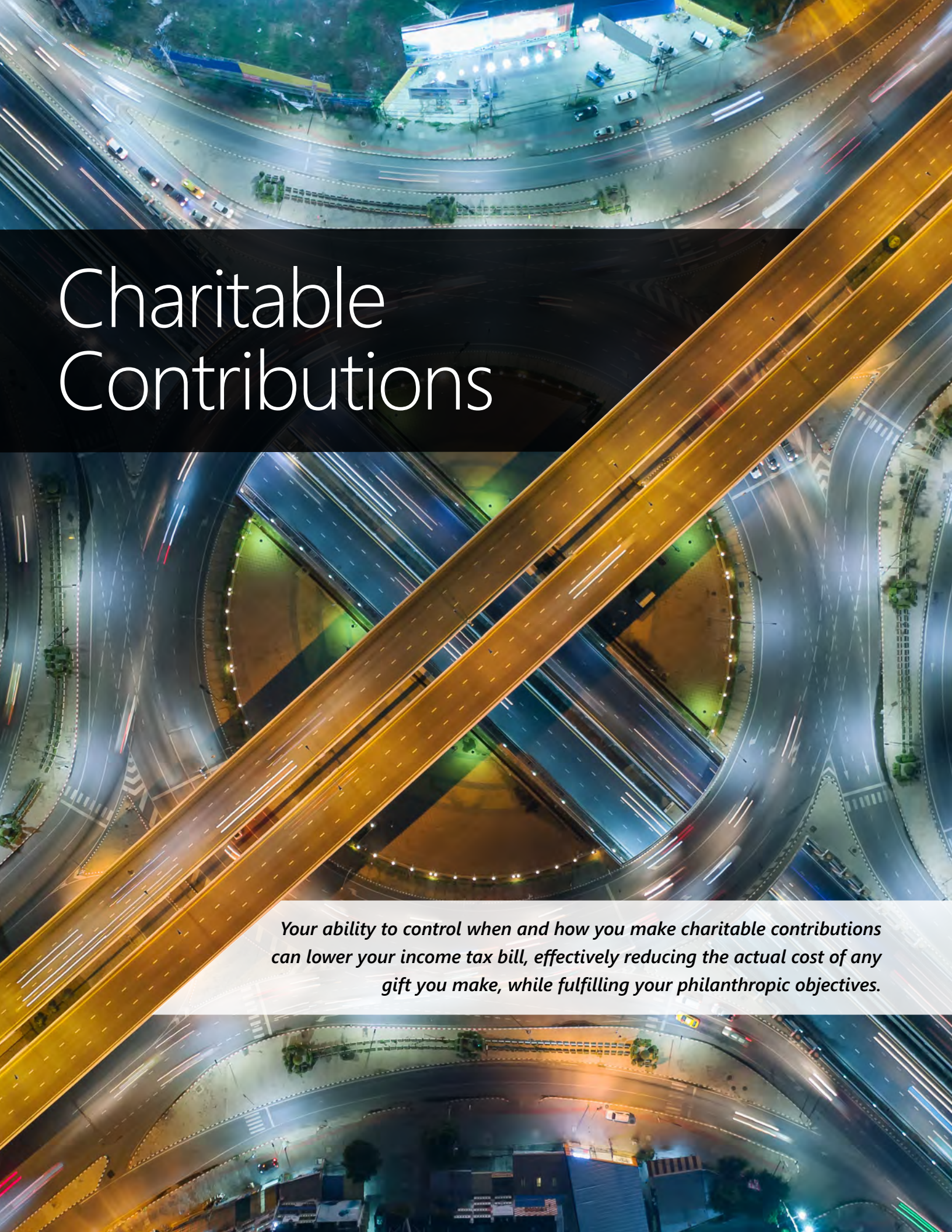
See Tax Tip 16 in the passive and real estate activities chapter for information on a planning opportunity using like-kind exchanges for vacation homes.

Reporting Requirements

You would typically report the sale of your principal residence on Schedule D of your personal income tax return. However, you do not have to report the sale of your principal residence on your income tax return unless:

- You have a gain on the sale. You would typically show the entire gain on the Schedule D of your tax return and then reduce your gain by the excludible portion.
- You have a loss and you received Form 1099-S. Since the IRS matches all Forms 1099 to your return, you would want to show the sale proceeds on the return and that there is no gain on the sale. Remember personal losses are not deductible.

Charitable Contributions



Your ability to control when and how you make charitable contributions can lower your income tax bill, effectively reducing the actual cost of any gift you make, while fulfilling your philanthropic objectives.

Basic Planning Ideas

You can save substantial taxes by simply:

- Using long-term appreciated property to fund your charitable contributions.
- Timing your contributions so that they are made in a year when your tax bracket will be higher.
- Bunching the contributions that you would normally make over a couple of years into one year in order to exceed the standard deduction threshold in that year. This planning idea has gained more importance as a result of the Tax Cuts and Jobs Act, wherein the standard deduction has increased substantially from prior years and many itemized deductions have been eliminated or limited.

Note: *You can only claim your charitable deductions as an itemized deduction on your personal income tax return.*

Tax Tip

17. Are You Really Receiving a Charitable Deduction at 60% of AGI?

You desire to make the following gifts to charity to help offset your 2019 tax liability: (1) a $70,000 cash donation to a public charity (PC); (2) a $20,000 cash donation to your family's private non-operating foundation (PF) and (3) a donation of short-term capital gain property with a fair market value of $50,000 and a tax basis of $40,000 to a PC. Your 2019 AGI is $200,000. The total amount that will be deductible on your return is $100,000 and $30,000 is carried over for five years, determined as follows:

In order to determine the portion of the gifts that are deductible, you would have to analyze each category of property given in a certain order:

1. Cash contributions to public charities are limited to 60% of AGI. Since the $70,000 cash contributed is less than 60% of the AGI, the entire $70,000 is deductible.
2. Short-term capital gain property is limited to the AGI amount of $200,000 multiplied by 50% and then reduced by the $70,000 amount already deducted. $30,000 of the $40,000 amount is deductible (the lower of the fair market value or basis) on the 2019 income tax return.
3. Cash contributions to PFs are limited to the lesser of $60,000 (30% of AGI) and $0 (the difference between combined $100,000 amount already being deducted and 50% of AGI). None of the $20,000 cash donation is deductible on the 2019 income tax return.

Description of Property Given (Applicable Threshold Percentage)	Total Gift	Deductible Amount
Cash to PC (60%)	$70,000	$70,000
Short-Term Capital Gain Property to a PC (50%)	40,000	30,000
Cash to PF (30%)	20,000	0
Total Deductible		$100,000
Percentage of AGI		50%
Carryforward to Subsequent Years	$30,000	

It is clear from this example that the deduction for charitable contributions allowed on the return is actually limited to 50% of AGI, even though there are contributions subject to the new 60% limitation. Only if your cash donations to PCs is equal to or exceeds 60% of your AGI, will the 60% limitation actually apply.

For example, assume the same facts as above, but instead of donating cash to PCs of $70,000, you donate $120,000. In that case you would receive the benefit of the full $120,000 (which is 60% of the AGI), and the other contributions of $60,000 will be carried forward for up to five years.

In order to claim a deduction on your personal income tax return, contributions can only be made to U.S.-based charitable organizations. Contributions to foreign charities do not generally apply. "Friends of" organizations are typically set up as U.S. domestic charities, and support foreign charities. Charitable contributions to such organizations are deductible. Treaty-based exceptions may apply.

While the TCJA restricted and even eliminated a good many itemized deductions (from 2018 to 2025), the deduction for charitable contributions remains intact. In fact, the Pease limitation on itemized deductions which in past years reduced itemized deductions by 3% for every dollar of taxable income over certain threshold and ultimately up to 80% of their itemized deductions has been repealed. Taxpayers will receive a dollar-for-dollar deduction for their contributions if they itemize.

More sophisticated planning techniques are discussed in this chapter, including using donor-advised funds, private foundations, and charitable trusts, to help you combine tax planning with your charitable goals.

Impact of the TCJA on Charitable Contributions

There are limitations on the amount of contributions that you can deduct in a given year based on your AGI, the type of property donated and the type of charity receiving the donation, as Chart 6 indicates. For cash contributions, the TCJA increased the 50% threshold to 60% starting in 2018 (and through 2025). The 60% limit only applies to cash gifts made to public charities. Unfortunately, because of the way in which this new law provision was inserted in existing law, the 60% limitation will not be available in cases where donors are gifting to both public charities and private foundations, or are making gifts of both cash and noncash items, such as securities and artwork. IRC Sec. 170, which discusses charitable contributions, is a complicated provision of the law, and the way in which these various categories of donations interact with one another causes more of the overall charitable deduction to be disallowed in the current year. The good news is that any amount disallowed can be carried forward and potentially used in the succeeding five years, depending upon application of these limitations to the particular tax circumstances in that year. Planning for future years is imperative as you do not want to find yourself in the situation where excess contributions are not used with the five-year period, and are ultimately lost (see tax tip 17).

For purposes of this provision, donor-advised funds and private operating foundations qualify as public charities. Further, a contribution to a private non-operating foundation which qualifies under the out-of-corpus rules as a pass-through or conduit foundation also qualifies for the 60% contribution base for cash contributions.

New for 2019

The enactment of the Taxpayer Certainty and Disaster Relief Act of 2019 temporarily suspends current AGI limitations for "qualified contributions." The term "qualified contributions" means any charitable contribution that is paid during the period beginning on January 1, 2018 and ending on the date which is 60 days after the date of the enactment of the Act (December 20, 2019) and is made for relief efforts in one or more qualified disaster areas. The taxpayer must obtain contemporaneous written acknowledgement from the organization that the contribution was used or will be used for relief efforts. The Act specifies that this provision does not apply to contributions to 509(a)(3) supporting organizations or to the establishment of a new, or maintenance of an existing, donor-advised fund.

Use Long-Term Appreciated Property

You should always use appreciated publicly traded securities that you have held for more than one year, rather than cash, to fund significant charitable

contributions. You should also consider using other eligible appreciated property, such as artwork, that you can give to a museum. By doing so, you can get the double tax benefit of receiving a deduction equal to the full fair market value of the security or property (as if you contributed cash) and avoid paying capital gains tax on the appreciation (see Tax Tip 18).

While a contribution of long-term appreciated property remains unchanged under the new tax law and is generally limited to 30% of your AGI, this is still usually a high ceiling and any disallowed contributions can be carried forward for the next five years, as described above.

Caution: *Units of a publicly traded partnership are not considered qualified appreciated stock. If a partner contributes a partnership interest with liabilities to a charity, the transaction is considered in part a charitable contribution and in part a deemed bargain sale, with the partner's share of liabilities treated as the amount realized on the deemed sale. If it is a bargain sale to a private foundation, the self-dealing private foundation rules will apply and penalties may be imposed.*

Time Your Contributions

Always consider your tax rate for this year and future years before deciding when to make your contributions. Your tax rate may vary significantly in a year of unusual financial events. Another aspect to consider in 2019 and through 2025 is the increase in the standard deduction. The TCJA doubles the amount previously allowed for both single and married filing joint filers. At the same time, certain itemized deductions are temporarily suspended through 2025. This may create a disincentive for certain individuals to make charitable contributions, since they may no longer get a tax benefit for the contribution. They may consider bunching their charitable contributions into a single year in order to qualify for itemization, and thus secure some tax benefit for the gift. Many charities may be impacted as they receive many donations with small amounts.

If you expect your tax rate to be the same next year, prepay your charitable contributions this year (if feasible and desired) to gain the advantage of accelerating the tax deduction. On the other hand, if you expect that your tax rate will increase next year, you might want to consider deferring contributions to next year in order

Tax Tip

18. The Benefit of Contributing Long-Term Appreciated Securities Rather Than Cash

A stock that you have owned for many years has appreciated to $100,000 from its original purchase price of $60,000. You have decided that it may have very little future growth potential. Instead of selling the stock, you donate it to your favorite charity. Your tax savings by donating the stock rather than cash would be:

	Cash Donation from Proceeds	Stock Donation
Tax savings on contribution ($100,000 at 37% in 2019)	$ 37,000	$ 37,000
Capital gains tax if stock was sold ($40,000 at 23.8%* in 2019)	(9,520)	0
Net federal tax savings	$ 27,480	$ 37,000

**Includes 3.8% Medicare Contribution Tax on net investment income.*

to secure more tax savings at the higher rate. Also, you will need to have itemized deductions in excess of the standard deduction in order to get the benefit of increased charitable contributions.

The year that you can take the deduction is the year the charity actually receives the property. Therefore, make sure that you satisfy the legal transfer requirements for contributions of securities or other property that you make prior to year-end. One way to do this is by having the securities transferred directly from your brokerage account to the charity's brokerage account before year-end, thereby accelerating the process.

Contributions Deductible Only at Cost Rather Than Fair Market Value

Certain types of property will not avail you of a charitable deduction equal to the appreciated fair market value of the property. So, before contributing property, consider its eligibility and other options available to fund your charitable contributions. These types of property include:

Securities held for 12 months or less

If you contribute securities that you have held for 12 months or less, your charitable deduction is equal to the lesser of the fair market value or your basis in the stock. Therefore, you lose the deduction for any of the appreciation of the security.

Securities with a fair market value less than your cost

Never use these securities to fund your contributions since your deduction will be limited to the lower fair market value of the stock and you will permanently lose the benefit that you would have received had you sold these securities at a capital loss.

Other ordinary income property

The charitable deduction for ordinary income property is limited to the lesser of the fair market value or your basis in the property, even if you have held the property more than 12 months. Ordinary income property includes inventory items and property subject to depreciation recapture.

Tangible personal property

To get the property's full fair market value as a deduction, the appreciated property must qualify for long-term capital gain treatment had it been sold and the charitable organization must use this property in its exempt function (such as a painting given to a museum). Otherwise, your deduction will be limited to the lesser of your basis or the property's fair market value. Furthermore, if the charitable organization disposes of the property within three years, the donor will be required to include as ordinary income for the year of the disposition the difference between the charitable deduction and the donor's basis. However, if the organization certifies to the IRS, in writing, that the property's use was, or was intended to be, related to its exempt purpose or function, this rule would not apply.

Vehicles

If the charitable organization does not use the vehicle in its exempt function, but instead sells the vehicle (for over $500), your charitable deduction will be limited to the gross proceeds received from the sale by the charity, not the appraised value.

Fractional interest

A fractional interest contribution consists of a gift of an undivided portion of property to a charity that uses the property in connection with its exempt purposes (e.g., an interest in artwork that is contributed to a museum). In this situation, your initial charitable deduction will be the fair market value of the property multiplied by the fractional interest contributed.

As an example, let's say you donate the use of a painting valued at $400,000 to a museum for three months and you retain the painting for the remaining nine months. Your charitable deduction would be $100,000 based on 25% of the value of the painting at the time of the contribution (three months of the year). If you gift the use of the same painting next year for six months (additional three months or additional 25%)

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and the fair market value of the painting has increased to $440,000, your contribution would not be $110,000 based on 25% of additional contribution multiplied by the value of the painting when contributed. Instead, it would be $100,000 since a subsequent fractional interest donation of the same property is limited to the lesser of the value at the time of the initial fractional contribution or the value on the additional contribution date.

Beware that "recapture" will occur if you make an initial fractional contribution of artwork, then fail to contribute all of your remaining interest in the artwork to the same donee on or before the earlier of the date that's ten years from the initial fractional contribution or the date of your demise ("specified period"). Recapture consists of an income inclusion in the year in which the specified period falls and is in the amount that was previously deducted plus interest running from the due date of the return for the year of the deduction until paid and a penalty of 10% of the amount of the income inclusion.

Remainder interest in real property

The owner of real estate, such as a vacation home, can have full use of the property throughout his or her life and leave a remainder interest to a charitable organization. You will receive a charitable deduction based on the present value of the remainder interest in the property in the year that the remainder interest is contractually conveyed, not when the charity actually takes title to the property. Therefore, you receive a current deduction even though the charity does not receive the property until the condition of the conveyance occurs (death of the donor).

Conservation easement

A conservation easement is a contribution of a real property interest to a charitable organization that uses the easement exclusively for conservation purposes. A real property interest for this purpose includes a perpetual restriction on the use of the real property. The donor does not give up ownership, control, or enjoyment of the land. The easement only restricts what can be done on or to the land. In the typical case, a perpetual conservation easement is given to a qualified conservation organization. The charitable deduction is equal to the difference in the fair market value of the property with and without the easement and requires a qualified appraisal. This type of charitable contribution often gives the IRS cause to scrutinize the valuation on which the deduction is based.

Under a temporary provision that had terminated for contributions made in taxable years beginning after December 31, 2014, the 30% contribution base limitation on deductions or capital gain property by individuals did not apply to 'qualified conservation contributions.' Rather, the 50% contribution base limitation and five-year carryover applies. The Protecting Americans from Tax Hikes Act of 2015 ("PATH") reinstated and made permanent these provisions.

Unreimbursed expenses

Although you cannot get a charitable deduction for services performed on behalf of a charitable organization, you may deduct incidental unreimbursed expenses incurred while performing these services. Travel expenses to and from the place where the services are performed are deductible. You can deduct expenses of operating your car including tolls and parking fees but not expenses connected with maintenance of the car such as depreciation, repairs or car insurance. Alternatively, you can deduct 14¢ per mile. Reasonable expenses for meals and lodging while "away from home" in performing charitable services are deductible as well. Expenses that are considered personal and not specifically incurred in the performance of services on behalf of a charitable organization are not deductible.

IRA Distributions as Charitable Contributions

The provision for qualified charitable distributions, which allows IRA and inherited IRA owners age 70½ or older to transfer portions of their accounts to qualifying charities tax-free while satisfying all or a portion of their

required minimum distributions, was made permanent as a result of PATH.

According to the provision, if you are age 70½ or older, you can make tax-free distributions to charity from an IRA of up to $100,000 per year. These distributions must be made directly to the charity and are neither includible as income nor deductible as an itemized deduction on your tax returns.

In order to qualify, the charitable distribution must be made to a public charity. Payments to a donor-advised fund, supporting organization or private foundation do not qualify.

This technique has additional benefits since, unlike a taxable distribution, the distribution is not included in AGI. This may therefore impact the Medicare Contribution Tax on net investment income, the 7.5% threshold for itemizing medical expenses, the deductibility of Social Security benefits, the amount of Part B Medicare premiums you pay as well as the allowance of many tax credits which are based on a modified AGI threshold. In addition, this provision can be a tax efficient way to donate to public charities especially in light of the TCJA.

How to Accelerate the Tax Benefit of Future Contributions and Meet Philanthropic Goals

Certain charitable vehicles allow you to accelerate the tax benefit of future contributions into the current year while retaining practical control over when such contributions are actually made to your intended charity. The most common charitable planning vehicles include:

- Donor-Advised Funds
- Private Foundations
- Charitable Trusts

Donor-Advised Funds vs. Private Foundations

Contributing to either a donor-advised fund or a private foundation offers a tax deduction (subject to different limitations), but they have their differences. The donor-advised fund is the simpler and less costly alternative. Using a private foundation requires you to create a legal entity with annual tax filings, subject to an excise tax on net investment income and other potential excise taxes (see the discussion below). Yet, despite these disadvantages, the private foundation can still be a preferable alternative if substantial amounts are involved, so consider the following similarities and differences when evaluating either of these options:

Obtain a large charitable deduction in the current year

Both a donor-advised fund and a private foundation allow you the ability to avoid paying capital gains tax on appreciated marketable securities held more than one year when such property is donated. However, funding a private foundation with securities is limited to 20% of your AGI, while a similar donation to a donor-advised fund has a larger limitation of 30% of your AGI.

Private foundation is subject to tax

For tax years beginning after December 20, 2019, a private foundation is subject to a flat excise tax of 1.39% on its net investment income, including realized capital gains on the appreciated property contributed. The excise tax rate was lowered by the Taxpayer Certainty and Disaster Relief Act of 2019 from the previous 2% rate, which will still apply for the calendar year 2019 private foundations. The new legislation also eliminated the provision that allowed a 1% tax rate to apply in place of the 2% rate if a private foundation met certain distribution requirements. Net investment income is defined to be interest income, dividend income, certain rental income and royalty income, reduced by expenses incurred in connection with the production of such income. An income tax will be assessed on a foundation's unrelated business income as well as an onerous excise tax if the foundation is involved

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in various acts of self-dealing or other prohibited transactions. A donor-advised fund is not subject to an excise tax on its net investment income. It can be subject to the unrelated business income tax and onerous penalty taxes if conducting prohibited transactions.

Retain control of the timing, amount and payment of future charitable contributions

The donor-advised fund permits you to make your contributions to a public charity that will retain them in an account (which can bear your name) for future charitable distributions. Typically, the fund will follow your charitable preferences, though it is not legally obligated to do so. The private foundation generally gives you more direct control, which can sometimes make it easier to achieve your investment goals and ensure that your charitable objectives are accomplished.

Maintain management control of the private foundation's investments

This can be one of the major advantages of the private foundation. You retain full control over all investment decisions, allowing you to use your investment expertise and resources to maximize the assets in the foundation.

Involve family members

A private foundation can provide intangible benefits by involving family members in a collaborative philanthropic effort. Your family can benefit from having the responsibility of making management decisions and formulating a mission statement to satisfy the family's overall charitable desires. The management responsibilities of the foundation can be passed down from one generation to another, perpetually keeping it in your family's name. It is also possible to give your children the ability to recommend charitable distributions for your donor-advised fund.

Make minimum distributions

A private foundation is subject to a rule which requires an annual distribution to charities equal to at least 5% of the average value of its non-charitable use assets. Excise taxes will be assessed on foundations that fail to distribute the required minimum distribution. Typically, although not always, the actual earnings and appreciation of the assets in the foundation are greater than the 5% minimum distribution. Donor-advised funds do not have a minimum grant distributions rule.

Charitable Trusts

A charitable trust can provide the following benefits:

- Convert appreciated property into an annuity.
- Diversify your portfolio and defer capital gains tax.
- Obtain a current-year charitable deduction for the present value of a remainder interest left to charities by using a charitable remainder trust. However, with the present low interest rate environment, this deduction is lower than in the past.
- Pass appreciation on to your beneficiaries by using a charitable lead trust.

There are two types of charitable trusts — charitable remainder trusts ("CRTs") and charitable lead trusts ("CLTs"). You can set up either as an annuity trust or a unitrust. The annuity trust pays a fixed dollar annuity that is based on a fixed percentage of the initial trust value. The unitrust pays an annuity that will vary since it is based on a fixed percentage of the trust's annual fair market value, which necessitates annual valuations.

Charitable Remainder Trusts

A CRT can help you diversify your portfolio and increase your annual income stream while satisfying charitable desires (see Tax Tip 19). If you contribute highly appreciated securities to a CRT, such as a concentrated position in low basis stock, the CRT can sell them without incurring a current capital gains tax. You will not only diversify your portfolio and reduce market risk, but you will also receive an annuity based on the securities' fair market value. You will be taxed as you receive annuity payments, as discussed below.

Tax Tip

19. Use a CRAT to Diversify Your Portfolio and Provide Yourself with an Annuity

As an original shareholder in a company that went public, you now own stock that is worth $1,000,000 with a tax basis of only $400,000. You would like to diversify your portfolio but you have been reluctant to do so because of the capital gains tax.

One option you might want to consider is establishing a charitable remainder annuity trust ("CRAT"). By doing so, you can combine your desire to diversify your portfolio with your charitable giving intentions. The trust can sell the stock and pay no tax on the $600,000 gain at the time of the sale since the trust is a tax-exempt entity. The trust can then use the proceeds from the sale to purchase other investments which, in turn, diversifies your overall portfolio allocation since you retain an annuity interest in the trust.

Assuming you choose a 10% payout rate, you will receive an annuity of $100,000 for the term of the trust, much of which will be eligible for the net long-term capital gains tax rate of 23.8% (inclusive of the Medicare Contribution Tax on net investment income) based on the undistributed gain of $600,000. You will also receive a current-year charitable contribution for the present value of the remainder interest going to charities. Remember, though, that the family loses the remainder value since it will pass to charities at the end of the trust's term.

The annuity you receive will probably exceed the income you are currently receiving from the contributed securities (but you will be foregoing future appreciation in excess of the annuity).

The CRT's assets grow tax-deferred because it is not subject to tax and you only pay tax on the annuity payouts as you receive them. Therefore, the CRT can immediately sell the appreciated stock that you contributed and spread out the tax on the gain over the life of the annuity (you may never actually pay the full tax). The taxable nature of the annuity is based on the trust's undistributed accumulated income at year-end, subject to the ordering rules. The assets remaining at the end of the trust's term go to your designated charities.

You can choose to have the annuity paid to your beneficiaries instead of yourself, but you must consider gift tax consequences since you will have made a gift to your beneficiaries equal to the annuity's present value. The gift amount is set at the date of the transfer to the CRT. Typically, this may result in lower overall gift and estate taxes if the IRS tables used for determining the present value of the annuity payouts are at a rate that is lower than the actual growth rate experienced by the CRT. You can also reduce overall family income taxes if the beneficiary's tax rates are lower than your tax rates.

To qualify as a CRT, the trust must satisfy the following rules:

- The term of the trust cannot exceed 20 years and the trust must be irrevocable.
- The annual annuity income payout to the beneficiary must be at least 5%, but not greater than 50% of either the initial amount transferred to an annuity trust or the annual year-end fair market value of the assets for a unitrust.
- The value of the remainder interest to the charity must be at least 10% of the trust's initial fair market value.

Charitable Lead Trusts

The CLT is basically the reverse of the CRT. The annuity is paid to the charity and you or your beneficiaries receive the remainder interest at the end of the trust's term. But the income tax implications are complex because you are only allowed a charitable deduction if the CLT is structured as a grantor trust (with you reporting the annual income and charitable deduction). If the trust is set up as a non-grantor trust, you don't receive a charitable deduction but you are also not taxed on the income the trust earns.

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Chart

6. Charitable Contribution Limitations Based on Adjusted Gross Income

The maximum deduction you are allowed for your charitable contributions is subject to a limitation based on your AGI, as noted below.

However, see the discussion above and notes below for ways to increase some of the limitation amounts. To the extent that your deduction is limited, you can carry the disallowed contributions forward for five years, subject to the same annual percentage limitations.

Contributions Made To	AGI Limitation	
	Cash and Ordinary Income Property	Appreciated Capital Gain Property
Public Charities*	50% or 60%*** for cash	30%
Nonoperating Private Foundations	30%	20%
Private Operating Foundations**	50% or 60%*** for cash	30%

These ceiling amounts can be increased in the following ways:

- If a non-operating private foundation makes qualifying distributions out of its corpus within 2½ months after the end of its taxable year equal to 100% of the contributions it received during that year, the 30% limitation for cash and ordinary income property increases to 50% (or 60%***), and the 20% limitation for appreciated capital gain property increases to 30%.
- The 30% limitation for appreciated capital gain property donated to public charities and private operating foundations can be increased to 50% by electing to reduce your contribution to the property's cost. This is only advisable if your contributions would otherwise be limited and it is unlikely that you will benefit from the carryover in the future.

**Donor-advised funds are treated as public charities.*
***Private operating foundations are non-publicly supported organizations that devote most of their earnings and assets to the conduct of their own tax-exempt purposes.*
****The TCJA provides that only cash contributions to public charities qualify for the 60% threshold. If any contributions are other than cash (such as ordinary income property), the 60% deductibility limit is not available. See tax tip 17.*

Despite these complexities, a CLT can be an effective gift and estate tax planning tool because you are subject to gift tax only on the present value of the remainder interest you are giving away. This allows you to gift a much greater interest in assets, such as stock in an early stage company, and pay little or no gift taxes. If the stock value grows significantly, your beneficiaries will enjoy the excess appreciation since the growth will be greater than the earnings rate in the IRS tables for valuing the present value of the remainder interest, which has recently been very low.

However, they will have to wait until the trust term ends in order to receive the remaining assets.

Substantiate Your Cash Charitable Contributions

Regardless of the amount of the contribution, cash donations to charitable organizations must be substantiated with a bank record or written communication from the donee organization showing the name of the donee organization, the date the contribution was made, the amount of the contribution and the value of any benefit to you. Therefore, you must make sure to obtain the necessary documentation to support your cash charitable donations. A cancelled check is no longer sufficient substantiation if the contribution is $250 or more. The written

acknowledgement must explicitly state whether any goods or services were received in connection with the donation. This rule eliminates your ability to deduct weekly cash contributions made at religious gatherings unless you can meet the substantiation rules.

Noncash Contribution Appraisal Requirements and Limitations

If you contribute property worth more than $5,000, you are required to obtain a qualified appraisal. Also, you must complete and attach Form 8283, Noncash Charitable Contributions Appraisal Summary, to your tax return. This form must include the qualified appraiser's signature, and an authorized person from the charitable organization must complete, sign and date the appropriate section of the form, indicating the date of the contribution and whether the property is being used for the charity's exempt purpose.

A complete copy of the signed appraisal must be attached to your tax return if you contribute any of the following:

- Artwork appraised at $20,000 or more.
- Any item, or group of similar items, for which you are claiming a charitable deduction greater than $500,000.
- Easements on buildings in historic districts.

Caution: *A qualified appraisal must meet certain criteria to be acceptable:*

- *The appraisal must be made no earlier than 60 days before the date you contribute the property and before the due date (including extensions) of your tax return on which the deduction is claimed.*
- *The appraiser must be an individual who has either earned an appraisal designation from a recognized professional appraisal organization, has met certain minimum education and experience requirements, and regularly prepares appraisals for which he or she is paid, or demonstrates verifiable education and experience in valuing the type of property being appraised.*

Contributions of similar items of property with an aggregate value exceeding $5,000 are subject to the same requirements. For example, if you contribute clothing valued at $3,000 to one charity and your spouse contributes clothing valued at $2,500 to another charity, you would need to obtain qualified appraisals for both contributions. The appraisal requirements do not apply to contributions of cash, publicly traded securities or non-publicly traded stock worth less than $10,000.

If these requirements are not satisfied, no charitable deduction is allowed, even if the charity received the property and the value is not in dispute.

Medicare Contribution Tax on net investment income

Charitable gifts are not deductible for the purpose of calculating 3.8% Medicare Contribution Tax on net investment income of high income taxpayers.

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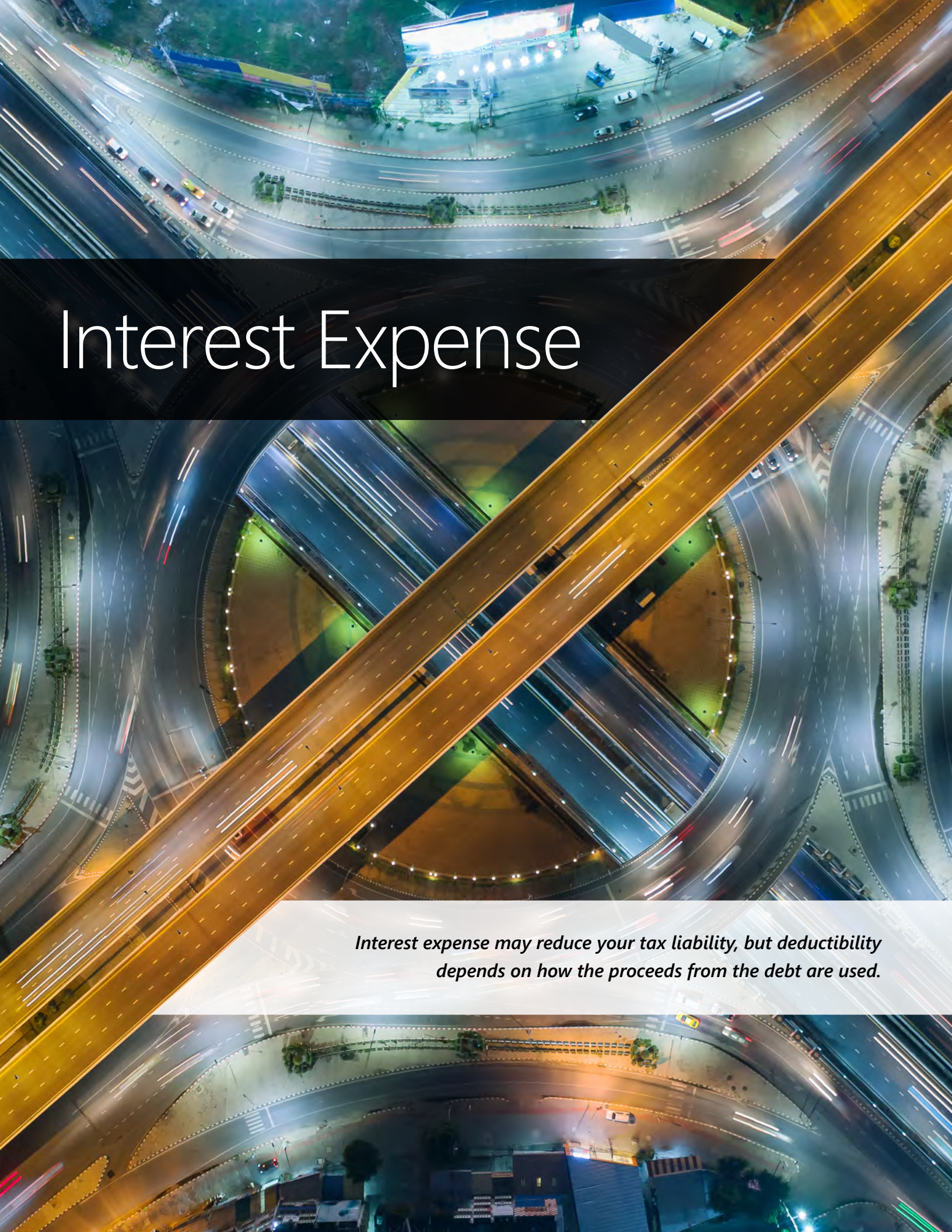
Interest Expense



Interest expense may reduce your tax liability, but deductibility depends on how the proceeds from the debt are used.

Interest Deductibility

Your ability to deduct interest payments is subject to many rules and limitations. Deductibility of interest expense depends on how you used the debt proceeds. Before incurring any new debt, you should consider the options available to you to get the best tax result from the interest you will pay on the debt. Also, periodically review your debt to determine whether you can replace debt generating non-deductible interest with other debt so that you can lower your taxes.

Once deductible, there are also rules that categorize whether the interest is deductible against your AGI (also known as "above the-line" deductions) or as an itemized deduction. Generally, above-the-line interest deductions will yield a better tax result. This difference can especially be significant in reducing your state and local income tax bill, since many states do not allow itemized deductions (or severely limit them). Chart 7 summarizes the nature of the different types of interest deductions.

Chart

7. Interest Expense Deduction

Nature of Debt	Nature of Deduction		
	Not Deductible	Itemized Deduction	Above-the-Line Deduction
Qualified residence (including a second home)		•	
Personal or consumer	•		
Taxable investments		•	
Tax-exempt investments	•		
Trading activities			•
Business activities			•
Passive activities			•
Education loans			•

Note: *Other rules may limit your ability to deduct the interest expense in full.*

Qualified Residence

Interest paid on mortgage debt used to acquire or improve your home is deductible as qualified residence interest, subject to limitations. The two types of qualified mortgage debt are:

Acquisition debt

This is debt incurred on the acquisition, construction or substantial improvement of your principal residence and/or your second home (a so-called vacation home if used for personal purposes). For 2019, the debt must be secured by the residence and is limited in total to $1 million ($500,000 if married filing separately) for debt incurred on or before December 15, 2017. The TCJA reduces the mortgage interest deduction to interest on $750,000 ($375,000 if married filing separately) of acquisition indebtedness for debt incurred after December 15, 2017. The limitation reverts back to $1,000,000 for tax years after December 31, 2025.

Acquisition debt also includes debt from a refinancing of an existing acquisition debt, but only up to the principal of that debt at the time of the refinancing plus any proceeds used to substantially improve your residence. A home equity loan that is used to substantially improve your residence qualifies as acquisition debt. Qualified residence interest does not include interest paid on loans from individuals, such as your parents, if your home is not security for the debt and the debt is not recorded at the appropriate government agency (for example, the county clerk's office).

What if you desire to purchase a particular home and finance it with a mortgage, but need to act immediately to secure the acquisition? You can buy the residence with cash and then put the debt into place within 90 days of the acquisition.

Under the Further Consolidated Appropriation's Act, income of up to $2 million from the cancellation of a mortgage on a principal residence is tax-free.

Home Equity Debt

The Tax Cuts and Jobs Act suspends the interest deduction on home equity indebtedness for tax years beginning after December 31, 2017 and before January 1, 2026, unless the debt is used to buy, build or substantially improve the residence that secured the loan.

Points

Points may be fully deductible in the year paid, or they may be deducted over the life of the loan. In order to be deductible in the year paid, the following are some criteria that must be met:

- Your loan is secured by your principal residence.
- You use the loan to buy or build your principal residence.
- The points were stated as a percentage of the indebtedness.
- The amount is clearly shown in the closing statement as points.

Tax Tip

20. Convert Nondeductible Debt into Deductible Margin Debt

You can reduce or eliminate your personal debt by converting it into deductible margin debt. Rather than using the proceeds from the sale of securities to buy other securities, use the proceeds to pay off your personal debt. You can then use margin debt, to the extent available, to buy new securities. Your total debt and your total stock portfolio remain the same, but you will have converted nondeductible interest into deductible investment interest (assuming no other limitations apply). And the interest rate on margin debt is typically lower than the rate on consumer debt.

Caution: *Keep loan proceeds totally separate from other funds whenever possible. This can avoid reallocation by the IRS, and may save important tax deductions.*

If the loan is to refinance your principal residence or a second home, points must be deducted over the life of the loan. If the loan is paid off early, you may deduct any points not already deducted in the year in which the loan is paid off.

The TCJA suspends the overall limitation on itemized deductions for tax years beginning after December 31, 2017, and before January 1, 2026.

Personal or Consumer Debt

Interest expense from personal (or consumer) debt is nondeductible. This includes interest paid on debt used to pay personal expenses, buy consumer goods (including cars), or satisfy tax liabilities. See Tax Tip 20 for a method to convert personal debt into investment debt.

If you have interest expense arising from a passive activity that is being limited because you have excess

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passive losses, consider replacing this debt with investment debt in the same manner as discussed in Tax Tip 20.

Investment Interest

Investment interest is interest on debt used to buy assets that are held for investment. Margin debt used to buy securities is the most common example of investment debt. Another typical source of investment debt is the pro rata share of investment debt incurred by a pass-through entity (partnership, LLC, or S corporation). The investment interest expense on this debt is treated in the same manner as if you personally paid the interest.

Interest on debt used to buy securities which generate tax-exempt income, such as municipal bonds, is not tax-deductible. But be careful, since this rule can reach further than you would expect. As Tax Tip 21 illustrates, you are required to allocate interest expense to the tax-exempt income, rendering a portion of the interest expense as nondeductible.

Investment interest expense is only deductible up to the amount of your net investment income. Generally, this includes taxable interest, nonqualifying dividends (as discussed below) and net short-term capital gains (but not net long-term capital gains). Any disallowed interest for the regular tax or AMT is carried forward and can be deducted in a later year, to the extent that there is adequate net investment income.

For 2019, qualified dividend income that is eligible for the 15% (20% if AGI exceeds $434,550 for single filers ($441,450 in 2020), $244,425 for married filed separately ($248,300 in 2020), and $488,850 for married filed jointly ($496,600 in 2020)) preferential tax rate is not treated as investment income for purposes of the investment interest expense limitation. However, dividends not qualifying for this rate, including dividends received from money market mutual funds and bond funds, are subject to ordinary income tax rates and therefore qualify as investment income.

If you have an investment interest expense limitation, an election is available to allow you to treat any portion of your net long-term capital gains and qualifying dividend income as investment income. Generally, this election should only be used if you do not expect to be able to utilize any of the investment interest carryover in the near future. This election can increase the amount of investment interest expense that you can deduct in the current year. By making this election, you lose the favorable lower capital gains and qualified dividend tax rate of 15% or 20%, but you get to reduce your taxable income by the increased investment interest expense you deduct at the higher ordinary income tax rates.

As an example, assume in 2019 you are subject to the maximum tax rate of 37% and you have $100,000 of investment interest expense in excess of your net investment income. You also have net long-term capital gains of $500,000. By electing to treat $100,000 of the $500,000 long-term capital gains as ordinary income, you pay an extra $17,000 of tax on the capital gains ($100,000 of elected gains taxed at 37% rather than 20%).

However, you save $37,000 of tax since your taxable income is lower by the additional investment interest expense ($100,000 at 37%). Therefore, your net tax drops by $20,000. Plus, you will save state taxes if your state of residency allows you to reduce your income by all, or some, of your itemized deductions.

Additionally, the investment interest expense deduction can help reduce the 3.8% Medicare Contribution Tax on net investment income.

Above-the Line Deductions

Interest expense deductible "above-the-line" against your AGI gives you a greater tax benefit than interest treated as an itemized deduction. This is because the interest expense reduces your AGI, which in turn

reduces, if applicable, the limitation on deductible medical expenses and other items affected by AGI. But even more beneficial for most taxpayers is that the interest will be deductible against your state income, rather than nondeductible if you live in a state that does not allow itemized deductions (such as Connecticut, Pennsylvania and New Jersey), or limited in a state that disallows a portion of your itemized deductions (such as New York and California).

Interest expense eligible for this favorable treatment includes:

Trading interest

This is interest incurred on borrowings against taxable securities if you are actively engaged in the business of trading personal property (securities), rather than simply as an investor. This interest commonly passes through a trading partnership or LLC. The interest will be classified as trading interest to you even if you have no involvement in the management of the entity, so long as the entity meets the tests for actively engaging in the business of trading personal property. However, in such a case, the trading interest is still subject to the investment interest expense limitation discussed above.

Business interest

This is interest on debt traced to your business expenditures, including debt used to finance the capital requirements of a partnership, S corporation, or LLC involved in a trade or business in which you materially participate. This also includes items that you purchase for your business (as an owner) using your credit card. These purchases are treated as additional loans to the business, subject to tracing rules that allow you to deduct the portion of the finance charges that relate to the business items purchased.

In addition, the TCJA limits the deduction for net interest expenses starting January 1, 2018. Please see the chapter on business owner issues and depreciation deductions.

Interest on education loans

A qualified education loan is any debt incurred solely to pay the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or an individual who was the taxpayer's dependent at the time the debt was incurred.

For 2019 and 2020, the maximum deductible amount for educational loan interest is $2,500. The student loan interest begins to phase-out for taxpayers whose MAGI exceeds $70,000 in 2019 ($140,000 for joint returns) and is completely eliminated when MAGI is $85,000 ($170,000 for joint returns). For 2020, the loan interest begins to phase-out for taxpayers whose MAGI exceeds $70,000 ($140,000 for joint returns) and is completely eliminated when MAGI is $85,000 ($170,000 for joint returns).

Passive activity interest expense

Passive interest expense is interest on debt incurred to fund passive activity expenditures, whether paid by you directly or indirectly through the capital requirements of a pass-through business entity. The interest is an

Tax Tip

21. Indirect Tax-Exempt Debt Can Limit Your Deductible Interest

It is common to have one investment account that holds mostly tax-exempt municipal bonds and a separate account that holds mostly taxable investments (such as stock in publicly traded companies). Assume that you want to use your available margin in the account holding taxable investments to purchase additional stock. Even though you are not using margin in your tax-exempt account, your interest deduction will be limited because of an IRS ruling that requires you to allocate a portion of the debt to your tax-exempt holdings based on the ratio of your tax-exempt investments to your total investments. This ruling was designed to prevent a taxpayer from reaping a double tax benefit, and thus treats your accounts as one account and deems you to have indirectly borrowed some of the debt to maintain your tax-exempt account. Therefore, before you borrow against your securities, consider the real after-tax cost of the interest you will be paying.

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additional deduction against the income or loss of the activity, thereby deductible against AGI. However, since the interest expense becomes part of your overall passive activity income or loss, it is subject to the passive activity loss limitations. See the chapter on passive and real estate activities.

Retirement Plans

Contributing to retirement plans can provide you with financial security as well as reducing and/or deferring your taxes. However, there are complex rules that govern the type of plans available to you, the amount you can contribute, whether contributions need to benefit your employees, and the requirements for taking funds out of the plan. Failure to adhere to these rules can have severe, adverse tax consequences.

Retirement Plan Benefits

Retirement plans (other than Roth IRAs and plans offering Roth 401(k) contributions) offer these tax saving advantages:

- Your contributions grow tax-deferred until withdrawn.
- Your contributions are tax deductible, thereby reducing your current year's taxes.

Roth IRAs and Roth 401(k) contributions offer different tax savings opportunities by providing for tax-free growth and withdrawals in the future, but there is no current-year tax deduction for your contributions.

Available Retirement Plans

There are many different types of retirement plans available with different contribution and distribution rules. The specific plan(s) you can contribute to depends on a variety of factors, including your income, whether you are an employee or self-employed, and whether you contribute to or participate in other retirement plans.

Self-employed individuals have more flexibility to choose plans to maximize contributions. Employees are more limited since they will have to make contributions based on the type of plan their employer offers, but may gain the advantage of having their employer match some or all of their contributions. Employees may also be eligible to make contributions to other plans in addition to the ones offered by their employer, if they have earned income from a self-employment activity (such as consulting or directors' fees). Employees or self-employed individuals and their spouses may also be eligible to contribute to a traditional or Roth IRA.

Chart 8 shows the different types of retirement plans that you may be eligible to participate in. Chart 9 shows the maximum annual contributions that you can make for 2019 and 2020.

Chart

8. Retirement Plans

Retirement plans available to self-employed individuals include:
- Simplified Employee Pension (SEP) Plans
- SIMPLE IRA or SIMPLE 401(k) Plans
- Defined Contribution Plans including 401(k) Plans
- Defined Benefit Plans

Note: *Partners in partnerships and owners of entities taxed as partnerships (generally LLCs) are treated as owner-employees for purposes of retirement plans and may not set up their own retirement plan to the exclusion of other employees or partners.*

Employer-sponsored salary deferral plans available to employees include:
- 401(k) Plans
- 403(b) Plans for Employees of Public Schools or Tax-Exempt Educational, Charitable and Religious Organizations
- 457(b) Plans for Employees of Government Organizations
- SIMPLE Plans for Companies with 100 or Fewer Employees

Individual Retirement Accounts (IRAs) available to all individuals, subject to income limitations:
- Roth
- Traditional
- Education

Simplified Employee Pension Plans

A SEP plan allows you, in your capacity as employer, to make contributions to your own IRA and to eligible employees' IRAs. If you do not have employees, the plan is a single participant plan for your benefit. If you have eligible employees, you must also make contributions on their behalf. The maximum allowable annual contribution to a SEP is $56,000 for 2019 and $57,000 for 2020. However, the contribution on behalf of a self-employed individual cannot exceed 25% of his or her eligible compensation (net of the deduction for the contribution). The contribution limit for common law employees covered by a SEP is the lesser of 100% of their eligible compensation or $56,000 for 2019 and $57,000 for 2020.

There are several advantages of a SEP compared to a qualified defined contribution plan (e.g., a profit-sharing plan). Unlike a defined contribution plan, which must be established by December 31, a SEP plan can be set up any time prior to the due date of the tax return for the current year of the sponsoring entity (including extensions) and you can still deduct contributions on your prior year's tax return, even though made in the next year. Another advantage is that SEPs do not require the same documentation as defined contribution plans, nor is Form 5500 required to be filed annually.

New for 2020

The Setting Every Community Up for Retirement Enhancement Act of 2019 ("SECURE Act") modifies the deadline for adopting a retirement plan for all types of qualified plans (except for 401(k) provisions). Plans can now be adopted by the due date of the plan sponsor's tax return including any extensions and be effective for the prior tax year. This gives plan sponsors an alternative to adopting a SEP plan, which until this change was the only type of plan that could be adopted after the end of the plan sponsor's taxable year and still be effective for the prior year. This change is effective to plans adopted for tax years beginning after December 31, 2019.

Qualified Defined Contribution and Defined Benefit Plans

A qualified defined contribution plan can be a profit-sharing plan, a money purchase pension plan, or a target benefit pension plan. The maximum contribution to a defined contribution plan for each employee is the lesser of $56,000 in 2019 and $57,000 for 2020 or 100% of his or her compensation. For self-employed individuals, the maximum contribution will generally be limited in the same manner as for SEPs unless 401(k) provisions are included in the plan.

A qualified defined benefit plan sets a future annual pension benefit and then actuarially calculates the contributions needed to attain that benefit. Because the plan is actuarially driven, the annual contribution may exceed those allowable for other types of plans, and is based on the employee's age, average annual income and annual desired benefit (limited to the maximum allowable annual benefit). The maximum allowable annual benefit is the lesser of $225,000 in 2019 and $230,000 for 2020 or 100% of earned income.

Whether you choose a defined contribution or a defined benefit plan, your plan must be in place by December 31 of the year for which you want to make tax deductible contributions to the plan. As long as the plan is in existence on that date, you can make tax deductible plan contributions to a defined contribution plan as late as the due date of that year's income tax return, including extensions (as late as October 15, or September 15 for sole proprietors, partnerships, LLCs or corporations). For calendar-year defined benefit plans, contributions must be made by September 15, regardless of an extension to file until October 15.

Note: *Effective for tax years beginning after December 31, 2019, the SECURE Act modifies the deadline for adopting qualified defined contribution and defined benefit plans. See above section entitled New for 2020.*

In-Plan Roth conversions

Employees can elect under certain conditions to convert some or all of certain amounts that were contributed to a plan on a pre-tax basis into a Roth after-tax account inside of the plan. This is known as an "in-plan" Roth conversion. Both 401(k) plans and 403(b) plans may permit such a conversion, but the plan documents must provide for the in-plan conversion.

Application to plans and participants

Any current or former plan participant who has an account balance in the plan and who is eligible to receive an eligible rollover distribution ("ERD") can make the Roth conversion election. The election is available to surviving spouses, but not non-spouse beneficiaries. There is no income limit or filing status restriction for this election. The conversion may be applied to any

type of vested contributions (and earnings thereon) that are currently distributable and would be treated as an ERD. Contribution types that would be eligible for conversion are: pre-tax 401(k), 403(b), and 457(b) deferrals; matching contributions; and profit sharing contributions. In addition, certain after-tax contributions may be rolled over to an in-plan Roth account.

Chart

9. Retirement Plan Maximum Annual Contribution Limits

	Maximum Annual Contribution	
Type of Plan	**2019**	**2020**
401(k), 403(b), salary deferrals	**$ 19,000**	**$ 19,500**
Defined-contribution plan including salary deferral amounts above	**56,000**	**57,000**
Defined-benefit plan*	**225,000**	**230,000**
Traditional and Roth IRAs	**6,000**	**6,000**
SEP Plans	**56,000**	**57,000**
457(b) salary deferrals to state and local government and tax-exempt organization plans	**19,000**	**19,500**
SIMPLE plans (savings incentive match plan for employees)	**13,000**	**13,500**
Catch-up contributions for individuals age 50 or older • 401(k), 403(b) and 457(b) plans • Traditional and Roth IRAs • SIMPLEs	 **6,000** **1,000** **3,000**	 **6,500** **1,000** **3,000**

**This is the maximum annual benefit that can be provided for by the plan, based on actuarial computations.*

Salary Deferral Plans (401(k), 403(b) and 457(b) Plans)

A 401(k) plan is a profit sharing plan that allows participants to elect to have a portion of their compensation contributed to the plan. The maximum employee elective contribution that can be made for 2019 is $19,000 and for 2020 is $19,500 ($25,000 and $26,000 respectively for taxpayers age 50 and over). This annual limit applies to your total contributions even if you have more than one employer or salary deferral plan.

Similar provisions apply for 403(b) and 457(b) plans.

Simple Plans

An employer that had no more than 100 employees who earned $5,000 or more of compensation in the preceding year can establish a SIMPLE plan as long as the employer doesn't maintain any other employer-sponsored retirement plan. A SIMPLE plan can take the form of an IRA or a 401(k) plan. Both plans allow employees to contribute up to $13,000 for 2019 and $13,500 for 2020 ($16,000 and $16,500 respectively for taxpayers age 50 and over) with the employer generally required to match employee contributions at a maximum of 3% of the employee's compensation. For a SIMPLE IRA, the employer may choose to reduce the matching contribution to less than 3% but no less than 1% in two out of every five years.

Caveat: *The benefit of a SIMPLE plan is that it is not subject to non-discrimination and other qualification rules, including the top-heavy rules, which are generally applicable to qualified plans. The downside is that you cannot contribute to any other employer-sponsored retirement plan and the elective contribution limit is lower than for other types of plans. For the employee, the mandatory employer matching requirement can be attractive, though limited. For the employer, the contributions are not discretionary.*

A taxpayer may roll over amounts from an employer-sponsored retirement plan (e.g., a 401(k) plan) to a SIMPLE plan, provided that the plan has existed for at least two years.

Individual Retirement Accounts (IRAs)

Reminder: *You can make only one rollover from an IRA to another (or the same) IRA in any 12-month period, regardless of the number of IRAs you own. The one-rollover-per-year limitation is applied by aggregating all of an individual's IRAs, including SEP and SIMPLE IRAs, as well as traditional and Roth IRAs, effectively treating them as one IRA for purposes of the limit. Please note that the following rollovers are exempted from this rule:*

- Trustee-to-trustee transfers between IRAs are not limited because you do not receive a physical check from the originating IRA to deposit to the new IRA. Therefore, the transfer is not considered a rollover by the IRS. The assets and/or cash are electronically transferred from the old IRA trustee to the new IRA trustee.
- Rollovers from traditional to Roth IRAs ("conversions") are not limited (because they generate tax revenue).

Example: *If you have three traditional IRAs (IRA-1, IRA-2 and IRA-3), and you took a distribution from IRA-1 on January 1, 2020 (received a check) and rolled it over into IRA-2 the same day (must be within 60 days), you could not roll over any other 2020 IRA distribution unless the rollover meets one of the above exceptions.*

Chart

10. Uniform Life Table

If you are either unmarried, or married but your spouse is either not the sole beneficiary or is not more than 10 years younger than yourself, you can compute your required minimum distribution by using this table. Assuming you are 73 years old and your qualified retirement plans, in the aggregate, were valued at $2,000,000 at the end of 2017, you would be required to take a minimum distribution of $80,972 in 2018 ($2,000,000 divided by a distribution period of 24.7).

Age	Distribution Period	Age	Distribution Period
70	27.4	85	14.8
71	26.5	86	14.1
72	25.6	87	13.4
73	24.7	88	12.7
74	23.8	89	12.0
75	22.9	90	11.4
76	22.0	91	10.8
77	21.2	92	10.2
78	20.3	93	9.6
79	19.5	94	9.1
80	18.7	95	8.6
81	17.9	96	8.1
82	17.1	97	7.6
83	16.3	98	7.1
84	15.5	99	6.7

The two most common types of IRAs are Roth IRAs and traditional IRAs. While there are significant differences between these IRAs, there are also common rules that apply to both of them. You can contribute up to $6,000 for 2019 and $6,000 for 2020 ($7,000 if at least age 50) to either IRA account, or both combined. To be deductible as a contribution for a traditional IRA (Roth contributions are not tax deductible) in the current year, you must make the contribution on or before April 15

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of the following year. An extension to file your tax return does not extend this date. To be eligible to contribute to either IRA, you must have earned income equal to or greater than the IRA contribution amount. Taxable alimony is considered earned income for IRA purposes.

Traditional IRA: Current Tax Deduction

Note: *The SECURE Act eliminates the age requirement of 70½ for making deductible contributions to a traditional IRA. The requirements regarding income, phase-out of the contribution's deductibility and other rules still apply to such contributions. This change is effective for tax years beginning after December 31, 2019.*

A traditional IRA allows a current tax deduction for your contributions and the earnings grow tax-deferred. The contributions lower your current year's taxes, but future distributions will be fully taxable as ordinary income, subject to ordinary income tax rates at the time of distribution. Also, once you reach age 70½, you can no longer make contributions in that year or future years. You can only make tax deductible contributions to a traditional IRA if you (or your spouse, if married) do not actively participate in an employer-sponsored retirement plan for any part of the year. However, you can still make contributions to an employer-sponsored plan and deduct your own IRA contributions if you meet one of these exceptions:

- You are single and your MAGI does not exceed $64,000 in 2019 and $65,000 for 2020. A partially deductible IRA contribution is allowed until your MAGI reaches $74,000 in 2019 and $75,000 for 2020.
- You are married, but only one of you actively participates in an employer-sponsored plan and your combined MAGI doesn't exceed $193,000 in 2019 ($196,000 in 2020). Only the non-active participant can make a deductible IRA contribution. A partially deductible contribution can be made until the combined MAGI reaches $203,000 in 2019 ($206,000 in 2020).
- Both you and your spouse (if filing jointly) participate in employer-sponsored plans, but your combined MAGI does not exceed $103,000 in 2019 and $104,000 in 2020. You can make a partially deductible IRA contribution until your MAGI reaches $123,000 in 2019 and $124,000 in 2020.
- You can always make a non-deductible contribution irrespective of the income limitations or participation in an employer-sponsored plan up until the year you attain age 70½.

Roth IRA: No Taxes on Distributions

A Roth IRA differs from a traditional IRA primarily because your contributions are made on an after-tax basis, but your withdrawals are generally tax-free. A Roth IRA offers these advantages over a traditional IRA:

- You never pay any income tax on the earnings if you take only qualified distributions. To qualify as a tax-free distribution, the Roth IRA must have been opened more than five years ago and the distribution must be made after age 59½ (with a few exceptions).
- Distributions before reaching age 59½ (and other nonqualified distributions) are first treated as a non-taxable return of your contributions. To the extent these distributions do not exceed your contributions, they are not taxed. This gives you more flexibility to withdraw funds to cover financial emergencies. However, amounts that exceed your accumulated contributions are subject to regular income tax, plus an additional 10% penalty as nonqualified distributions.
- Original account owners and their spouses who are designated beneficiaries are not required to take distributions beginning at age 70½ — or ever.
- Your contributions can continue to be made to the plan after you reach age 70½, as long as you have sufficient earned income and/or alimony.
- Contributions to a Roth IRA can be made even if

your MAGI is too high for a traditional IRA or you are covered by an employer-sponsored plan. The AGI limits for making Roth IRA contributions are $193,000 in 2019 ($196,000 in 2020) if you are married filing jointly, or $122,000 in 2019 ($124,000 in 2020) if you are single or head of household (with partial contributions permitted until your AGI reaches $203,000 in 2019 ($206,000 in 2020), if married filing jointly and $137,000 in 2019 ($139,000 in 2020) if single or head of household).

Note: *Effective for tax years after December 31, 2017, the TCJA repealed rules allowing recharacterization of a previous conversion of traditional IRA contributions to a Roth IRA by October 15 of the subsequent tax year.*

If you already have a traditional IRA in place, you may want to consider rolling part or all of the balance into a Roth IRA. The advantage of this rollover is that you convert tax-deferred future growth into tax-free growth. The disadvantage is that the amount of the rollover from the traditional IRA is taxable, as if you received the distribution. Before you roll over anything, evaluate the potential benefit of the tax-free growth compared to the lost earnings on the tax you pay because of the rollover.

- **Who should make a conversion to a Roth IRA?** Those individuals who have many years to go before retirement and who should be able to recover the tax dollars lost on the conversion may benefit from a conversion. Others who may benefit are those who anticipate being in a higher tax bracket in the future and those able to pay the tax on the conversion from non-retirement account assets.

- **What are some planning ideas for high-income taxpayers?**

High-income individuals can make nondeductible contributions to a traditional IRA this year and in future years so that the amounts can be converted to Roth IRAs. However, to the extent an individual also has a traditional IRA funded with pre-tax contributions, the conversion is deemed to be made pro rata from each IRA.

High income individuals whose spouses are much younger and who do not anticipate the need to take distributions should consider a conversion to a Roth since the spouse may take the Roth IRA as her own and distributions will not be required until the second spouse passes.

Required Minimum Distribution ("RMD") Rules

Note: *Under the SECURE Act, effective for required minimum distributions made after December 31, 2019 to qualified plan participants or IRA account holders who will attain age 70½ after December 31, 2019, the age to begin required minimum distributions is increased from 70½ to age 72. Participants who attained age 70½ prior to December 31, 2019 will be required to continue taking their minimum under the old rules.*

You must generally start taking RMDs from your qualified retirement plan or traditional IRA by April 1 of the year following the year in which you reach age 70½. For each year thereafter, the RMD amount must be taken by December 31 of that year. If you are a participant in a qualified retirement plan of your current employer, you should refer to the plan document or consult with your employer regarding when you must begin receiving distributions from the plan as some plans do not require you to take distributions until you terminate your employment even if you have already reached age 70½ before leaving your employer. For example, if you own 5% or less of the employer and are still employed by the employer at 70½, the plan document may allow you to defer taking distributions from the plan until you actually retire. This exception does not apply to SEPs or SIMPLE IRAs.

Note: *If you turned or will turn 70½ during the year, you can either take a distribution in that year or defer the distribution until the following year. If you elect to defer, you must take two distributions the following year (the first by April 1 and the second by December 31).*

Generally, if you fail to take an RMD from your

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qualified retirement plan or traditional IRA after you reach 70½, you are subject to a 50% penalty on the shortfall. If you are subject to the penalty, you do not have to take a catch-up distribution since the penalty effectively covers the income tax that you would have had to pay on the distribution, as well as a penalty. The RMD is computed by taking the aggregate value of all your qualified retirement plans at December 31 of the prior year and dividing that sum by a distribution period determined by the IRS. There are two tables for determining the distribution period. One is called the Uniform Lifetime Table and is used by unmarried individuals, or a married individual if the individual's spouse is either not the sole beneficiary or is not more than ten years younger than the individual. The other table is the Joint Life and Last Survivor Expectancy Table and is used when the spouse is the sole beneficiary and is more than ten years younger than the individual. The Uniform Lifetime Table, the more commonly used table, is reproduced in Chart 10 with an example of how to compute your RMD.

Avoid Early Withdrawal Penalties

Generally, withdrawals from employer-sponsored qualified plans and IRA accounts are taxed at your ordinary income tax rate. If taken before reaching age 59½ you are also subject to a 10% early withdrawal penalty unless you meet one of the following exceptions:

- You take distributions because of job separation (such as early retirement) and you are at least 55 years old at the time you terminate your employment with the employer. These distributions must be made as part of a series of substantially equal periodic payments (made at least annually) for the individual's life (or life expectancy) or the joint lives (or joint life expectancies) of the individual and the designated beneficiary (or beneficiaries). If early distributions are from an employee plan, payments must begin after separation of service.

Note: *This exception does not apply to IRA accounts.*

- You receive distributions under a qualified domestic relations order (pertaining to a court-ordered separation or divorce).
- You have a qualifying disability.
- You are the beneficiary on the account of a deceased participant.
- You use distributions for medical expenses, limited to the amount not otherwise deductible.
- You take distributions in the form of substantially equal periodic or annuity payments for a period of at least five years and the last payment is received in a year after you reach age 59½.
- You use the distribution to make a first-time home purchase (limited to $10,000).
- You use the distribution to pay for qualified higher education expenses for you, your spouse, your children or your grandchildren.

Distribution Between Age 59½ and 70½

Even though you are not required to take distributions between the ages of 59½ and 70½, you may need to take them to meet expenses or you may want to take them if your tax bracket is low. Though you are not subject to the early withdrawal penalties, the distributions are taxable in the year withdrawn. If you take distributions to take advantage of a low tax bracket, make sure you compare the benefit of the reduced rate against the loss of the tax-deferred growth had the funds been left in the retirement account.

Lump-Sum (or Other Eligible) Distributions

Amounts distributed from a qualified retirement plan can be rolled over tax-free into an IRA or another qualified plan as long as the transfer is done directly from trustee to trustee. If you personally receive the funds, 20% of

the distribution is required to be withheld for federal income taxes (some states also require state income tax withholding). If you fail to roll over the full amount of the distribution (before any withholding tax) within 60 days to another IRA or qualified retirement plan, you will also be subject to income tax and possibly early withdrawal penalties on the distribution if you are under age 59½.

Special Planning Note: *Distributions from qualified plans that are not made from a designated Roth account may be rolled over directly to a Roth IRA. Under these rules, you will be required to pay income taxes in the year of the distribution, but will not be subject to the mandatory 20% tax withholding or the 10% early distribution penalty if you are younger than age 59½. Previously, only distributions from designated Roth accounts of qualified plans could be directly rolled over to a Roth IRA without being subject to the income limitation.*

Surviving Spouse Distribution Rules

Upon the death of a participant/owner of a qualified retirement plan or IRA, a surviving spouse can make an eligible rollover distribution into his or her own plan or IRA. Distributions from the surviving spouse's plan or IRA would not be required until he or she reached age 70½. At that time, the RMD rules discussed above would apply.

Nonspouse Beneficiaries

Note: *The SECURE Act modifies the rules below. Effective for distributions with respect to plan participants or IRA account holders that die after December 31, 2019, the entire account balance of the account holder will have to be distributed to non-spouse beneficiaries by the end of the tenth year following the year the account holder died. This rule applies regardless of whether the account holder dies before or after their required beginning date for required minimum distributions.*

If allowed under the terms of the plan document, distributions from a deceased participant's qualified retirement plan are permitted to be rolled over into an IRA for a beneficiary who is not the decedent's spouse, such as a child of the deceased. The rollover must be in the form of a direct trustee-to-trustee transfer to an IRA for the benefit of the beneficiary. The IRA is treated as an inherited IRA so the beneficiary will not have the ability to roll over the IRA to another IRA in the future. However, the beneficiary will now be allowed to take funds out of the inherited IRA over his or her life expectancy, beginning in the year after the decedent's death, rather than fully within five years (as noted below).

If the plan document governing your plan does not provide for non-spouse rollovers to an inherited IRA, then non-spouse beneficiaries such as children of the deceased are not eligible to roll over a decedent's qualified plan balance into their own plan or IRA. They must take distributions based on the minimum distribution method used by the decedent if he or she had already reached 70½, or within five years after the decedent's death if the decedent had not yet begun taking required minimum distributions.

A non-spouse beneficiary of a decedent's IRA will have to commence taking RMDs beginning in the year following the year of the IRA account holder's death based on the life expectancy of the oldest beneficiary (if more than one primary beneficiary is named). This is true whether the IRA account holder was already taking RMDs or died before his or her required beginning date. Alternatively, if the IRA account holder died before his or her required beginning date, the beneficiary (or beneficiaries) have the option of still using the five-year rule, which does not require any distributions from the account until the year containing the fifth anniversary of the IRA account holder's death. However, in that year, the entire account must be distributed.

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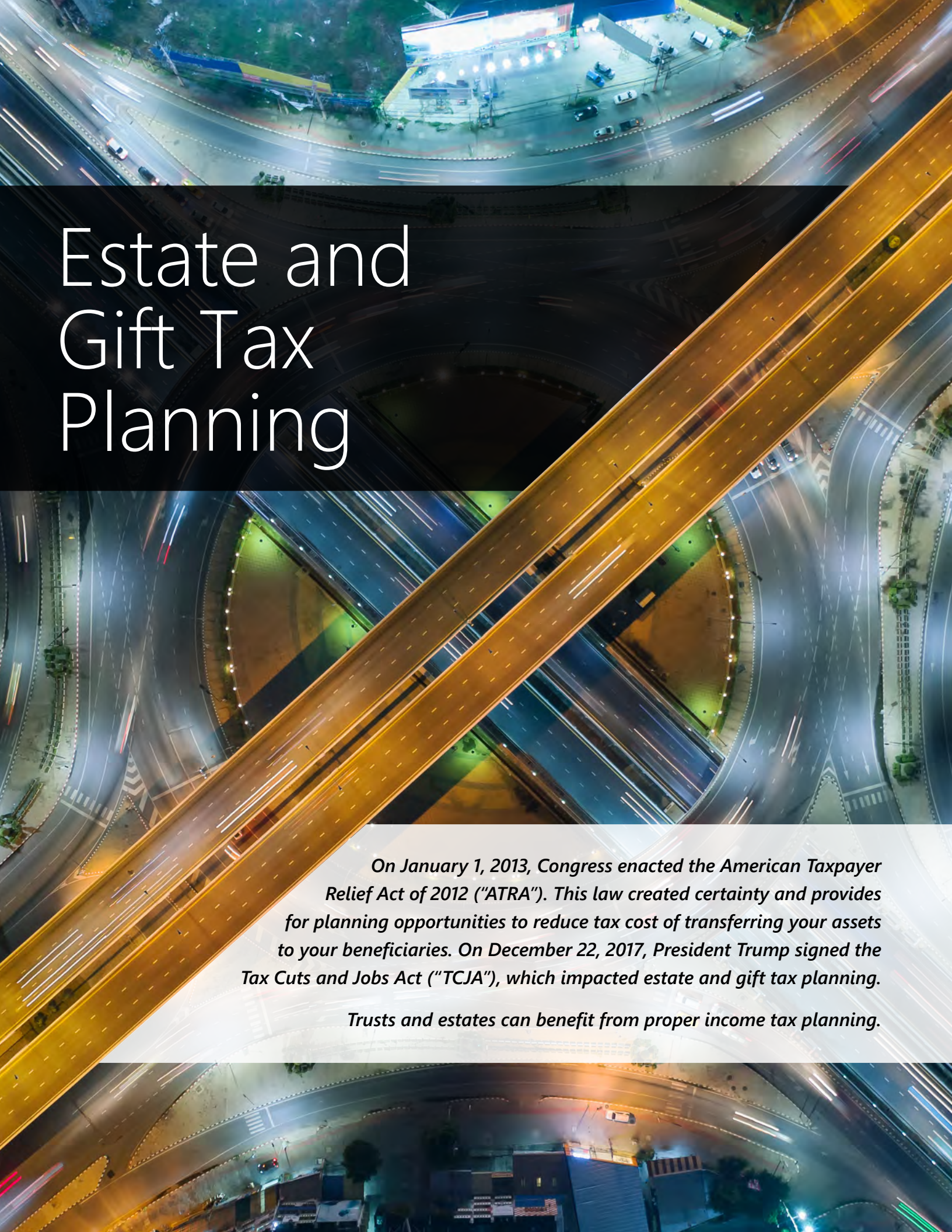
Estate and Gift Tax Planning



On January 1, 2013, Congress enacted the American Taxpayer Relief Act of 2012 ("ATRA"). This law created certainty and provides for planning opportunities to reduce tax cost of transferring your assets to your beneficiaries. On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act ("TCJA"), which impacted estate and gift tax planning.

Trusts and estates can benefit from proper income tax planning.

Estate, Gift, and Generation-Skipping Transfer ("GST") Taxes

Background

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") provided, among other provisions, a phased reduction in the maximum rate of estate and generation-skipping transfer taxes during the years 2002 through 2009, elimination of these taxes for 2010, and a reinstatement of these taxes after 2010 at the tax rates (and with the exclusions) in effect in 2001. Almost everybody believed that Congress would act to either permanently repeal the estate and generation-skipping transfer taxes or, more likely, enact a modified regime for these taxes to begin in 2010 (or earlier).

In December 2010, Congress enacted the 2010 Tax Relief Act— a temporary, two-year reprieve from the sunset provisions of EGTRRA. This Act extended and modified the federal estate, gift, and generation-skipping transfer tax provisions through December 31, 2012. These provisions allowed estates of married couples whose assets were $10 million or less to avoid federal transfer taxes in 2011. For 2012, an inflation adjustment made this $5.12 million per person ($10.24 million for a married couple).

On January 1, 2013, the final compromise was reached and ATRA permanently extended and modified federal estate, gift, and generation-skipping transfer tax provisions. As a result of ATRA, the $5 million exclusion, adjusted for inflation, has been made permanent with a maximum tax rate of 40%. This rate was a compromise between 35% and 55% marginal tax rates of previously enacted estate and gift tax provisions.

Impact of the TCJA

As a result of the TCJA, and effective for tax years beginning in 2018, the estate, generation-skipping transfer, and gift tax exclusion amount is doubled from $5 million to $10 million, indexed for an adjusted inflation amount, using a new "chained" CPI. The 2019 lifetime exclusion was $11.40 million and the 2020 lifetime exclusion is $11.58 million. The increased exclusion sunsets on December 31, 2025, and the maximum estate, generation-skipping transfer, and gift exclusion will revert back to the amount of $5 million and will be adjusted for post-2011 inflation using the new chained CPI.

The TCJA retains the IRC Sec. 1014(a) for a "step-up" in basis for the appreciated assets or a "step-down" in basis for the depreciated assets. The basis of appreciated property acquired from a decedent will be at the fair market value ("FMV") on the date of decedent's death or, if elected, the FMV on an alternative valuation date.

For estates in excess of exclusion amounts, there are still opportunities to decrease tax cost of transferring assets to beneficiaries.

Where do you begin?

Estate planning will help you to maximize the wealth that can be transferred to your beneficiaries. This is especially true in light of the recent changes under the TCJA. The increased estate, generation-skipping transfer, and gift tax exclusions provide an opportunity to transfer significant wealth to family members.

Here are some effective strategies that you should consider to reduce or eliminate the estate tax on your assets:

Make annual gifts

For 2019, the annual gift exclusion allowed you to make tax-free gifts up to $15,000 per individual (or $30,000 as a married couple). The annual gift exclusion remains $15,000 for 2020. By making gifts annually to any number of your relatives or friends, you could end up transferring substantial amounts out of your estate without using any of your lifetime gift tax exclusion.

The federal annual exclusion amount for gifts to a non-citizen spouse has increased from $155,000 in 2019 to $157,000 in 2020.

Use your lifetime exclusion

Also consider utilizing during 2020 all or a portion

of your remaining $11.58 million lifetime exclusion. If married, this gives you and your spouse the ability to transfer up to $23.16 million (adjusted annually for inflation, using chained CPI) tax-free during your lifetimes. This is in addition to your annual gift exclusions mentioned previously. See Chart 11 for the rates and exemptions for 2010 through 2020. Also, see Tax Tip 22.

Consider portability of the lifetime exclusion

Prior to the 2010 Tax Relief Act, married couples had to do careful planning and maintain separately owned assets in order to exclude $7 million (each had a $3.5 million estate tax exclusion) of their assets from federal transfer taxes imposed on their estates after both died. Commencing in 2011, married couples could exclude $10 million ($22.80 million for 2019 and $23.16 million for 2020) of their assets from federal transfer taxes without being as concerned about separately titling their assets. This is accomplished by a concept known as "portability."

The executors of estates of first-to-die married decedents dying on or after January 1, 2011 may elect to transfer any unused exclusion to the surviving spouse. The amount received by the surviving spouse is

Chart

11. Maximum Gift, Estate, and GST Tax Rates and Exemptions

The following chart shows the rates and exemptions for the tax years 2010 through 2020 and thereafter:

Year	Maximum Rates	Exemptions (Cumulative Tax-Free Transfers)			State Tax Credit
	Gift, Estate, and GST Tax	Gift	Estate	GST	
2010*	35%	$1,000,000	$5,000,000	$5,000,000	NO
2011	35%	$5,000,000	$5,000,000	$5,000,000	NO
2012	35%	$5,120,000	$5,120,000	$5,120,000	NO
2013	40%	$5,250,000	$5,250,000	$5,250,000	NO
2014	40%	$5,340,000	$5,340,000	$5,340,000	NO
2015	40%	$5,430,000	$5,430,000	$5,430,000	NO
2016	40%	$5,450,000	$5,450,000	$5,450,000	NO
2017	40%	$5,490,000	$5,490,000	$5,490,000	NO
2018	40%	$11,180,000	$11,180,000	$11,180,000	NO
2019	40%	$11,400,000	$11,400,000	$11,400,000	NO
2020 and thereafter**	40%	$11,580,000	$11,580,000	$11,580,000	NO

**Unless carryover basis and no estate tax is chosen.*
***As a result of the TCJA, the exclusions are doubled and will be adjusted for inflation, using a new chained CPI. In 2026, the exclusion will revert back to $5 million plus adjustments for post-2011 inflation, using the new chained CPI.*

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called the Deceased Spousal Unused Exclusion ("DSUE") amount. If the executor of the decedent's estate filed a federal estate tax return (form 706) and elects transfer, or portability, of the DSUE amount, the surviving spouse can apply the DSUE amount received from the estate of his or her last-deceased spouse against any taxable transfers arising from subsequent lifetime gifts and transfers at death.

As an example, assume that one spouse dies in calendar year 2020 with a taxable estate of $18 million and leaves it all outright to the surviving spouse (who has $5 million of his or her own assets). No federal estate tax would be due from the estate of the first to die because the surviving spouse receives all of the assets and there is an unlimited marital deduction, and none of the deceased spouse's $11.58 million exclusion would be used. If the deceased spouse's executor elects to transfer the unused $11.58 million exclusion, the surviving spouse will have a combined $23.16 million exclusion (disregarding the inflation indexing) available from future federal transfer taxes. If the surviving spouse has $24 million of assets on his or her death, only $840,000 will be subject to the federal estate tax (assuming the surviving spouse dies prior to January 1, 2026 and no change in the tax legislation occurs prior to that date). As a result of ATRA, portability has been made permanent.

Although portability of the exclusion simplifies estate tax planning for many couples, there are still significant advantages to using the exclusion in the estate of the first spouse to die, which often necessitates the creation of a "bypass trust." These include:

- Removal of future income and appreciation from transfer taxes.
- Protection of the assets from potential creditors.
- Preservation of the assets for the first-to-die spouse's children and grandchildren (e.g., in a situation where the surviving spouse remarries).

Tax Tip

22. Use Your Lifetime Gift Tax Exclusion Now

You should consider using your lifetime gift tax exclusion immediately if you haven't already done so. Otherwise, the transferred assets may remain in your estate with all future income and appreciation thereon subject to estate tax, either at your death, or, if married, typically at your surviving spouse's death. As a result of TCJA, if you and your spouse have not yet used your exclusions, you can make gifts of $22.80 million in 2019 or $23.16 million in 2020 (in addition to the annual exclusion gifts of $15,000 in 2020 to each donee from each of you).

The benefit of utilizing all of your lifetime gift tax exclusion is as follows (assuming a 5% compounded annually after-tax growth rate):

If you transfer $23.16 million in 2020, the $23.16 million will grow to $61,450,375 in 20 years, which will be available to your beneficiaries free of gift and estate taxes. If the appreciated assets remaining in your gross estate pass to your beneficiaries, assuming you and your spouse will have a combined estate in excess of the estate tax exclusion at the time of your surviving spouse's death, the estate tax on the assets that you did not transfer during your lifetime may be as high as $15,316,150 ($61,450,375 less the $23,160,000 at an assumed tax rate of 40%). Your beneficiaries will receive the net balance of $46,134,225, rather than the $61,450,375 had you transferred the assets now.

Make taxable gifts

Although there is a reluctance to pay gift taxes, for those people who have used up their available exclusion and can afford to transfer additional assets, paying gift taxes will often increase the amount available for your beneficiaries. For example, assume that you have previously used your available exclusion amount and you have another $5 million that you wish to gift. If you have a large estate at the 40% estate tax rate, your beneficiaries will only receive $3,000,000. However, if you make a net gift of $3,571,429, which is the $5 million amount less gift taxes of $1,428,571 ($3,571,429 at the 40% rate) and survive for three years, your beneficiaries will receive an extra $571,429 ($3,571,429 less $3,000,000). (This example ignores the time value of money.) This difference arises because the estate tax is "tax inclusive," which means that the tax is on the amount of total assets and not the amount

actually going to the heirs. Furthermore, if the grantor survives three years, the taxes are removed from his or her estate.

Gifts to minors

One of the common methods of making gifts to children and grandchildren under the age of 21 is to arrange for ownership of the assets to be held by an individual as custodian for the minor under a state's Uniform Transfers to Minors Act ("UTMA"). This type of ownership was previously under the Uniform Gifts to Minors Act ("UGMA"). Under the UTMA, the custodian is required to transfer the property to the minor upon the minor attaining age 21, or to the minor's estate upon the minor's death before age 21. However, it is possible for the custodianship to terminate at age 18 if the designation of ownership contains, in substance, the phrase "until age 18."

It is important to make sure that the person who gifts the property does not serve as a custodian under the UTMA for the minor with respect to that property. If the donor is serving as a custodian and dies before the UTMA status terminates (e.g., before the minor reaches the age of 21), the property held under the UTMA will be included in the donor's taxable estate for estate tax purposes. Fortunately, this result can be avoided with proper advance planning. For example, if a spouse transfers his or her property for the benefit of his or her child and his or her spouse serves as custodian under the UTMA, the property would not be included in the deceased spouse's taxable estate should he or she die before the UTMA status terminates.

Other methods for transferring assets to minors (or for their benefit of) include:

- IRC Sec. 529 college savings accounts,
- IRC Sec. 2503(c) trusts for the benefit of persons under 21 years of age,
- Life insurance trusts,
- Discretionary trusts,
- Direct payment of educational and medical expenses to the qualified educational institution or the medical provider, and
- Totten trust (pay-on-death) bank/securities accounts

Pay medical and education costs

You can directly pay unlimited tuition and medical expenses for any person free of gift taxes. This exclusion is in addition to the annual gift exclusion. Payments can include health insurance premiums and tuition for elementary school through graduate school. You must make these payments directly to the qualifying educational organization or medical provider.

Use loans rather than gifts

Lending money to your beneficiaries is a viable option to avoid current gift taxes or the use of your lifetime gift exclusion. You can then use your annual gift tax exclusion to enable your beneficiary to pay the interest due and/or part of the debt principal each year.

For the month of January 2020, the minimum interest rates required by the IRS to be charged on loans with interest to be compounded annually, referred to as applicable federal rates ("AFR"), are:

- 1.60 % if the term of the loan is three years or less (short-term).
- 1.69 % if the term is more than three years and less than nine years (mid-term).
- 2.07 % if the term is nine years or longer (long-term).

These rates are low by historical standards and provide an excellent opportunity to use loans to your beneficiaries as a technique for transferring wealth free of gift and estate taxes. However, you need to make sure that the loan is bona fide (i.e., you intend for it to be repaid) and properly documented.

Note: *Connecticut is the only state which imposes gift tax.*

Use trusts and other family entities

Entities and trusts that should be considered for

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transferring future appreciation out of your estate at minimal or no gift tax include:

- **Grantor Retained Annuity Trust ("GRAT"):** A GRAT pays you an annuity at a fixed rate in exchange for the assets transferred to the GRAT. If the transferred assets appreciate in excess of the interest rate used by the IRS (2.0 % in January 2020), the excess appreciation will pass tax-free to your beneficiaries. With the IRS rates relatively low, the GRAT is an attractive option (see Tax Tip 23).
- **Family limited partnerships and LLCs:** Family limited partnerships ("FLPs") and family limited liability companies ("FLLCs") can be very effective gift and estate tax planning vehicles (though not without some complications and risks). These entities allow you to transfer assets to your beneficiaries, typically at a discounted value, while you retain control of investment decisions and the timing and amount of distributions to the partners (typically family members) (see Tax Tip 24).
- **Personal residence trust:** This is a form of a GRIT (which is a grantor retained interest trust) that uses your principal residence as the asset contributed to the trust with your right to live in the house for a period of time as the retained interest.
- **Irrevocable life insurance trust ("ILIT"):** An ILIT can remove life insurance proceeds from your estate, thereby transferring substantial wealth to your beneficiaries. However, payment of premiums and gift taxes on the premiums may reduce the tax benefits.
- **Charitable trust:** A charitable trust can help you diversify your portfolio and combine estate planning with your charitable desires. See the chapter on charitable contributions for a more detailed discussion.
- **Bypass trust:** This trust can help you divide your assets properly, so that the future income and appreciation on the assets in the bypass trust escape estate tax when the second spouse dies. However, in states that only allow an exclusion that is less than the

Tax Tip

23. Transfer Appreciation with a GRAT Free of Gift Taxes

You transfer securities in a company that has great potential for future appreciation to a two-year grantor retained annuity trust. The securities are currently valued at $1,000,000 (200,000 shares at $5 per share). As an example, based on a 2.0 % IRC Sec. 7520 rate (for January 2020) you could set the annuity at 51.503914% to effectively zero out the remainder interest and pay no gift tax on the transfer. You would receive an annuity payment of $515,039 per year ($1,000,000 times 51.503914%) totalling payments of $1,030,078. Assume the stock appreciates to $8 per share at the end of the first year and $9 at the end of the second year. Since the GRAT does not hold any liquid assets, you will need to use the stock to pay your annuity, as follows:

Shares transferred to GRAT	**200,000**
Shares used to pay annuities:	
Year 1 ($515,039 divided by $8 per share)	(64,380)
Year 2 ($515,039 divided by $9 per share)	(57,227)
Shares remaining at the end of the GRAT's term	78,393
Value of shares transferred to beneficiaries ($9 per share)	**$ 705,537**

Tax Tip

24. The Advantages of an FLP or FLLC

Let's assume in 2020 you and your spouse have not yet used any of your lifetime gift exclusions of $23.16 million ($11.58 million each). You can transfer assets valued at $33,085,714 to an FLP or FLLC, in addition to your annual exclusion gifts, free of gift taxes (based on the assumption that you can sustain a 30% minority and marketability discount on the value of the limited interests).

How much will your beneficiaries receive? The value of their limited partnership interests could grow, free of gift or estate taxes, to $87,786,249 in 20 years from the initial amount of $33,085,714 using a 5% after-tax growth rate. By comparison, if the assets were left to accumulate in your estate, the estate tax could be as high as $25,850,500 (net of the $23.16 million exclusion assuming a maximum rate of 40%), leaving $61,935,749 to your beneficiaries. Thus, there is a potential savings of $25,850,500.

federal exclusion, it may be appropriate to limit the amount going into a bypass trust.

Utilize Your GST Exclusion

If you transfer assets directly to your children and they eventually pass the assets down to their children, two levels of estate tax will be paid (assuming both estates are in excess of the exclusion amounts). If you make transfers directly to your grandchildren, or for their eventual benefit, through a trust or other entity, or to other "skip persons" (individuals two or more generations younger than you), you will be subject to the GST tax (at a 40% estate tax rate under current law) in addition to gift or estate taxes.

The GST exclusion allows you to transfer up to $11.40 million free of the GST tax in 2019 (increased to $11.58 million in 2020). If you have not yet used the full amount of your gift tax exemption, consider making gifts to your grandchildren (or to a trust for their benefit) up to the amount of your remaining GST tax exclusion, if you can afford to do so. There is no portability between spouses for the GST exclusion.

Grantor Retained Annuity Trust

When you create a GRAT, you (as a grantor) have made a gift equal to the fair market value of the assets transferred to the trust less the present value of the annuity payments you will receive from the trust during the GRAT's term. The annuity payments are calculated at the IRC Sec. 7520 rate so there is no gift tax on transfer to the GRAT ("zero-out" GRAT) and theoretically no assets should be left at the end of the GRAT term.

The success of the GRAT depends on the amount of income earned and appreciation on the assets during the GRAT term. Income and asset appreciation in excess of the IRC Sec. 7520 rate (for example 2.0 % used for January 2020 transfers) will cover annuity payments during the term of the GRAT and remaining assets will pass to your beneficiaries gift tax-free (see Tax Tip 23).

All income earned by the GRAT is taxable to you, so the trust's assets are not depleted by income taxes.

Note: *If you should die before the expiration of the GRAT's term, the assets would be includible in your gross estate, subject to certain limitations.*

Family Limited Partnerships and Family Limited Liability Companies

As Tax Tip 24 illustrates, FLPs or FLLCs can be very beneficial estate planning tools. You can contribute assets to such an entity in exchange for general partnership and limited partnership interests (or

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member interest if a FLLC). You and/or your spouse typically keep the general partner interest (or remain the managing member of a limited liability company). This interest allows you to retain management control of the investment and distribution decisions (though this control must be set up carefully). You would typically gift only the limited partnership interests, but not in excess of your available annual and lifetime exclusions, thereby avoiding gift tax. Because the limited interests are minority interests subject to lack of marketability and lack of control, the value of the gift can be discounted and the corresponding tax-free amount of the gift can be increased. You should obtain an appraisal to substantiate the discounted value. Care must be exercised to be sure that the control does not result in the FLP's entire assets being included in the donor's estate.

An even more effective way to use an FLP or FLLC is to create trusts to hold the limited partnership interests for your beneficiaries. These trusts can be grantor trusts for tax purposes, requiring you, as grantor, to include all of the income of the trust on your tax return. You pay all the taxes on the income earned by the FLP or FLLC, allowing the trust to grow tax-free. In effect, you are making an additional tax-free gift. Before doing this, you should make sure your financial position will allow you to continue paying all the income taxes even though you may not be able to receive any cash distributions from the trust.

Rather than gifting the limited partnership interests, another way to transfer the interests to your beneficiaries is to sell the interests to a grantor trust for their benefit. Since such a trust usually has limited funds to purchase the interests, the sale would be done on an installment basis (subject to a rule requiring the trust to be adequately capitalized). The installment payments that you are required to receive would come from distributions to the trust from the partnership, typically from the annual income. By using this grantor trust method, the trust can receive the income free of taxes,

Chart

12. State Estate Tax Rates and Exemptions

State	Maximum Estate Tax Rate	Maximum Gift Tax Rate	Exemption
New York	16%	None	$5,850,000*
New Jersey	(a)	None	None**
Connecticut	12%	12%	$3,600,000/$5,100,000***
Pennsylvania	(b)	None	None

(a) An inheritance tax will be entirely exempt on transfers to direct descendants and lineal heirs, and a maximum inheritance tax rate of 16% on transfers to siblings and other beneficiaries. The tax will be assessed to the beneficiaries or transferees.

(b) An inheritance tax of 4.5% is imposed on transfers to direct descendants and lineal heirs, 12% on transfers to siblings and 15% on other taxable transfers.

*The exemption amount from January 1, 2020 through December 31, 2020 will be $5,850,000. If the NY taxable estate is 105% more than the exemption amount, the entire estate is subject to estate tax, not just the amount in excess of the exemption amount.

** Effective January 1, 2018, the New Jersey Estate Tax was repealed. However, the New Jersey Inheritance tax was not repealed.

***Beginning 2019, the CT estate and gift tax exemption increased from $3.6 million to $9.1 million in 2022. In 2023 and beyond, the Connecticut exemption will match the federal estate and gift tax exemption. CT doesn't have the portability option. The taxable estate exceeds the exemption amount will be taxed at a margin rates between 7.8% and 12%.

Note: *California and Florida have no estate tax. In Florida, there may be a need to file other forms to remove the automatic Florida estate tax lien.*

thereby increasing the annual cash to fund repayment of the principal and interest on the installment note.

While FLPs and FLLCs can be effective estate planning vehicles, they must be carefully structured, fully implemented substantially before death occurs, and have a bona fide, nontax purpose. In addition, the proper tax and accounting records should be maintained, income and gift tax returns should be carefully prepared and all transactions should conform to the legal documents. Unless these precautions are taken, the arrangement may not be upheld in the event of a challenge by the IRS.

In August 2016, the IRS issued proposed regulations under IRC Sec. 2704 that imposed limitations on valuation discounts for transfers of interests in family-controlled entities. These regulations would have limited or eliminated lack of control discounts and would have had an impact on marketability discounts. On October 4, 2017, the U.S. Treasury Department released a final report stating that the proposed regulations under IRC Sec. 2704 would be withdrawn as they would hurt family-owned businesses by limiting valuation discounts and made it difficult and costly for families to transfer their businesses to the next generation.

Qualified Personal Residence Trust

A qualified personal residence trust ("QPRT") is a form of a GRIT that allows you to transfer your personal residence to a trust (typically for your children's benefit) even though you continue to live in the home during the QPRT's term (e.g., ten years). You hold an income interest in the home based on the present value of your right to live there during the term of the QPRT. Gift tax applies to the fair market value of the house reduced by the retained income interest (as actuarially computed using IRS interest rates).

The value of the house at the end of the QPRT's term will go to your beneficiaries free of additional gift or estate taxes. When the QPRT term expires, your children (or a trust for their benefit) will own the residence. They must charge you a fair market value rent to allow you to continue using the residence, and the rent you pay will further decrease your taxable estate. If you do not intend to live in the home and your beneficiaries do not want to live there, the trust can sell the house and reinvest the funds in other investments. In either case, there is no additional gift tax when the QPRT terminates. However, the benefits are lost if you die before the QPRT term ends because the full value of the residence will be includible in your gross estate.

Life Insurance

Life insurance can serve an important function in your estate plan because it can provide your beneficiaries liquidity to pay estate taxes, especially if the value of your business (or other non-liquid assets) represents a significant portion of your estate. Life insurance can also provide immediate funds to help your family maintain their standard of living and for other purposes. But if the proceeds are left in your taxable estate, the federal estate tax could reduce the proceeds by as much as 40% for 2019 and beyond. To avoid this tax, you must ensure that the proceeds of your life insurance policies are not payable to either you or your spouse's estate, and that neither of you possess any incidence of ownership in the policy at death.

A properly structured ILIT can remove life insurance proceeds from your estate, if the trust is both the policy's owner and beneficiary. The trust can also provide income to your surviving spouse and principal to your children (or other beneficiaries) upon your spouse's death. In addition, the trustee can properly manage and invest the insurance proceeds for future growth.

If you use any of the following funding methods, you can make the trust the owner of the insurance policy without being deemed to have any incidence of ownership:

- Gift sufficient funds to a grantor-type trust so it can

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buy the insurance policy and pay all current and future premiums.

- Assign a current policy to the trust and gift future premiums. However, the transfer must be completed at least three years before your death to avoid inclusion in your taxable estate.
- Gift to the trust the annual premiums on a policy owned by the trust either by paying them directly or first depositing them in a trust account.

Be careful of gift tax issues to the extent you gift funds to purchase the policy, pay premiums or transfer an existing policy that has value. You will only incur a gift tax if the amount exceeds the available annual exclusion and any remaining lifetime gift tax exclusion. The government's position is that the annual exclusion is only available if the trust document includes a withdrawal (Crummey) power and the beneficiaries are notified in writing of their right of withdrawal. It is important to properly comply with this administrative requirement.

There are some disadvantages to life insurance trusts, but they can be minimized with proper planning. There will be some additional costs: You will incur legal fees since a carefully drafted trust instrument is needed to satisfy specific rules, and there may be trustee commissions. Also, income tax returns may be required if the trust has assets generating taxable income. Life insurance trusts are almost always grantor-type trusts. However, if the trust only holds the life insurance policy and you pay the annual premiums through gifts, income tax returns will generally not be required.

If you have a life insurance policy that has been in force for at least three years, it may prove beneficial to review the policy to see if premiums can be lowered and/or the death benefit can be increased. It is sometimes possible to find a more favorable policy and obtain it in exchange for your old policy on a tax-free basis.

State Estate Tax Considerations

You should keep in mind that many states also impose an estate or inheritance tax on persons who are domiciled in the state or have property located in the state. Some of these states continue to impose their estate or inheritance tax even if there is no federal estate tax. Others (e.g., Florida) impose no such tax when there is no federal estate tax credit for taxes paid to a state.

Changes to estate taxes in New York

On April 1, 2014, New York State passed legislation known as the Budget Legislation with the new estate tax rates and estate exclusion amounts. The new estate tax provisions are in effect for decedents dying on or after April 1, 2014.

Prior to this legislation, New York estates above $1 million in assets were subject to New York estate taxes. Under the Budget Legislation, the estate exclusion amount gradually increased and by April 1, 2017, reached the 2013 federal estate tax exclusion of $5.25 million. After January 1, 2020 and before January 1, 2021 the basic exclusion amount is $5,850,000. Below are the basic exclusion amounts ("BEAs") for decedents dying on or after the following dates:

- April 1, 2014 and before April 1, 2015: $2,062,500
- April 1, 2015 and before April 1, 2016: $3,125,000
- April 1, 2016 and before April 1, 2017: $4,187,500
- April 1, 2017 and before Jan. 1, 2019: $5,250,000
- January 1, 2019 and before Jan.1 2020: $5,740,000
- January 1, 2020 and before Jan.1 2021: $5,850,000

Unfortunately, the above basic exclusion amounts start to phase out once the estate's taxable value exceeds the BEA in effect at that time. Furthermore, the estate's exclusion amount is fully phased out once the estate's taxable amount is over 105% of the current BEA.

On January 15, 2019, The New York Governor's Fiscal Year 2020 Executive Budget was released and would have retroactively extended the "clawback" provisions for certain taxable gifts made by New York residents within three years of death for estates of decedents on or after January 16, 2019, and before January 1, 2026. For estates of decedents dying on or after January 1, 2019, and before January 16, 2019, there is no addback of taxable gifts.

Another new change in the New York estate tax is that the tax law requires a New York qualified terminable interest property (QTIP) election be made on a New York estate return directly for decedents dying on or after April 1, 2019. The surviving spouse's New York gross estate must include any QTIP allowed from a previously allowed New York marital deduction whether the QTIP election was made on the transferring spouse's New York estate tax return or on a federal pro forma return if no federal return was required.

Impact on Certain Exempt Organizations

As a result of PATH, the gift tax will not apply to the transfer of money or other property to a tax-exempt organization described in IRC Sec. 501(c)(4) (generally, social welfare organizations), IRC Sec. 501(c)(5) (generally, labor and agricultural organizations) or IRC Sec. 501(c)(6) (generally, trade associations and business leagues).

Consistent Basis Reporting for Estates

Under the Surface Transportation and Veterans Health Care Choice Act of 2015, IRC Sec. 6035 introduced reporting requirements to assure that a beneficiary's basis in certain property acquired from a decedent be consistent with the value of the property for estate tax purposes. Because many executors were not prepared to comply with the new reporting requirements, the IRS extended the due date for filing Form 8971, Information Regarding Beneficiaries Acquiring Property from a Decedent and distributing Schedules A to beneficiaries. Final regulations issued in December 2016 confirmed that no further extensions beyond June 30, 2016 would apply to initial reporting and that the rule going forward is to file the form within 30 days of filing Form 706.

Non-Tax Considerations

There are many non-tax reasons to review your estate plan and the related documents.

It is advisable to periodically review your estate plan to make sure it is in conformity with your current wishes and current law. This review should include nontax considerations, such as:

- Who are your executors and trustees?
- Do you have a power-of-attorney and is it current?
- Is your health care proxy and/or living will current?
- Have you provided for long-term care for your spouse and yourself?
- Are the designated beneficiaries of your qualified retirement plans and life insurance policies in accordance with your present desires?
- Does your estate plan include new children, grandchildren, etc.?
- Have you named appropriate guardians for your minor children should both parents be deceased while the children remain minors?
- Has anyone mentioned in your will died?
- Will your assets be preserved for your family in the case of a divorce?
- Do you have adequate creditor protections included in your planning?
- At what age do you want your children, grandchildren or other beneficiaries to have full access to inherited assets?

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- Do you have a beneficiary with special needs that you want to provide for?
- Do you wish to leave a legacy to a charitable or educational organization?
- If there is a family business, are you satisfied with the beneficiaries who will receive that interest? Has a succession plan for the business been put into place? Do you need to equalize amongst your children where only children working in the business are receiving interests in the business?

Income Tax Planning for Trusts and Estates

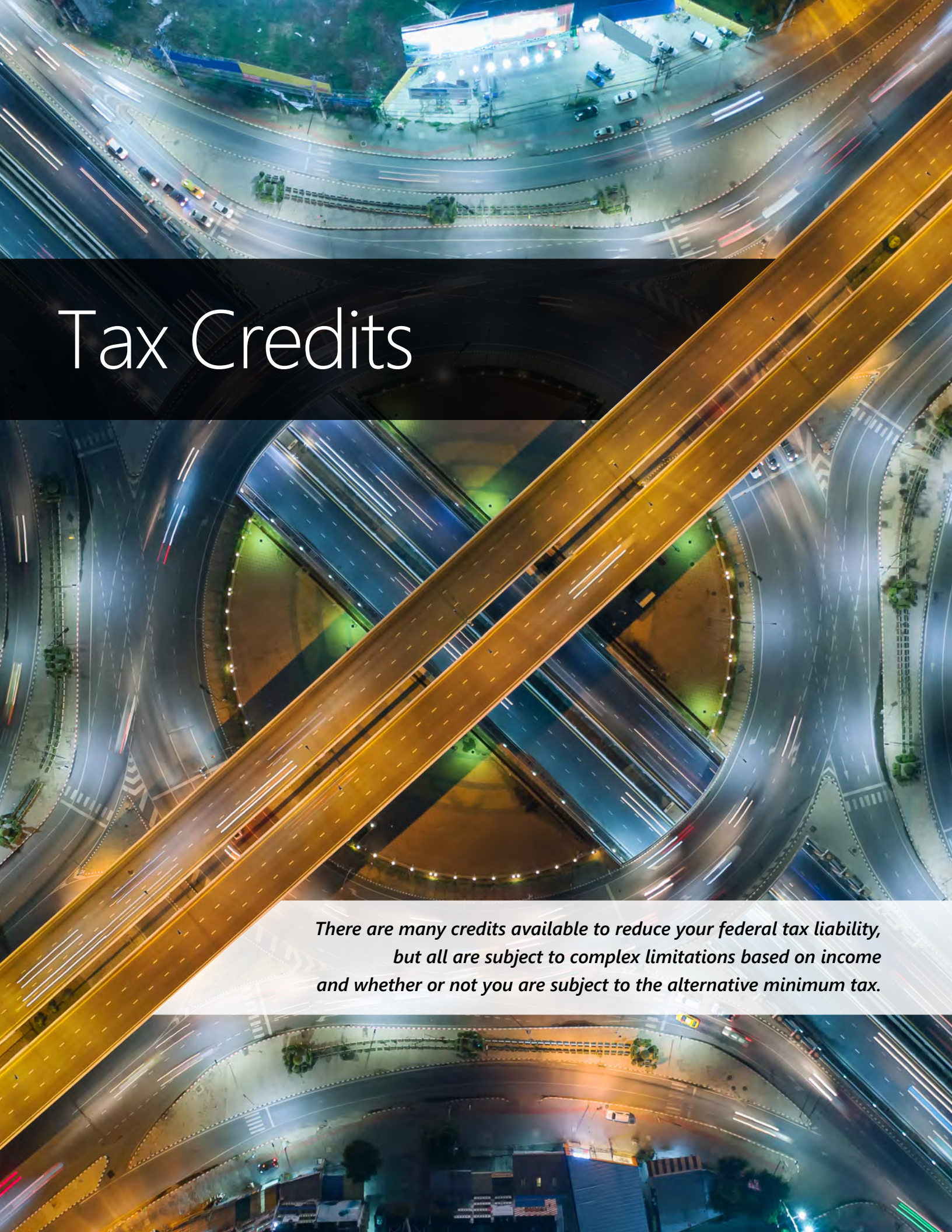
As a result of the TCJA, the income tax rates for trusts and estates have changed to the following:

2019			2020		
Taxable income over	**But not over**	**Rate**	**Taxable income over**	**But not over**	**Rate**
$0	$2,600	10%	$0	$2,600	10%
$2,600	$9,300	24%	$2,600	$9,450	24%
$9,300	$12,750	35%	$9,450	$12,950	35%
$12,750		37%	$12,950		37%

Planning surrounding income taxation of estates and trusts should consider the respective tax brackets and determination of the ability to potentially reduce income tax liabilities through the means of beneficiary distributions. As the trust is subject to the top ordinary income tax rate once taxable income reaches $12,950 for 2020 (a much lower threshold than individuals), making distributions to current income beneficiaries and receiving a taxable deduction at the trust level may provide an overall tax savings.

Choosing the fiscal year-end of an estate involves more planning. The timing of income and deductions can reap tax savings, if planned for properly.

Tax Credits



There are many credits available to reduce your federal tax liability, but all are subject to complex limitations based on income and whether or not you are subject to the alternative minimum tax.

Tax Credit Overview

The following is a discussion of the credits that impact most taxpayers:

Foreign Tax Credit

The U.S. taxes its residents on their worldwide income including foreign-source income which may be also subject to tax in foreign jurisdictions. To avoid double taxation, subject to certain limitations, the U.S. allows its residents either a credit or deduction for taxes imposed by foreign countries and possessions of the U.S. In general, a credit is more advantageous as it is a dollar-for-dollar offset to the taxpayer's U.S. income tax liability, whereas a deduction is a reduction of income subject to tax. There are limits on the amount of foreign tax credits an individual may be able to take in a particular year. There is a separate calculation of foreign tax credits allowed each year which could result in a difference between your regular and AMT foreign tax credit allowed. Any foreign tax credits not fully utilized in the current year due to limitations may be carried back one year and forward ten years. The most common forms of income that result in the payment of foreign taxes include dividends paid by foreign corporations and business income earned by foreign pass-through entities. It is very common to incur foreign taxes through securities that are held in your investment accounts or from an underlying ownership interest in a partnership or other pass-through entity that has an investment in a foreign entity.

Child Tax Credit

Beginning in 2018 through 2025, a Child Tax Credit of $2,000 per qualifying child is available to offset your tax liability ($1,000 for tax years beginning before 2018 and after 2025). Up to $1,400 of the credit can be refundable for each qualifying child as the Additional Child Tax Credit. A refundable tax credit may give you a refund even if you don't owe any tax.

Qualifying children are defined as:

- A son, daughter, stepson, stepdaughter, or a descendant of such child; a brother, sister, stepbrother, stepsister, or a descendant of such relative.
- A child who has not attained the age of 17 by the end of the tax year and who is either a U.S. citizen or national, or a resident of the U.S.

The Child Tax Credit begins to phase out when MAGI reaches $400,000 for joint filers, and $200,000 for unmarried individuals, head of household, married filing separately and qualifying widowers. The tax credit is reduced by $50 for every $1,000, or fraction thereof, of MAGI above the threshold amount.

Dependents who can't be claimed for the Child Tax Credit may still qualify you for the Credit for Other Dependents. This is a non-refundable tax credit of up to $500 per qualifying person. The qualifying dependent must be a U.S. citizen, U.S. national, or U.S. resident alien.

Child and Dependent Care Credit

If you pay someone to take care of your children or other qualifying persons so that you and your spouse can work or go to school, then you qualify to take the credit for child and dependent care expenses. Qualifying expenses include expenses paid for household services and for the care of a qualifying individual. A qualifying individual can include a dependent who was under age 13 at the close of the tax year or a dependent who was physically or mentally incapable of self-care and who had lived with you for more than half of the year.

The maximum amount of dependent care expense on which you can calculate the credit is $3,000 for one qualifying individual or $6,000 for two or more qualifying individuals. The amount of the dependent care expenses eligible for a credit must be reduced by any payments received through an employer-provided dependent care assistance program. The amount of the allowable credit is based on your AGI, with the applicable credit percentage ranging from 20% to 35%. The 35% credit is for lower income taxpayers. Once

your AGI exceeds $43,000, the maximum rate allowed is 20%.

These percentages entitle you to a credit of $600/$1,200 and $1,050/$2,100, respectively, based on the number of qualifying individuals.

American Opportunity and Lifetime Learning Credits

There are two education-related credits: the American Opportunity Credit ("AOC"), which is a modified Hope Credit, and the Lifetime Learning Credit. These credits are available to individuals who incurred tuition expenses pursuing college or graduate degrees or vocational training. The AOC allows taxpayers a maximum credit per eligible student of $2,500. The Lifetime Learning Credit allows a taxpayer to take a maximum credit of $2,000 per taxpayer. A more detailed discussion of these credits can be found in the chapter on education incentives.

PATH has made the American Opportunity Credit permanent.

Adoption Credit

For 2019, a nonrefundable credit of up to $14,080 may be claimed for qualified adoption expenses. The credit is phased out ratably for taxpayers with MAGI over $211,160 and no credit is allowed for taxpayers with MAGI over $251,160 or higher. Qualified adoption expenses include reasonable and necessary adoption fees, court costs, attorney fees and other expenses which are directly related to the legal adoption of an eligible child. An eligible child is an individual who has not attained the age of 18 at the time of the adoption or who is physically or mentally incapable of caring for himself or herself. A credit for the adoption of a special needs child is allowed regardless of the actual qualified expenses.

For U.S. adoptions, you may be able to claim the credit before the adoption is finalized and if you adopt a special needs child you may qualify for the full amount of the credit.

For 2020, the credit allowed is $14,300 and phased out ratably for taxpayers with MAGI over $214,520 and completely phased out at $254,520.

Residential Energy Efficient Property Credit

The Bipartisan Budget Act of 2018 extends the residential energy efficient property credit allowed up to 30% of the cost of qualified energy property. The credit for each half kilowatt of capacity of fuel cell property is limited to $500. This credit applied to expenditures for the following qualified energy equipment installed and placed in service through December 31, 2021:

- Small wind energy property,
- Geothermal heat pump property, and
- Fuel cell property.

The credit for solar electric property and solar water heating property, however, is available for property placed in service through December 31, 2021, based on an applicable percentage. The applicable percentages are:

- In the case of property placed in service after December 31, 2016, and before January 1, 2020, 30%.
- In the case of property placed in service after December 31, 2019, and before January 1, 2021, 26%.
- In the case of property placed in service after December 31, 2020, and before January 1, 2022, 22%.
- 2022 onwards, 10%.

Qualified Plug-In Electric Drive Motor Vehicle Credit

The maximum tax credit allowed for individuals who purchase plug-in electric vehicles is $7,500, and if the vehicle did not have battery capacity of at least 5 kilowatt hours, the minimum credit of $2,500 applied.

To qualify as a plug-in electric drive vehicle, the vehicle must:

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- be made by a manufacturer,
- be acquired for use or lease but not resale,
- have its original use commencing with the taxpayer,
- be treated as a motor vehicle for purposes of Title II of the Clean Air Act,
- have a gross vehicle weight rating of not more than 14,000 pounds,
- be propelled to a significant degree by an electric motor that draws electricity from a battery with a capacity of not less than 4 kilowatt hours and that is capable of being recharged from an external source of electricity.

The credit begins to phase-out after 200,000 vehicles have been sold for use in the United States. The phase-out period begins with the second calendar quarter following the calendar quarter in which the 200,000th unit is sold. For the first two quarters of the phase-out period, the credit is cut to 50% of the full credit amount. The credit is cut to 25% for the third and fourth quarters of the phase-out period. Thereafter, no credit is allowed.

No qualified plug-in electric drive motor vehicle credit is allowed for property used predominantly outside of the United States.

For two-wheeled plug-in electric vehicles, the provision extends through 2019 and is a 10% credit for highway-capable, two-wheeled plug-in electric vehicles (capped at $2,500). Battery capacity within the vehicles must be greater than or equal to 2.5 kilowatt-hours.

Qualified Research Credit

This is a credit for expenditures paid or incurred for research that was technological in nature and whose application was for use in developing a new or improved business component. This credit is made permanent as a result of PATH. In general, the credit was equal to 14% of the qualified research expenditures incurred that exceeds 50% of the average qualified research expenses for the three prior years. In addition, for taxable years beginning after December 31, 2015, eligible small businesses ($50 million or less in gross receipts) may claim the credit against AMT liability.

Further, the credit against the employers' payroll tax liabilities is available for certain businesses (gross receipts of $5 million or less and no gross receipts for any taxable year before the five years ending with the tax year). So, for a 2019 return, a business is not eligible if it generated gross receipts prior to 2015.

AMT Credit

If you pay the AMT in one year, you may be entitled to a tax credit against your regular tax in a subsequent year. You qualify for an AMT credit if any of your AMT liability is derived from "deferral items" such as depreciation adjustments and the tax preference on the exercise of ISOs. See the chapter on the AMT for a more detailed discussion.

Work Opportunity Credit

The work opportunity tax credit is a federal tax credit available to employers for hiring individuals from certain target groups who have consistently faced significant barriers to employment through taxable years beginning on or before January 1, 2020. The credit is based on qualified wages paid to the employee for the first year of employment. In general, qualified wages are capped at $6,000. The credit is 25% of the qualified first-year wages for those employed at least 120 hours but fewer than 400 hours and 40% for those employed 400 hours or more.

PATH also extends the credit beginning in 2016 to apply to employers who hire qualified long-term unemployed individuals (those unemployed for 27 weeks or more).

Due Diligence Checklist

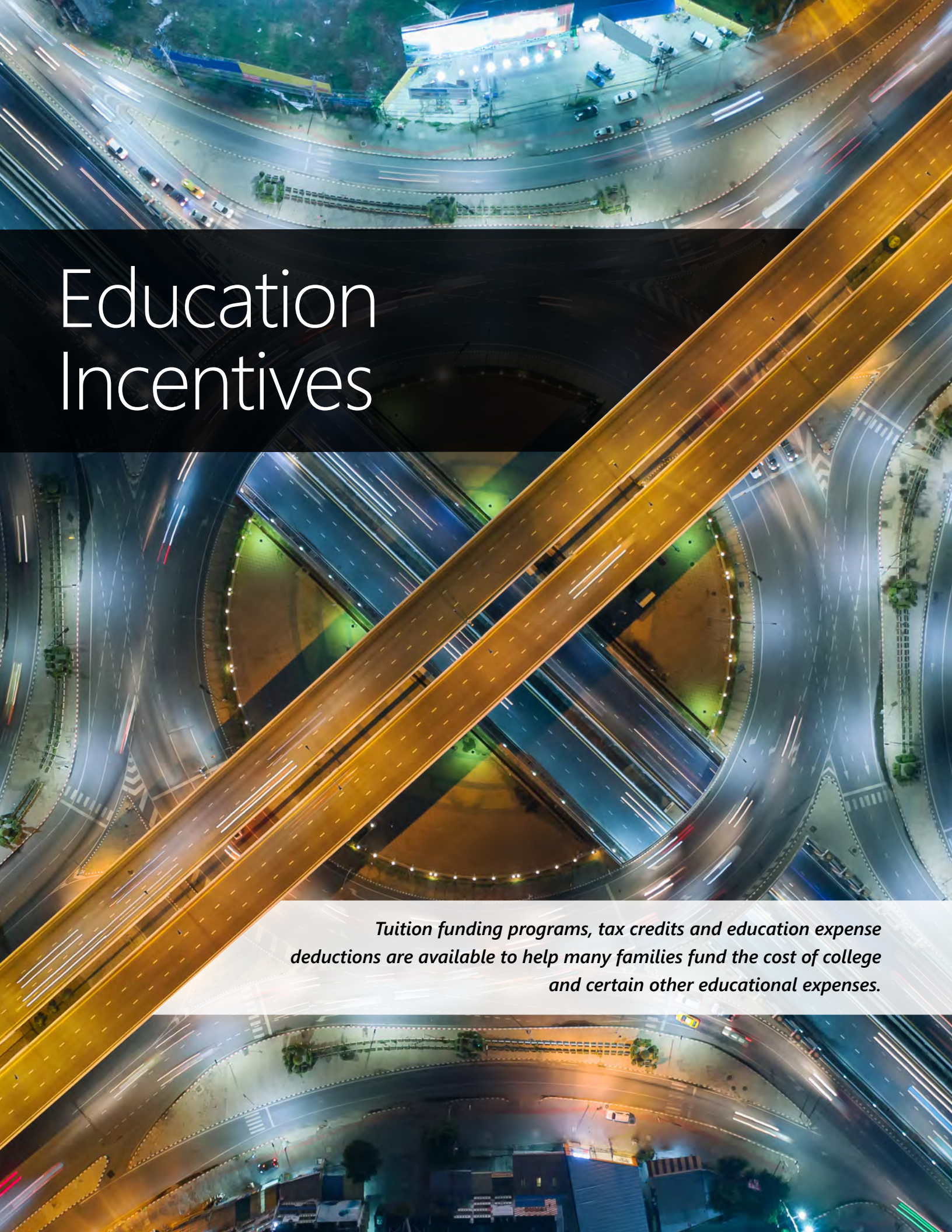
Paid preparers will be required to complete and attach Form 8867 to the return in those cases where the Earned Income Credit, the Child Tax Credit and Additional Child Tax Credit, and the American Opportunity Credit are utilized. Preparers will be

required to maintain copies of the documents that were relied upon to determine eligibility of the qualifying taxpayer.

Family Medical Leave Tax Credit

The TCJA affords businesses a new tax credit to those companies that offer paid family and medical leave to their employees. See chapter on business owner issues and depreciation deductions.

Education Incentives



Tuition funding programs, tax credits and education expense deductions are available to help many families fund the cost of college and certain other educational expenses.

Education Incentives Available

There are education incentives that provide tax benefits to assist you in funding the cost of a college education for your family members, but some of them are subject to phase outs based on AGI, thereby limiting the incentives that may be available to you. See the state tax issues chapter for additional incentives.

The tax incentives available to help pay college costs include:

- IRC Sec. 529 plans.
- American Opportunity Credit and Lifetime Learning Credit.
- Education deductions, including student loan interest.

IRC Sec. 529 Plan

Probably the most popular tax incentive college funding method is an IRC Sec. 529 plan (qualified tuition program), since it is available to all taxpayers regardless of their income. These plans offer the following benefits:

- Although the contributions to the IRC Sec. 529 plans are not currently tax deductible on the federal level, the earnings from the plan are tax-deferred for federal and state taxes.
- Distributions are tax-free if used to pay qualified education expenses at any accredited college, university, or graduate school and most community colleges and certified technical training schools in the United States as well as many schools abroad.
- Distributions can be used to pay for tuition, certain room and board expenses, books, supplies, a computer, computer software and even internet expenses, so long as the computer is used primarily by the beneficiary and the beneficiary's family during any years the beneficiary is enrolled at an eligible educational institution. Allowable computer software must be predominantly educational in nature, so software designed for games, sports or hobbies is excluded. Distributions of up to $10,000 per designated beneficiary may be used for "qualified expenses" (tuition) for elementary or secondary public, private, or religious school.
- Control of the funds remains in the hands of the account owner (not the beneficiary), even after the beneficiary reaches legal age, permitting the account owner to change beneficiaries at any time and for any reason. You may change the beneficiary to another child if the original beneficiary does not go to college, or excess funds remain in one child's account after college. You can also change the beneficiary to yourself if a financial emergency requires you to have access to the funds. However, any distributions representing income earned within the plan will be taxable if not used for qualified education purposes.
- Age and income restrictions do not apply to the account owner or beneficiary, unlike other tax incentive education plans.
- You are not limited to just the plans offered by the state you live in. In addition, you can change your choice of plan every 12 months and roll over plan funds to a new plan. This gives you more investment options and possibly higher contribution ceilings.

Funds deposited into an IRC Sec. 529 plan for the benefit of another person are considered a gift for gift tax purposes. Although the plan's assets are excluded from your estate, there are gift tax considerations. However, to the extent you used your annual gift exclusion to fund an IRC Sec. 529 plan, you will have to limit other tax-free gifts to stay within the annual exclusion amount of $15,000 per donee for 2019 and 2020. For 2019 and 2020, you may elect to treat up to $75,000 ($150,000 if married) of the contribution for an individual as if you had made it ratably over a five-year period. The election allows you to apply the annual exclusion to a portion of the contribution in each of the five years, beginning with the year of contribution.

Also, if your state of residence allows a deduction for the contributions to the plan, you will generally only be allowed to take the deduction for one year's amount in the initial year that you fund the plan.

Private institutions can offer a prepaid tuition program if they satisfy IRC Sec. 529 requirements. Distributions from these private plans used for qualified education expenses will also be tax-free.

IRC Sec. 529 plans also have their disadvantages. Investment options are limited to the plan's choices of investment vehicles. Also, even though you can withdraw funds for uses other than qualified higher education expenses, you'll have to pay income tax and an additional 10% penalty on the earnings, similar to a premature distribution from a retirement account.

PATH modified IRC Sec. 529 rules to treat any distribution from an IRC Sec. 529 account as coming from that account, rather than aggregating all of the accounts. This is so even if the individual making the distribution is operating more than one account. Additionally, a refund of tuition paid with amounts distributed from an IRC Sec. 529 account is treated as a qualified expense if those amounts are re-contributed to an IRC Sec. 529 account within 60 days.

Observation: *The Tax Increase Prevention Act of 2014 ("TIPA") included the Achieving a Better Life Experience ("ABLE") Act, which allows states to establish and operate an ABLE program. Severely disabled individuals (under age 26) would be able to open an IRC Sec. 529 savings account and make annual contributions up to the gift tax exclusion limit of $15,000 for 2019 and 2020, adjusted annually for inflation. The account may be used to meet qualifying disability expenses of a designated beneficiary. Any distribution that exceeds qualified disability expenses is included in gross income and subject to an additional tax of 10%.*

American Opportunity and Lifetime Learning Credits

The American Opportunity/Hope Scholarship Tax Credit ("AOTC") and Lifetime Learning Credit are available if you pay qualified tuition and related education expenses, which includes course materials such as books, supplies and equipment. Room and board expenses do not qualify for either credit.

However, these credits have income limitations which phase out the available credits. The AOTC is phased out ratably with MAGI between $80,000 and $90,000 if single or head of household and $160,000 and $180,000 if married filing jointly for 2019. The Lifetime Learning Credit is phased out ratably with MAGI between $58,000 and $68,000 for 2019 ($59,000 and $69,000 for 2020) if single or head of household and $116,000 and $136,000 for 2019 ($118,000 and $138,000 for 2020) if married filing jointly.

- **American Opportunity Tax Credit.** A $2,500 annual credit per student is available for the first four years of post-secondary education with enrollment on at least a half-time basis in a program leading to a degree. Generally, you can receive up to $1,000 as a refundable credit even if you owe no taxes. However, the refundable credit will not be allowed to an individual if he or she is subject to the kiddie tax and other limitations.
- **Lifetime Learning Credit.** A $2,000 annual credit per taxpayer is available for an unlimited number of years of post-secondary, graduate, or certain other courses to acquire or improve your job skills. The credit is equal to 20% of the first $10,000 of qualified expenses, up to the maximum amount of $2,000.

Employer-Provided Educational Assistance

Under a qualified educational assistance plan, up to $5,250 of the benefits will not be included in the gross

income of the employee. There is no requirement that educational assistance be job-related. Educational expenses include tuition, fees and similar payments; books; supplies and equipment. However, employer-provided tools or supplies that the employee may retain after completing a course of instruction are includible in gross income. Further, you cannot use any of the tax-free education expenses paid for by your employer under this plan as the basis for any other deduction or credit, including the American Opportunity Tax Credit and Lifetime Learning Credit.

Interest on Education Loan

Certain education expenses are deductible in computing against your federal AGI, subject to income limitations, including interest on education loans. You can take the above-the-line deduction of up to $2,500 of interest paid on qualified education loans annually, subject to a phase out that eliminates the deduction. For 2019 and 2020, the maximum deduction is reduced when MAGI exceeds $70,000 ($140,000 if married filing jointly) and is completely eliminated when MAGI is $85,000 ($170,000 if married filing jointly).

Tuition Fees and Deductions

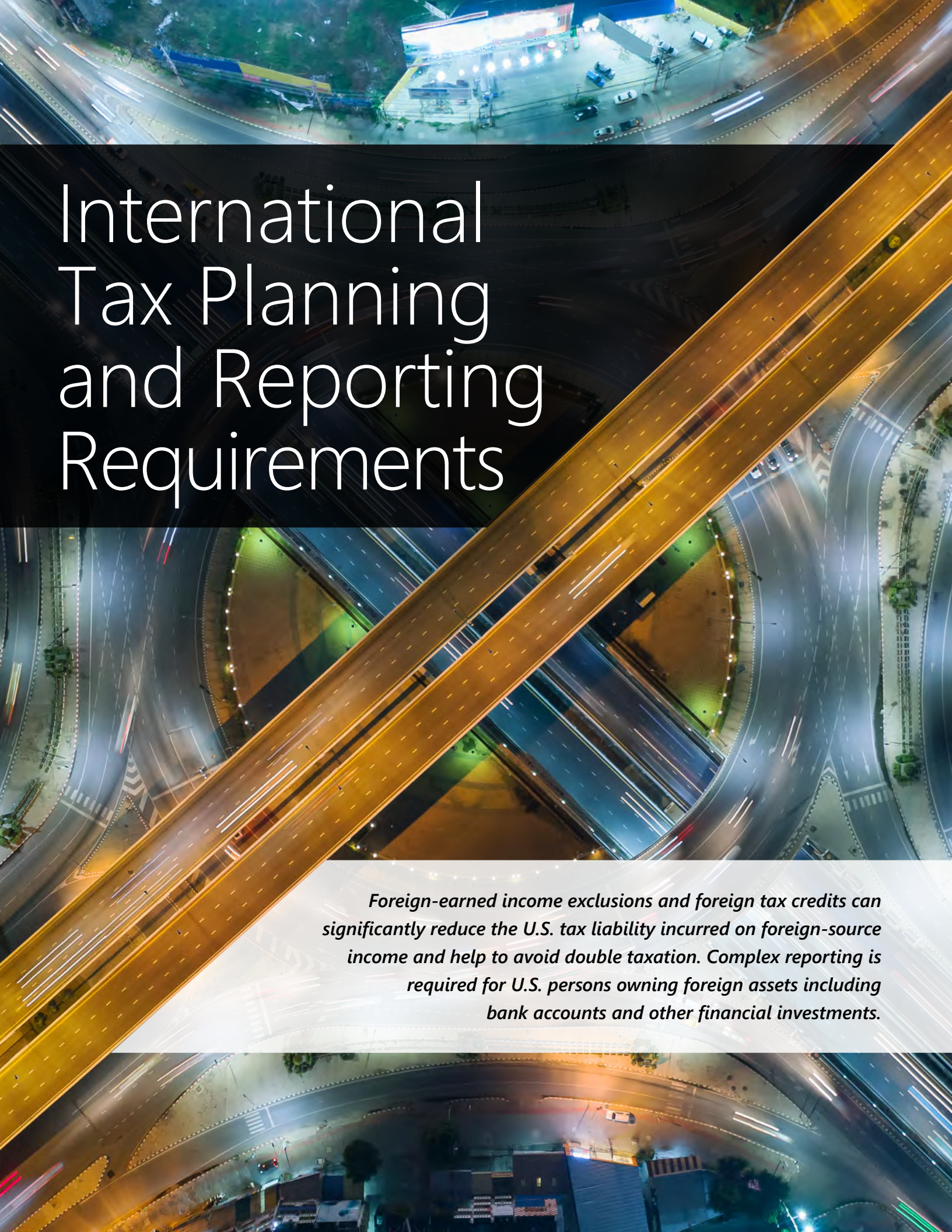
Under the Further Consolidated Appropriations Act, individuals with MAGI of up to $80,000 ($160,000 for married filing jointly status) can take a deduction from gross income of up to $2000 for tuition and fees for higher education for 2019 and 2020.

Tax Tip

25. AGI Too High to Claim a Credit? Have Your Child Take it

If you pay qualified expenses for your children but income limitations prevent you from taking the American Opportunity Tax Credit or Lifetime Learning Credit, you may have your children claim the credit on their tax returns instead. If your child can claim the full amount of the lifetime learning credit to reduce his or her own tax liability, you will save a maximum of $2,000.

Please note that a child under age 24 cannot claim the refundable portion of American Opportunity Tax Credit as long as one of the parents is alive.



International Tax Planning and Reporting Requirements

Foreign-earned income exclusions and foreign tax credits can significantly reduce the U.S. tax liability incurred on foreign-source income and help to avoid double taxation. Complex reporting is required for U.S. persons owning foreign assets including bank accounts and other financial investments.

Impact of the Tax Cuts And Jobs Act

The TCJA has had a significant impact in the international tax arena. Most notably, there was a mandatory one-time repatriation of offshore foreign earnings held in a specified foreign entity that impacted (or will impact) calendar 2017 and FYE 2018 taxpayers. All U.S. shareholders with at least 10% ownership in a specified foreign entity are required to include their share of the offshore earnings and profits which have not previously been taxed in the U.S. Only a portion of the foreign earnings are taxable based on the applicable percentage. U.S. shareholders will be allowed a 77.1% deduction for non-cash amounts and a 55.7% reduction for cash amounts. The effective tax rate will ultimately depend on the U.S. shareholder's tax bracket. The repatriation amount was determined as of November 2, 2017 or December 31, 2017; whichever period has the greater amount, and the income was included in the U.S. shareholder's 2017 tax return. Please note, that for fiscal year specified foreign corporations (i.e., FYE in 2018) there may be an additional repatriation of offshore earnings and profits to U.S. shareholders. At the election of the taxpayer, the tax can still be paid over an eight-year period.

Although many taxpayers believed this to be a one-time event, all taxpayers with an inclusion and who qualified to make the deferral election for payment of tax will need to keep track of this for the future, until the entire inclusion has been satisfied. One must be aware of various "triggering" events to ensure the inclusion does not occur sooner than expected.

Other Recent Developments

Starting with the 2017 tax year, there is a filing requirement for foreign-owned U.S. disregarded entities. If a foreign person (which includes individuals,

Tax Tip

26. Tax Benefits of the Foreign-Earned Income and Housing Exclusions

Your company sent you to work in Dubai in 2019 for several years, so you qualify as a bona fide resident of the UAE in 2019. Assume you earn $500,000 per year and your company reimburses you for $125,000 of housing costs which are taxable to you. You would be able to exclude the following income from your U.S. income tax return:

- $105,900 of your salary.
- $40,230 of the housing expense reimbursements.

The maximum 2019 foreign earned income exclusion is $105,900, regardless of which foreign country you are working in. The housing exclusion is based on which country and city you are living in (see Chart 13 for some of the more common foreign cities).

Dubai is considered to be an expensive city to live in, so the annual housing exclusion amount is $57,174. Of this amount, you are not eligible to exclude $46.42 per day, or $16,944 for a full year. Therefore, your 2019 housing exclusion will be $40,230 ($57,174 - $16,944). When added to your foreign earned income exclusion of $105,900, you can exclude a total of $146,130.

Therefore, you will be taxed in the U.S. on $478,870 related to your employment in Dubai ($500,000 compensation plus $125,000 housing cost reimbursements less the exclusions of $146,130).

Note: *Although the UAE does not impose an income tax, in this example, if you paid income tax to a country that imposes a tax, you may also be eligible to receive a foreign tax credit against the U.S. tax imposed on the remaining income. However, only 76.62% of these taxes will be allowable as a foreign tax credit that can offset your U.S. income tax (i.e., only $478,870 of the total $625,000 of income will be subject to tax: $478,870 divided by $625,000 is 76.62%).*

As you can see, your foreign housing exclusion might be limited depending on where you live. In order to see the differences in limits for housing deductions in 2019, see Chart 13 on the next page.

Chart

13. Foreign Housing Exclusions

The amount of foreign housing exclusions costs that you can exclude from your 2019 U.S. income tax return depends on both the country and city you are living in. Below are listed the maximum amounts you can exclude for some common foreign cities, before the adjustment for the daily living cost of $45.55 per day, or $16,624 for a full year.

Country	City	Maximum Annual Housing Exclusion
Canada	Toronto	$ 50,200
China	Hong Kong Beijing	114,300 71,200
France	Paris	71,800
Germany	Berlin	43,000
India	New Delhi	56,124
Italy	Rome	47,900
Japan	Tokyo	93,200
Russia	Moscow	108,000
Switzerland	Zurich	39,219
United Arab Emirates	Dubai	57,174
United Kingdom	London	69,200

partnerships and corporations) owns 100% of a U.S. LLC, it will effectively be treated as disregarded. Such entities are now required to file a pro forma Form 1120 with the Form 5472 attachment. This filing requirement is in addition to filing Form 1120-F. The pro forma 1120 cannot be filed electronically. It is due April 15, 2020 and can be extended. Reportable transactions between the U.S. LLC and its foreign owner include contributions and distributions between the two, and would certainly include the setup and closure of the LLC. There are onerous penalties for non-filing.

Foreign Tax Issues

Multinational clients with cross-border income from employment and investments are in today's mainstream. Many taxpayers are discovering that they are subject to taxation and/or reporting in both U.S. and foreign jurisdictions. Not all U.S. citizens and resident aliens are aware of their obligation to report their worldwide income to the IRS. As a result, the U.S. continues to pursue U.S. persons who fail to report income and file certain tax forms. These complex issues not only impact you if you are on an overseas assignment or retired abroad, but have broad-reaching implications even if you have never left the U.S. For instance, these issues arise if you invest in hedge funds, private equity funds, and other entities that own interests in foreign operating businesses or invest in foreign securities or have foreign retirement plans. Even holding cash in a foreign bank can trigger a reporting requirement.

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This chapter is intended to provide an overview of the income exclusions, foreign tax credits, reporting requirements, and elections involving foreign employment and investments.

Significant legislation enacted in 2010 (the "HIRE Act") imposed a U.S. withholding regime for U.S. income earned by non-U.S. persons and tightened the reporting requirements for offshore accounts and entities set up in foreign jurisdictions. This provision of the HIRE act is the Foreign Account Tax Compliance Act, also known as FATCA. FATCA requires that certain foreign financial institutions play a key role in providing U.S. tax authorities greater access into U.S. taxpayers' foreign financial account information. See FATCA section below. Through the creation of the FATCA regime, the U.S. has inspired a movement towards greater global tax transparency; similar to the FATCA compliance regime, banks and other investment institutions of foreign nations will have significant additional reporting responsibilities.

Foreign-Earned Income Exclusion and Foreign Housing Exclusion/ Deduction

In general, the worldwide income of a U.S. citizen or resident who is working abroad is subject to the same income tax and return filing requirements that apply to U.S. citizens or residents living in the U.S. However, if you are working abroad, you may qualify for one or more special tax benefits:

- Exclude up to $105,900 of foreign-earned income in 2019 and $107,900 in 2020.
- Either (a) exclude part, or all, of any housing income reimbursements you receive or (b) deduct part, or all, of any housing costs paid (i.e., for taxpayers having salary or self-employment earnings).
- Claim a foreign tax credit against your U.S. tax liability for income taxes you pay or accrue to a foreign country, or if more beneficial, take an itemized deduction for the taxes paid.
- Reduce your overall tax liability under tax treaties that the U.S. has with foreign countries.
- If eligible, claim exemption from paying social security tax in the foreign country, based on a Totalization Agreement the U.S. has with the foreign country. Totalization Agreements are essentially "treaties that cover social security taxes" designed to eliminate dual coverage for the same work. You will be required to pay U.S. Social Security and Medicare tax on such income.

To qualify for the foreign-earned income and the foreign housing exclusions, you must establish a tax home in a foreign country and meet either the bona fide residence or physical presence test, defined below:

Bona fide residence test

To qualify under this test, you must establish residency in a foreign country for an uninterrupted period that includes an entire calendar year. Brief trips outside the foreign country will not risk your status as a bona fide resident, as long as the trips are brief and there is intent to return to the foreign country.

Physical presence test

This test requires you to be physically present in a foreign country for at least 330 full days in a consecutive 12-month period, but not necessarily a calendar-year period.

Planning Tip: *If you pay no foreign tax or the effective tax rate in the foreign jurisdiction is lower than the U.S. effective tax rate, claiming the exclusion will generally be more beneficial.*

On the other hand, if the foreign jurisdiction imposes tax at a higher effective rate than the U.S., it is likely that the U.S. tax on the foreign-earned income will be completely offset by the foreign tax credit regardless of whether the exclusion is claimed.

You should consider whether foregoing the exclusion may result in a lower utilization of foreign tax credits in the current year so that a larger amount of foreign

tax credits can be carried back or forward for utilization in other years. You should also consider whether the foreign-earned income exclusion and housing exclusion election will mitigate your state tax burden to the extent that you remain taxable on worldwide income in the state of residency.

Otherwise, in certain circumstances, it may be more beneficial to forego the exclusion in favor of claiming only a greater foreign tax credit.

Claiming the exclusion is a binding election. Once you have claimed the exclusion, you will be required to continue to claim it in all future years. If you revoke the election, you will not be allowed to claim the exclusion again until the sixth tax year after the year of revocation unless you receive permission from the IRS. If you have claimed the exclusion in the past, the benefit of revoking the exclusion must be weighed against the possible ramifications of being unable to re-elect the exclusion for five years. There is no downside of forgoing the exclusion if you have never claimed it in the past.

Note: *For Americans residing overseas, the foreign-earned income exclusion is not considered when calculating the applicable thresholds for either the 3.8% Medicare Contribution Tax on net investment income or the .9% Additional Medicare Tax on earned income.*

Foreign Tax Credit

A foreign tax credit may be claimed by U.S. citizens, resident aliens, and in certain cases by nonresident aliens. Typically states do not allow foreign taxes to offset state income tax liabilities. An exception to this includes New York State, which allows a credit for certain Canadian provincial income taxes. Unlike the exclusions discussed above, you do not need to live or work in a foreign country in order to claim the foreign tax credit. You may be eligible for the credit if you paid or accrued foreign taxes in the tax year. Common examples of foreign-source income that may generate foreign tax credits include dividends paid by foreign corporations, including those paid on your behalf through a mutual fund, and foreign business income earned by a flow-through entity.

You are entitled to claim either a tax credit or an itemized deduction for taxes paid to foreign countries. Though not always the case, the tax credit is typically more beneficial since it can reduce your U.S. federal tax liability on a dollar-for-dollar basis.

Generally, only foreign income taxes qualify for the foreign tax credit. Other taxes, such as foreign real and personal property taxes, do not qualify.

- Taxes paid on income excluded from U.S. gross income (e.g., foreign-earned income exclusion or a treaty-based return position taken).
- Taxes paid to the countries that participate in certain international boycotts.
- Taxes of U.S. persons controlling foreign corporations and partnerships if certain annual international returns are not filed.
- Certain taxes paid on foreign oil-related, mineral, and oil and gas extraction income.

This deduction is virtually eliminated for 2018 (and through 2025) under the Tax Cuts and Jobs Act.

Your ability to claim a credit for the full amount of foreign taxes paid or accrued is limited based on a ratio of your foreign-source taxable income to your total taxable income. This ratio is applied to your actual tax (excluding the 3.8% Medicare Contribution Tax on net investment income) before the credit to determine the maximum amount of the credit that you can claim. If you are not able to claim the full amount of the credit in the current year, you must carry the excess back to the immediately preceding tax year and if not utilized in the prior year, the remaining credit is carried forward for the next ten tax years, subject to a similar limitation in those years.

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The credit is calculated for each separate type of foreign-source income. In other words, foreign taxes paid on dividends are subject to a separate limitation than foreign taxes paid on income from salary or an active trade or business. Foreign-source income is generally classified into two different baskets for determining the allowable credit:

- **Passive income:** This category includes dividends, interest, rents, royalties, and annuities.
- **General limitation income:** This category includes income from foreign sources which does not fall into the passive separate limitation category and generally is income earned from salary, pensions or an active trade or business.

In addition, you are required to maintain a separate foreign tax credit limitation basket for each country in which income is resourced under an income tax treaty. This provision applies to income classified as U.S. source income under U.S. tax law, but treated as foreign-source under an income tax treaty.

Expatriation Exit Tax

If you plan on giving up your U.S. citizenship or relinquishing your U.S. legal permanent residency status ("Green Card") and are considered a "covered expatriate," you will pay an income tax at the capital gains rate as though you had sold all of your assets at their fair market value on the day before the expatriation date. The 3.8% additional Medicare Contribution Tax on net investment income may apply in the case of a "covered expatriate" who is subject to the exit tax. Any gain on the deemed sale in excess of a floor of $725,000 for 2019 ($737,000 for 2020) is immediately taxed ("mark-to-market tax"). Losses are taken into account and the wash sale rules do not apply. An election can be made to defer the tax on the deemed sale until the asset is actually sold (or the taxpayer's death, if sooner) provided a bond or other security is given to the IRS. Deferred compensation items and interests in non-grantor trusts are not subject to the tax but are generally subject to a 30% withholding tax on distributions to the expatriate. IRAs and certain other tax-deferred accounts are treated as if they were completely distributed on the day before the expatriation date (early distribution penalties do not apply).

Former long-term residents who held a U.S. Green Card for anytime during eight out of the last 15 years and all U.S. citizens are subject to the expatriation regime if they:

- Had average annual net income tax liability for the five years ending before the date of expatriation or termination of residency in excess of an annual ceiling, which is $168,000 for 2019 and $171,000 for 2020;
- Had a net worth of $2 million or more when citizenship or residency ended; or
- Failed to certify compliance under penalties of perjury on Form 8854, Initial and Annual Expatriation Statement, with all U.S. federal tax obligations for the five tax years preceding the date of expatriation.

A U.S. citizen or resident will have to pay tax on a gift or bequest received from an individual who had expatriated after June 17, 2008. The tax does not apply to the extent that the gift or bequest during the year is within the annual gift tax exclusion ($15,000 for 2019 and 2020). The tax does not apply if the transfer is reported on a timely filed gift tax return or estate tax return or to transfers that qualify for the marital or charitable deductions. The value of a transfer not covered by an exception is taxable to the recipient at the highest rate on taxable gifts, which is currently 40%.

U.S. Income Taxation of Nonresident Individuals

Residents are taxed differently than nonresidents. Resident aliens are taxed on worldwide income at graduated tax rates much the same as a U.S. citizen. A

nonresident alien, however, is taxed at graduated rates only on income that is effectively connected with a U.S. trade or business or at a flat 30% rate on U.S.-source income that is not effectively connected with a U.S. trade or business (unless a lower income tax treaty rate applies). Nonresident taxpayers are specifically exempt from the 3.8% Medicare Contribution Tax on net investment income.

A foreign national is generally deemed a resident alien of the U.S. if one of the two following tests is met:

- Lawful permanent residence (Green Card test); or
- Substantial presence test.

If an individual is physically present in the U.S. for at least 31 days during 2019 and has spent at least 183 days during the period of 2019, 2018, and 2017 counting all of the days of physical presence in 2019, but only one-third of the days of presence in 2018, and only one-sixth of the number of days in 2017, the individual will be deemed a resident for U.S. tax purposes.

Except as noted below, you are treated as being present in the U.S. on any day that you are physically present in the country at any time during the day. Exceptions include days spent in the U.S. for the following circumstances:

1. Days you regularly commute to work in the U.S. from a residence in Canada or Mexico.
2. Days you were in the U.S. for less than 24 hours when you were traveling between two places outside the U.S.
3. Days you were temporarily in the U.S. as a regular crew member of a foreign vessel engaged in transportation between the U.S. and a foreign country or a possession of the U.S. unless you otherwise engaged in trade or business on such a day.
4. Days you were unable to leave the U.S. because of a medical condition or medical problem that arose while you were in the U.S.
5. Days you were an exempt individual (e.g., foreign government-related individual, teacher or trainee, student or a professional athlete competing in a charitable sporting event).

Note: *If you qualify to exclude days of presence in the U.S. because you were an exempt individual (other than a foreign government-related individual) or because of a medical condition or medical problem, you must file Form 8843, Statement for Exempt Individuals and Individuals with a Medical Condition. In addition, there are certain elections available to nonresidents who move to the U.S. that could minimize global taxation.*

Even though you may otherwise meet the substantial presence test, you will not be treated as a U.S. resident for 2019 if you do not have a green card and:

- You were present in the U.S. for fewer than 183 days during the calendar year in question,
- You establish that during the calendar year, you had a tax home in a foreign country, and
- You establish that during the calendar year, you had a closer connection to one foreign country in which you had a tax home than to the U.S., unless you had a closer connection to two foreign countries.

You will be considered to have a closer connection to a foreign country other than to the U.S. if you or the IRS establishes that you have maintained more significant contacts with the foreign country than with the U.S.

IRS Form 8840, Closer Connection Exception Statement for Aliens, will need to be submitted with your U.S. nonresident income tax return for the year in which you meet the substantial presence test and you are exempt from it because you also meet the closer connection test.

Alternatively, you may be considered a nonresident if you also would qualify as a resident of your home jurisdiction under the tie breaker clause of an income tax treaty with the U.S.

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U.S. Reporting Requirements for Nonresident Aliens

Form 1040NR/1040NR-EZ

This form is used by nonresident aliens of the U.S. to annually report U.S.-source income and the payments of U.S. tax, made either through withholding by the payor or through estimated tax payments. The U.S. tax liability for the year is computed and any tax due in excess of payments made during the year is remitted to the U.S. Treasury. A U.S. nonresident may also be subject to state income tax on the income earned in one or more states.

Foreign nationals, nonresident aliens and other taxpayers who have filing or payment obligations under U.S. law and are not eligible for a social security number are required to obtain an Individual Taxpayer Identification Number ("ITIN"). The IRS will only issue ITINs when applications include original documentation (e.g., passports and birth certificates) or copies of these documents that have been certified by the issuing agency. There are certain exceptions for families of military personnel and for persons who have certain types of income subject to withholding (e.g., pensions). ITINs issued after 2012 may have a five-year expiration period.

Note: *When reporting as a U.S. nonresident, residents of another country under the provision of a treaty will be required to file Form 1040NR/1040NR-EZ and include applicable forms to report interests in foreign entities (e.g., Forms 8621, 5471, and 8865) and financial accounts (see below).*

Form 1042-S

If you are a nonresident of the U.S. and receive income from U.S. sources, you will receive Form 1042-S. This is the annual information return prepared by the payor to report your name, address, amount and type of income paid and any taxes withheld.

This form is normally distributed no later than March 15 of the following year. If the recipient of the income is a U.S. person, a Form 1099 would be issued instead; Forms 1099 are generally due to be received by U.S. persons no later than January 31 of the following year. Information on Form 1042-S may also be reported to the tax authorities in the recipients' country of residence.

Form W-8 BEN

This form is provided by a nonresident alien to a payor to certify the recipient's residency status as beneficial owner of the income. If applicable, this form should also be completed to claim the benefits of an income tax treaty.

Form W-8 BEN-E

This form is provided by a foreign entity to document its foreign status to a payor to certify the recipient's status as beneficial owner of the income. If applicable, this form should also be completed to claim the benefits of an income tax treaty.

Caution: *If you give the payor the wrong form you will likely receive unnecessary (and avoidable) correspondence from the IRS.*

Foreign Reporting Requirements for U.S. Citizens And Residents

There are many IRS tax forms that must be completed and attached to your tax return to disclose foreign holdings and to make elections that could prove valuable to you. If you have investments in foreign companies, whether held directly by you or through a pass-through entity such as an investment partnership or hedge fund, your reporting requirements increase. These requirements place an additional burden on the amount of information you must include with your U.S. income tax return. Failure to do so could result in substantial penalties and the loss of beneficial tax elections. Some of the most common of these forms are:

- Form 114, Report of Foreign Bank and Financial Accounts.

- Form 8621, Return by a Shareholder of a Passive Foreign Investment Company (PFIC) or Qualified Electing Fund (QEF).
- Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation.
- Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships.
- Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations.
- Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts.
- Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner.
- Form 8938, Statement of Foreign Financial Assets.

Form 114 — Report of Foreign Bank and Financial Accounts ("FBAR")

If you are a U.S. person (including a corporation, partnership, exempt organization, trust or estate) and have a financial interest in or signature authority over a foreign financial account, you may be subject to FBAR reporting.

The FBAR must be filed on an annual basis if you have a financial interest in or signature authority over one or more financial accounts in a foreign country with an aggregate value exceeding $10,000 at any time during the year. Beginning with the 2016 FBAR and forward, the due date for this form is April 15 of the following year and a six-month extension of this deadline may be granted. FinCEN automatically extended the due date for all FBARs until October 15 for the 2019 returns.

Note: *The requirement for submission of both new and amended filings for all years must be done online and CPAs can file FBAR forms on behalf of their clients as long as they have a document granting them that authority. If amending an FBAR filing, the prior BSA Identification number must be provided from the original filing.*

Financial accounts include banks, securities, derivatives, foreign mutual funds or other financial accounts (including any savings, demand, checking, deposit, annuity, or life insurance contract other than term insurance or other account maintained with a financial institution). The IRS continues to suspend the reporting of offshore commingled funds, such as hedge funds and private equity funds.

A financial interest in an account includes being the owner of record or having legal title, even if acting as an agent, nominee, or in some other capacity on behalf of a U.S. person. Taxpayers who have signatory authority over accounts owned by others (e.g., minor children, parents, etc.) are also reportable. A financial interest also includes an account held by a corporation in which you own, directly or indirectly, more than 50% of the total voting power or value of shares; a partnership in which you own an interest of more than 50% in the capital or profits; or a trust as to which you or any other U.S. person has a present beneficial interest in more than 50% of the assets or receives more than 50% of the current income.

In the case of a nonwillful failure to file the FBAR, the IRS may impose a maximum penalty of $10,000 per account. Procedures issued by the IRS in 2015 limit the maximum penalty imposed where there is willfulness. The memo specifically instructs examiners to calculate a single penalty for all years combined and then allocate it to each year. The single penalty is 50% of the highest aggregate balance in any of the years under examination. Criminal penalties could also be assessed for willful violations.

Note: *In previous years the maximum penalty was the greater of $100,000 or 50% of the highest balance in the account during the year.*

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Offshore Voluntary Disclosure Programs

Since 2009 the IRS has offered various programs designed for taxpayers to voluntary disclose previously unreported foreign income or assets. Two of the programs which focus on disclosure of foreign assets are the Offshore Voluntary Disclosure Program ("OVDP") and the Streamlined Filing Compliance Procedure ("SFCP"). Both programs provide an opportunity for taxpayers to come forward and disclose unreported foreign income and file information returns while paying a reduced penalty or, in some cases, no penalty at all. In the case of the OVDP, the individual may also avoid criminal prosecution. In 2014 the IRS announced important changes to both programs. Specifically, the IRS imposed stricter requirements and potentially higher penalties for taxpayers participating in the OVDP, and expanded the original SFCP program in taxpayer-friendly ways to include taxpayers residing both in the U.S. and abroad.

Note: *The OVDP program was closed on September 28, 2018. It has since been replaced with a New Civil Resolution Framework for Willful Violations. Unlike the OVDP, taxpayers do not receive automatic protection against criminal liability or significant civil penalties. It is recommended to seek outside council regarding either program, if needed. The SFCP program remains open, but can close at any time. Thus, taxpayers who can benefit from participating in the SFCP program should act promptly.*

Form 8621, Return by a Shareholder of a Passive Foreign Investment Company ("PFIC") Or Qualified Electing Fund ("QEF")

U.S. persons who invest in a foreign corporation which is a PFIC are subject to the harsh PFIC regime. Unless a QEF election or mark-to-market ("MTM") election is made they will pay tax on gains from the sale of the investment or on certain distributions from the PFIC ("excess distributions"). Also if neither of these two elections is made, upon disposition of all or some of the PFIC stock or certain distributions ("excess distributions") the harsh PFIC rules will also apply. These rules require a ratable allocation of any gain over the years during which the shares were held and that gain is taxed at the highest rate on ordinary income in effect for each of the years involved, rather than the beneficial long-term capital gains rate in the year of disposition. An interest charge is also imposed on the tax, and begins running from the period to which such gain is allocated. In certain situations, this tax can exceed 100% of the gain (ergo, "harsh").

Classification as a PFIC occurs when 75% or more of the corporation's income is passive or when more than 50% of the corporation's assets generate passive income. Passive income includes, but is not limited to, interest, dividends, and capital gains.

U.S. shareholders who make the QEF election on Form 8621 are required to annually include in income the pro rata share of the ordinary earnings and net capital gains of the corporation, whether or not distributed, thus avoiding the onerous PFIC tax.

Alternatively, a shareholder of a PFIC may make an MTM election on Form 8621 for marketable PFIC stock. If the election is made, the shareholder includes in income each year an amount equal to the excess, if any, of the fair market value of the PFIC stock as of the close of the tax year over the shareholder's adjusted basis in the stock; or deducts the excess of the PFIC's adjusted basis over its fair market value at the close of the tax year (the deduction is limited to cumulative income that was included in previous years).

If the election is made, the PFIC rules do not apply. Amounts included in income or deducted under the MTM election, as well as gain or loss on the actual sale or other disposition of the PFIC stock, are treated as ordinary income or loss.

U.S. persons (i.e., individuals, corporations, partnerships, trusts, and estates) owning PFICs are required to file Form 8621 regardless of whether an

excess distribution has occurred or an election has been made. This applies to U.S. shareholders who own shares directly and indirectly who are at the lowest tier of a chain of companies.

Ownership of PFIC stock through another U.S. taxpayer may also trigger reporting in certain instances. U.S. persons who are required to include an amount in income under the QEF or MTM regimes for PFIC stock held through another U.S. taxpayer are not required to file if another shareholder through which the U.S. person holds the PFIC stock timely files. The filing applies to domestic estates, non-grantor trusts and U.S. owners of domestic or foreign grantor trusts that own PFIC stock.

U.S. persons who are beneficiaries of foreign estates and foreign non-grantor trusts that have made QEF or MTM elections are required to file, while those beneficiaries of domestic estates or trusts are only required to file if the estate or trust fails to file the form. U.S. beneficiaries are required to report in any case in which the beneficiary receives an excess distribution or recognizes gains treated as excess distributions.

A limited filing exception applies for certain shareholders with respect to an interest owned in a PFIC for which the shareholder is subject to PFIC tax where no QEF or MTM election is in effect. The exception applies only if the shareholder is not subject to PFIC tax with respect to any excess distributions or gains treated as excess distributions and either (a) the aggregate value of all PFIC stock owned by the shareholder at the end of the tax year of the shareholder does not exceed $25,000 ($50,000 for joint filers), or (b) the PFIC stock is owned by the shareholder through another PFIC, and the value of the shareholder's proportionate share of the upper-tier PFIC interest in the lower-tier PFIC does not exceed $5,000.

Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation

Form 926 is used to report certain transfers of tangible or intangible property to a foreign corporation. While there are certain exceptions to the filing, generally the following special rules apply to reportable transfers:

- If the transferor is a partnership, the U.S. partners of the partnership, not the partnership itself, are required to report the transfer on Form 926 based on the partner's proportionate share of the transferred property.
- If the transfer includes cash, the transfer is reportable on Form 926 if immediately after the transfer the person holds, directly or indirectly, at least 10% of the total voting power or the total value of the foreign corporation, or the amount of cash transferred by the person to the foreign corporation during the 12-month period ending on the date the transfer exceeds $100,000.

The penalty for failure to comply with the reporting requirements is 10% of the fair market value of the property at the time of the transfer, limited to $100,000 if the failure to comply was not due to intentional disregard.

Form 8865, Return of U.S. Persons with Respect to Certain Foreign Partnerships

Form 8865 is required to report information with respect to controlled foreign partnerships, transfers to foreign partnerships, or acquisitions, dispositions, and changes in foreign partnership ownership. A separate Form 8865, along with the applicable schedules, is required for each foreign partnership.

There are four categories which define who is required to file the form and how much information must be provided. The categories are:

- **Category 1:** A U.S. person who owned more than a 50% interest in a foreign partnership at any time during the partnership's tax year.
- **Category 2:** A U.S. person who at any time during the tax year of the foreign partnership owned a 10% or greater interest in the partnership while the partnership was controlled by U.S. persons each owing at least 10% interest. However, if there was a Category 1 filer at any time during that tax year, no person will be considered a Category 2 filer.
- **Category 3:** A U.S. person, including a related person, who contributed property during that person's tax year to a foreign partnership in exchange for an interest in the partnership, if that person either owned directly or indirectly at least a 10% interest in the foreign partnership immediately after the contribution, or the value of the property contributed by such person or related person exceeds $100,000. If a domestic partnership contributes property to a foreign partnership, the partners are considered to have transferred a proportionate share of the contributed property to the foreign partnership. However, if the domestic partnership files Form 8865 and properly reports all the required information with respect to the contribution, its partners will generally not be required to report the transfer. Category 3 also includes a U.S. person that previously transferred appreciated property to the partnership and was required to report that transfer under IRC Sec. 6038B, if the foreign partnership disposed of such property while the U.S. person remained a partner in the partnership.
- **Category 4:** A U.S. person who had acquired or disposed of or had a change in proportional interest may be required to report under this category if certain requirements are met.

A penalty of $10,000 can be assessed for failure to furnish the required information within the time prescribed. This penalty is applied for each tax year of each foreign partnership. Furthermore, once the IRS has sent out a notification of the failure to report the information, an additional $10,000 penalty can be assessed for each 30-day period that the failure continues, up to a maximum of $50,000 for each failure.

Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations

Form 5471 is used to satisfy the reporting requirement for U.S. persons who are officers, directors, or shareholders in certain foreign corporations. You will be required to file this form if you meet one of the following tests:

- **Category 1:** Includes a U.S. shareholder of a foreign corporation that is an IRC Sec. 965 specified foreign corporation ("SFC") at any time during any tax year of the foreign corporation, and who owned that stock on the last day in that year on which it was an SFC. (This Category has been reinstated since the "IRC Sec. 965 Transition Tax" applicable to 2017 & 2018 U.S. Tax Filers).
- **Category 2:** You are a U.S. person who is an officer or director of a foreign corporation in which a U.S. person has acquired stock that makes him/her a 10% owner with respect to the foreign corporation, or acquired an additional 10% or more of the outstanding stock of the foreign corporation.
- **Category 3:** You are a U.S. person who acquires stock in a foreign corporation which, when added to any stock owned on the date of acquisition or without regard to stock already owned, meets the 10% stock ownership requirement with respect to the foreign corporation, or
- You are a person who becomes a U.S. person while meeting the 10% stock ownership requirement with respect to the foreign corporation, or
- You are a U.S. person who disposes of sufficient stock in the foreign corporation to reduce your interest to less than the 10% stock ownership requirement.

- **Category 4:** You are a U.S. shareholder who owns more than 50% of the total combined voting power of all classes of stock entitled to vote or more than 50% of the total value of the stock in a foreign corporation during the annual accounting period of the foreign corporation.
- **Category 5:** You are a U.S. shareholder who owns stock in a controlled foreign corporation ("CFC") at any time and who owns the stock on the last day of that year. A CFC is defined as a foreign corporation that has U.S. shareholders (counting only those with at least a 10% interest) that own on any day of the tax year of the foreign corporation more than 50% of the total combined voting power of all classes of its voting stock, or the total value of the stock of the corporation.

Note: *Certain constructive ownership rules apply in determining stock ownership for these purposes.*

The same penalties that apply for failure to file Form 8865 also apply to Form 5471 (see the discussion in the previous section). The information required to properly complete Form 5471 can be extensive and at times difficult to obtain.

One of the issues faced by U.S. multinationals is that profits earned by foreign subsidiaries can often be subjected to U.S. federal income tax, even if the cash that represents those earnings is not repatriated. This is the result of the wide variety of anti-deferral rules introduced by Congress over the years.

Most notably, Subpart F was designed to tax the types of income that could be easily moved into low tax jurisdictions, such as dividends, interest, rents and royalties. The anti-deferral rules aim to subject such income to federal tax in the year in which the subsidiary earns it. The CFC look-through rule provides that certain dividends, interest, rents and royalties paid between related parties are excluded from the calculation of Subpart F. Accordingly the look-through rule operates to reduce the global effective tax rate for many multinational companies.

Observation: *The look-through rule for related parties has been permanently extended as a result of PATH.*

Global Low Taxed Intangible Income ("GILTI") is an additional regime designed to capture offshore income that Subpart F does not. U.S. shareholders of a CFC are required to include their share of GILTI into their gross income. GILTI is a complex new area of international tax law with very little exclusions.

Another oft-encountered rule under the Subpart F regime is the rule which limits the CFC's investment in the U.S. Under this provision if a CFC extends a loan to its U.S. shareholder or a party related to its U.S. shareholder, the loan is deemed a dividend for U.S. taxpayers. Included in the definition of a loan are certain trade receivables as well as using the CFC as collateral or as a guarantor to obtain a bank loan in the U.S.

Note: *Proposed regulations under IRC Sec. 956 have been issued by the IRS discussing new rules in which a Corporation would benefit from the dividend received deduction in computing their IRC Sec. 956 inclusion. However, this benefit will not apply to individuals.*

Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts and Form 3520-A, Annual Information Return of Foreign Trust with a U.S. Owner

U.S. persons who either create a foreign trust, receive distributions from a foreign trust, or receive gifts or bequests from foreign persons are required to file Form 3520.

A foreign trust is defined as a trust in which either a court outside of the U.S. is able to exercise primary supervision over the administration of the trust or one or more non-U.S. persons have the authority to control all substantial decisions of the trust.

The information return must be filed in connection with the formation of a foreign trust, the transfer of cash or

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other assets by the settlor or grantor to a foreign trust, and the receipt of any distributions by a U.S. beneficiary from a foreign trust. Any uncompensated use of foreign trust property (e.g., real estate or personal property) by a U.S. grantor, U.S. beneficiary, or any related person is treated as a distribution to the grantor or beneficiary equal to the fair market value of the use of the property and must be reported. The use or loan of trust property will not be considered a distribution to the extent the loan is repaid with a market rate interest or the user makes a payment equal to the fair market value of such use within a reasonable time frame.

Gifts or bequests that you receive in the form of money or property from a non-resident alien (including a foreign estate) that is valued in the aggregate at more than $100,000 annually and gifts in excess of $16,388 in 2019 ($16,649 for 2020) from a foreign corporation or foreign partnership are also reported on Form 3520.

Form 3520 must be filed by the due date of your individual income tax return, including extensions. The failure to do so may subject you to a penalty of 35% of the gross value of any property transferred to the trust, 35% of the gross value of the distributions received from the trust, or 5% of the amount of certain foreign gifts for each month for which the gift goes unreported (not to exceed 25% of the gift).

In addition to the filing requirements of Form 3520, there is also a requirement to file Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner, which is an annual information return of a foreign trust with at least one U.S. owner and which is considered a grantor trust. If you are a U.S. person who directly or indirectly transfers property to a foreign trust, the trust is presumed to have a U.S. beneficiary and is considered a grantor trust unless you can demonstrate that under the terms of the agreement, no income or corpus of the trust can be paid or accumulated for the benefit of a U.S. person. As the U.S. owner, you are responsible for ensuring that the foreign trust annually furnishes certain information to the IRS and the other owners and beneficiaries of the trust.

Form 3520-A must be filed by March 15 after the foreign trust's tax year, in the case of a calendar-year trust. A six-month extension can be requested on IRS Form 7004.

Form 8938, Statement of Foreign Financial Assets

U.S. citizens or resident aliens filing joint returns who hold, at the end of the year, an aggregate of more than $100,000 (or $50,000 for single taxpayers) in certain foreign assets (e.g., a foreign financial account, an interest in a foreign entity, or any financial instrument or contract held for investment that is held and issued by a foreigner) will be required to report information about those assets on Form 8938. Those taxpayers filing jointly who hold $150,000 (or $75,000 for single) in foreign assets at any time during the year also have a filing obligation regardless of whether the end-of-year threshold is met. This requirement is in addition to the FBAR reporting. Form 8938 is part of the annual income tax return, whereas the FBAR is filed separately.

Beginning after December 31, 2015, certain domestic corporations, partnerships, and trusts that are considered formed or availed of for the purpose of holding, directly or indirectly, specified foreign financial assets (special domestic entities) must file Form 8938 if the total value of those assets exceeds $50,000 on the last day of the tax year or $75,000 at any time during the tax year.

For U.S. citizens or resident aliens living outside of the U.S. the filing thresholds are increased to $400,000 (or $200,000 for single taxpayers). Also, individuals not required to file a U.S. income tax return for the tax year are not required to file Form 8938 even if the aggregate value of the specified foreign financial assets is more than the appropriate reporting threshold and there is a reporting exception for foreign financial assets reported on certain information returns.

Noncompliance with these rules for any tax year

could result in a failure-to-file penalty of $10,000 and continuing failure to file penalties up to $50,000. In addition, a 40% understatement penalty for underpayment of tax as a result of a transaction involving an undisclosed specified foreign financial asset can be assessed; criminal penalties may also apply.

For tax returns filed after March 18, 2010, the statute of limitations for assessing tax with regard to cross-border transactions or for certain foreign assets will be extended for three years from the date certain informational reporting is submitted related to the transaction or the asset if the failure to report was due to reasonable cause and not willful omission. If an omission is in excess of $5,000 related to a foreign financial asset, the statute of limitations will be extended from three years to six years and would not begin to run until the taxpayer files the return disclosing the reportable foreign asset.

Observation: *The definition of a reportable foreign asset is much broader than under the FBAR rules and includes interests in offshore hedge funds, private equity funds, and real estate holding companies.*

Foreign Account Tax Compliance Act — FATCA

Beginning July 1, 2014, foreign financial institutions are required to report directly to the IRS certain information about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. To properly comply, a foreign financial institution was required to enter into a special agreement with the IRS by June 30, 2014. A participating institution will be required to implement certain due diligence procedures prior to opening an account, identify U.S. account holders who have opened accounts or after the effective date of the agreement, and have certain procedures for pre-existing accounts. The U.S. account holder will need to provide the institution with a Form W-9 to identify the status as a U.S. person and the institution will report the information to the IRS. Those institutions that do not participate and account owners unwilling to provide information will be subject to a 30% withholding tax on certain U.S.-source payments including interest, dividends and proceeds from the source of securities.

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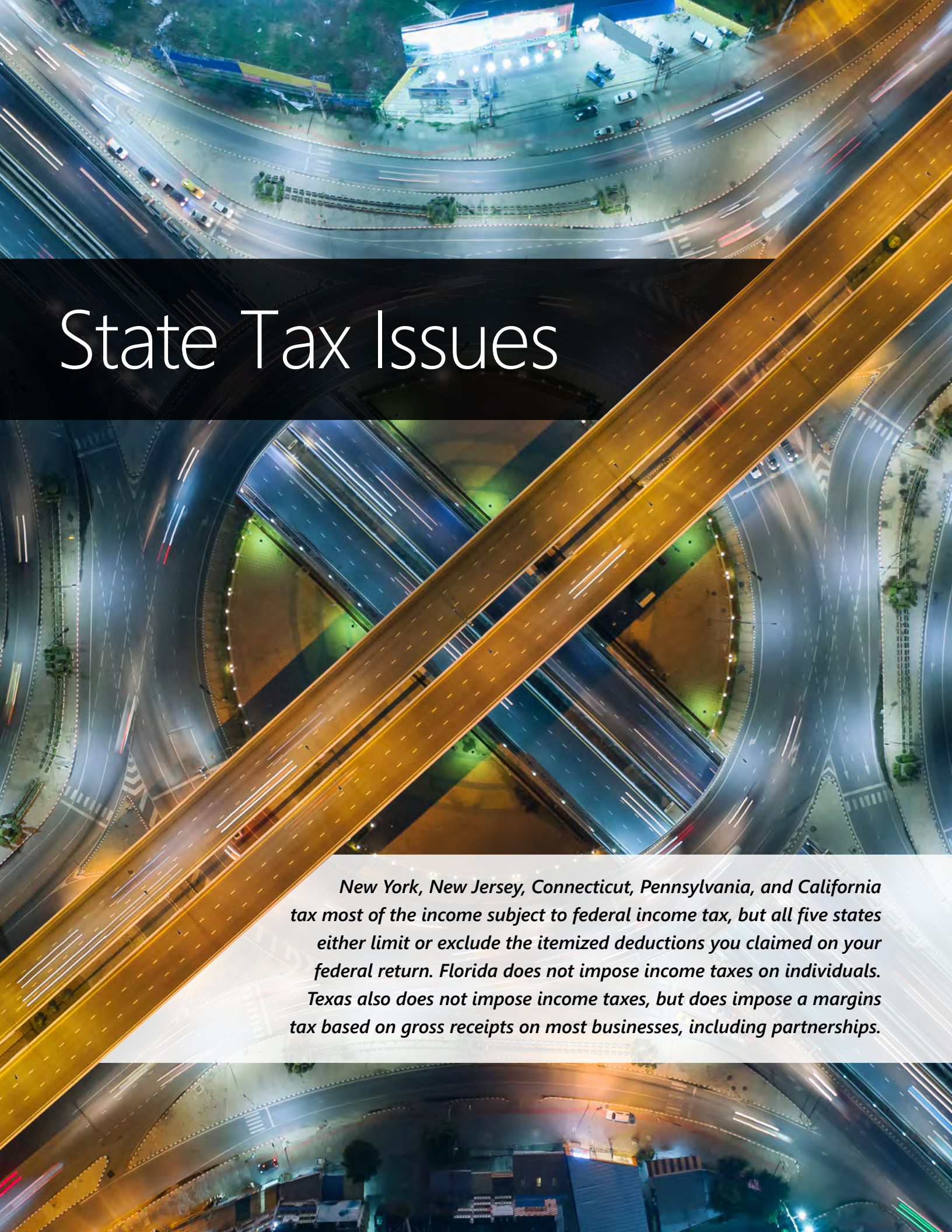
State Tax Issues



New York, New Jersey, Connecticut, Pennsylvania, and California tax most of the income subject to federal income tax, but all five states either limit or exclude the itemized deductions you claimed on your federal return. Florida does not impose income taxes on individuals. Texas also does not impose income taxes, but does impose a margins tax based on gross receipts on most businesses, including partnerships.

Introduction

You do not get a complete picture of your personal tax situation until you consider the impact of income taxes in the state or states where you work or live, or from which you derive certain types of income. Each state has specific tax laws so the impact can be very different depending on the state jurisdictions in which you are subject to tax. This chapter is devoted to providing a summary of the state income taxes that may impact you if you work or live in the states of New York, New Jersey, Connecticut, Pennsylvania and California. Neither Florida nor Texas imposes a personal income tax.

But before we discuss the factors that distinguish these states from each other, we should point out the rules relating to income exclusions, which are quite similar.

Income Exclusions

New York, New Jersey, Connecticut, Pennsylvania and California do not tax the following items of income:

- Interest on obligations of:
  1. The U.S. and its possessions, such as Puerto Rico (e.g., U.S. Treasury bills and bonds),
  2. Governmental agencies and municipalities within your state of residence, and
  3. Port Authority of New York and New Jersey for residents of New York and New Jersey, including such interest earned through bond funds.

Caution: *New York, New Jersey, Connecticut, Pennsylvania and California tax the interest income from municipal bonds issued by any state other than their own. A mutual fund needs to have at least 50% of its assets invested in tax-exempt U.S. obligations and/or in California or its municipal obligations in order for any "exempt-interest dividends" to be exempt from California tax. The amount of income that can be excluded from California is based on the percentage of assets so invested.*

Chart

14. 2019-2020 Maximum New York Tax Rates

State or City	Maximum Tax Rates
New York State	**8.82%**
New York City	**3.876%**

For 2019, the maximum NYS tax rate is applicable for married filing joint taxpayers with income over $2,155,350. For income under $2,155,350, the top rate is 6.85%. For 2020-2024, the highest tax rate for such taxpayers is scheduled to be 6.85% for income above $323,200.

A mutual fund needs to have at least 80% of its assets in tax-exempt U.S. obligations and/or in New Jersey or its municipal obligations in order for "exempt-interest dividends" to be exempt from New Jersey tax. The amount of income that can be excluded from New Jersey is based upon the percentage of assets so invested. However, distributions from mutual funds attributable to interest from federal obligations are exempt from New Jersey tax irrespective of whether the 80% test is met.

- State and local income tax refunds (since they do not allow a deduction for payments of state and local income taxes).
- Social Security benefits.
- Certain pension and retirement benefits, subject to various limitations, including the payor of the pension, the age of the recipient, and which state is being considered.

An Update on *Wayfair*

The U.S. Supreme Court's *Wayfair (South Dakota v. Wayfair, Inc.*, Docket No. 17-494 (6/21/2018), 585 U.S. (2018)) decision has impacted taxation of e-commerce.

Prior to this decision, states could generally only subject an out-of-state seller to sales tax if it had some type of "physical presence" in that state. The term physical presence was often misinterpreted to mean some type of permanent physical establishment. In reality, physical presence could be established through agents, affiliates, employee visits, and/or the presence of online marketing agreements or software such as "cookies" in a state. In *Wayfair,* the Supreme Court overturned the physical presence requirement and found that the economic nexus provisions enacted by South Dakota withstood constitutional muster, and were therefore valid. Specifically, the provisions in question imposed a sales tax collection and filing responsibility on remote sellers that had either $100,000 in remote sales, or 200 separate transactions, into the state. The Court didn't rule that these thresholds were the minimum, just that these were sufficient. As a result, many states have enacted provisions that mirror those of South Dakota. Currently, all states with a general sales tax except Florida and Missouri have some type of economic nexus provision regarding sales tax, including requirements for marketplace sellers, and reporting requirements (which may have a much lower threshold). As a result, many companies, of all sizes, now find themselves subject to a vast array of sales tax requirements across the country. Many companies which previously had filing requirements in only one or two jurisdictions, now find themselves struggling to keep up with new collection and filing requirements in over 40 states, plus local jurisdictions.

Some of the issues companies must now deal with include:

1. Keeping current on the over 10,000 sales tax rates across the country and implementing these rates with their invoicing/point of sale system;
2. Updating systems to be able to track and obtain the information necessary to file the required returns;
3. Numerous registrations just to get on the tax rolls and obtain a tax account;
4. Filing monthly sales tax returns across the country; and
5. The prospect of increased audits.

For some smaller companies, these burdens could literally be a backbreaker. The increased costs of complying with these requirements across the country can easily exceed $50,000. Consider as an example: A company whose average sale is $20 could meet the transaction threshold in a state with only having $4,000 of sales in that state. Thus, the cost of compliance for companies with a $1 million of sales, if spread evenly across the country, could be enough to force the company to close its doors (or website).

The below paragraphs summarize the economic nexus, and related provisions, of selected states. For more information, please refer to our *Wayfair* Hub on our website at: https://www. eisneramper. com/knowledge-center/articles/wayfair-hub-folder/ wayfair-hub/

- **California**
  Under California's provisions, effective April 1, 2019, a remote retailer is required to collect and remit tax in California if, during the current or previous calendar year, its sales to California exceed $500,000. California has literally hundreds of local tax rates which must be taken into account.

- **Connecticut**
  Effective December 1, 2018, marketplace facilitators with retail sales of at least $250,000 are required to collect and remit sales tax on behalf of their marketplace sellers. Further, effective July 1, 2019, remote sellers that make at least 200 retail sales in Connecticut and have at least $100,000 in gross receipts from Connecticut sales must collect and remit sales tax.

- **Florida**
  Florida has not yet enacted any economic nexus or marketplace facilitator provisions.

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- **New Jersey**
  Effective November 1, 2018, remote sellers must collect and remit sales tax if their gross revenue to New Jersey customers exceeds $100,000, or they have more than 200 separate transactions with New Jersey customers. Further, marketplace facilitators must collect sales tax on the sales they facilitate into New Jersey in various circumstances.

- **New York**
  Under New York's economic nexus provisions, remote sellers must collect and remit sales tax if they have more than $500,000 in sales (effective retroactive to June 21, 2018) and had more than 100 separate transactions delivered into New York in the immediately preceding four sales tax quarters. New York is not clear on exactly when this provision is effective, and has yet to issue FAQs or any other definitive guidance.

- **Pennsylvania**
  Marketplace facilitators and remote sellers who have more than $100,000 in Pennsylvania sales must now register, collect and remit sales tax starting July 1, 2019. These thresholds are measured by the calendar year. Note that Pennsylvania also has reporting requirements for remote sellers. Specifically, marketplace facilitators and online sellers that have more than $10,000 but less than $100,000 in sales are required to either collect and remit tax, or comply with onerous notification and reporting requirements. These reporting requirements were effective March 1, 2018.

- **Texas**
  Effective October 1, 2019, remote sellers must obtain a permit and collect and remit sales tax if they have more than $500,000 in Texas revenue in the preceding twelve calendar months. The Texas sales tax rate varies by municipality; however, remote sellers may elect to charge a single local rate. They must notify the Comptroller's office of their election by filing Form 01-799, *Remote Seller's Intent to Elect or Revoke Use of Single Local Use Tax Rate*. For the period of October 1, 2019 through December 31, 2019, the single local tax rate will be 1.75%, in addition to the state rate of 6.25%, for a total of sales tax of 8%. This is a calendar year election that will automatically renew unless you notify the Comptroller by October 1 of the current year. Note if you change your election, you must continue to collect the single local tax rate until the end of the calendar year.

An Update on the State Treatment if Deemed Repatriation Income and Global Intangible Low Taxed Income ("GILTI")

A taxpayer that had or will have income/deductions reported under IRC Sec. 965 and/or GILTI income on their federal personal income tax return must also consider the state tax treatment of such income. IRC Sec. 965 income was reportable for most taxpayers on their 2017 federal income tax return while GILTI is generally first applicable for tax years beginning on or after December 31, 2017. In both cases, the TCJA requires taxpayers to recognize deemed income prior to the actual receipt of such income. IRC Sec. 965 generally requires U.S. shareholders to pay a one-time transition tax on the untaxed earnings of certain specified foreign corporations. Taxpayers reporting such income are allowed a "participation exemption" under IRC Sec. 965(c), which is a deduction that reduces the federal tax rate on repatriation income. In certain cases, a taxpayer can elect, for federal income tax purposes, to defer the tax liability on IRC Sec. 965 income until a specified triggering event (this applies for S corporation shareholders) or, in the case of individuals, they can elect to pay the tax on such income over eight years.

The personal income tax treatment of such provisions in selected states is subject to change as some states have been slow to issue guidance on the treatment of deemed repatriation/GILTI income. Further, there may be state legislative changes that are under consideration. Thus, prior to filing your state tax return(s), we recommend that you consult your tax advisor for the latest state guidance.

- California has not adopted the TCJA changes to IRC Sec. 965 or the GILTI provisions in IRC Sec. 951A. Accordingly, neither the income nor the deductions are reportable on California personal income tax returns.
- Connecticut and New York State both use federal adjusted gross income as the starting point to arrive at state taxable income. As such, both states recognize the same net IRC Sec. 965 income and gross GILTI income that an individual taxpayer reports in their adjusted gross income for federal income tax purposes. However, neither Connecticut nor New York State allow a taxpayer to elect to defer payment of any portion of the tax associated with IRC Sec. 965 income.
- The Pennsylvania Department of Revenue has issued guidance indicating that IRC Sec. 965 and GILTI income are not taxable for personal income tax ("PIT") purposes; the rationale being that only actual cash or property distributions, out of current or accumulated earnings and profits, are taxable under the PIT. Importantly, when an actual cash or property distribution is made out of earning and profits, PIT taxpayers must report it as taxable dividend income regardless of whether or not they receive a Form 1099-DIV with respect to such distribution.
- The New Jersey Division of Taxation has addressed IRC Sec. 965 income in various notices. In January 2019, the Division advised that "dividends reported under IRC Section 965 must be included in New Jersey gross income in the same tax year and in the same amount as reported for federal tax purposes." Additionally, the notice explained that, for purposes of the Gross Income Tax, there is no IRC Sec. 965(c) deduction allowed for individual taxpayers, sole proprietorships or partnerships. However, S corporations are allowed an IRC Sec. 965(c) deduction. There are similarities between New Jersey and Pennsylvania's personal income tax regimes including their definition of what constitutes a dividend. Thus, the fact that Pennsylvania does not tax IRC Sec. 965 income (until an actual dividend is received) while New Jersey is following the federal recognition and timing raises a concern that New Jersey may be mistaken in its interpretation. As such, we recommend that taxpayers consult with their tax advisors prior to paying New Jersey Gross Income Tax on IRC Sec. 965 income.

With respect to GILTI, the Division of Taxation ("Division") advised that, for Gross Income Tax ("GIT") purposes, such income must be reported by a shareholder in an S corporation in the same year and in the same amount as for federal purposes. For other GIT taxpayers (including individuals and partners in partnership), the Division advised that GILTI should be reported when the income is actually distributed from earnings and profits in the category dividend income.

- The New York City Department of Finance issued a memorandum advising that unincorporated businesses generally must include the net amount of IRC Sec. 965 income in their Unincorporated Business Tax Returns and that the options for deferring the federal tax on such income do not apply for New York City tax purposes. While the Department of Finance has not addressed GILTI for Unincorporated Business Tax purposes, our initial interpretation is that the City will follow the federal treatment. This is due to the Unincorporated Business Tax's conformity with federal taxable income as the starting point for the tax computation and that, currently, there are no modifications allowing for a deduction of such income.

New York

Tax Rates

Chart 14 shows the maximum tax rates imposed by New York State and New York City. These rates apply to all types of income since New York does not have lower tax rates for net long-term capital gains or qualifying dividend income.

Deduction Adjustments

Beginning in 2018, NYS and NYC allow taxpayers to

itemize their deductions whether or not the taxpayers itemized their deductions for federal income tax purposes. Itemized deductions should be computed based on the federal rules as they were in effect prior to the federal TCJA.

New York State allows a deduction of $1,000 for each dependent. In addition, New York State allows a deduction for some qualified education expenses, subject to certain limitations.

Bonus Depreciation

New York State does not conform to federal rules regarding bonus depreciation, as discussed in the business owner issues and depreciation deductions chapter.

The exception to this rule is that federal bonus depreciation is allowed in limited areas of Lower Manhattan — the "Liberty Zone," south of Canal Street to the East River; and the "Resurgence Zone," south of Houston Street and north of Canal Street.

To the extent you take advantage of bonus depreciation on your federal return, either directly or from a pass-through entity, you will need to separately compute your New York depreciation without applying the bonus depreciation rules. New York State does conform to the federal rules regarding IRC Sec. 179 depreciation expense, as discussed in the business owner issues and depreciation deductions chapter.

Change to the Empire State Child Tax Credit

The current tax year's federal child tax credit or additional child tax credit amount may no longer be used to compute your Empire State child credit for New York. Your Empire State child tax credit will now be based on the 2017 federal credit amounts and income. Form IT-213, Claim for Empire State Child Credit, has been updated to reflect these changes.

"Circuit Breaker" Tax Credit

For tax years 2014 through 2019, there is a refundable credit of $350 available for New York residents with NYAGI of at least $40,000 but not more than $300,000 who claimed one or more dependent children under the age of 17 on the last day of the tax year and had a tax liability that was equal to or greater than zero.

Employer Compensation Expense Program

The Employer Compensation Expense Program (ECEP) establishes an optional Employer Compensation Expense Tax (ECET) that employers can elect to pay if they have employees that earn over $40,000 annually in wages and compensation in New York State. Employees of participating employers may be eligible to claim the ECEP wage credit when filing their New York State personal income tax return.

New York City UBT

Self-employed persons working in New York City are subject to a 4% Unincorporated Business Tax ("UBT") if their total unincorporated business gross income exceeds $85,000 (after the maximum allowance for taxpayer's services of $10,000 (limited to 20% of UBT income) and a $5,000 exemption).

New York City residents can claim a credit against their NYC personal income tax for a portion of the UBT paid by them, including their share of the UBT tax paid by a partnership. The credit is 100% of the UBT paid if your taxable income is $42,000 or less, gradually declining as your income reaches $142,000, at which point the credit is limited to 23% of the UBT paid.

New York City has concluded the process of ending its slow transition to a single sales factor: For years beginning in 2018 and forward, the UBT will be computed based on a single receipts factor.

Metropolitan Commuter Transportation Mobility Tax ("MCTMT")

Beginning in 2009, a tax was imposed on employers and self-employed individuals engaged in business within the five boroughs of New York City and the counties of Nassau, Rockland, Orange, Putnam, Suffolk, Dutchess, and Westchester. A graduated tax rate between 0.11% and 0.34% applies to employers based upon the amount of quarterly payroll. For

quarters beginning on or after April 1, 2012, payroll must be greater than $312,500 in a calendar quarter before the employer tax applies. The tax also applies to self-employed individuals, including partners in partnerships and members of LLCs that are treated as partnerships based on their net earnings from self-employment allocated to the MCTD. The tax does not apply if the allocated net earnings from self-employment are $50,000 or less for the year.

College Savings Program, Credits and Expenses

New York State has a program that allows you to make contributions to IRC Sec. 529 plans as discussed in detail in the chapter on education incentives. New York State allows a deduction up to $5,000 ($10,000 if married filing jointly) if paid to a New York IRC Sec. 529 plan.

In addition, a tuition credit or itemized deduction is available if you were a full-year New York State resident and your spouse or dependent (for whom you take an exemption) was an undergraduate student enrolled at or who attended an institution of higher education and paid qualified tuition expenses, and are not claimed on another person's return. The credit may be as much as $400 per student; 4% of qualified expenses up to $10,000. Alternatively, the maximum tuition deduction is $10,000 per student. You may claim the credit or the deduction, but not both.

New York opted not to follow changes made by the TCJA to the types of withdrawals that are allowed from a Qualified Tuition Program ("QTP") account established under IRC Sec. 529. For New York purposes, withdrawals for kindergarten through 12th grade school tuition are not qualified withdrawals under the New York 529 college savings account program.

For New York purposes, a withdrawal is nonqualified if the withdrawal is actually disbursed in cash or in-kind from a New York State 529 college savings account and the funds are not used for the higher education of the designated beneficiary. Higher education generally means public or private, non-profit or proprietary post-secondary educational institutions, in or outside New York State. Therefore, any withdrawal from a New York 529 college savings account used to pay tuition in connection with enrollment or attendance at elementary or secondary public, private, or religious schools is a nonqualified withdrawal.

New Jersey

New for 2020

New Jersey Enacts Pass-Through Entity Tax Election to Combat $10,000 SALT Cap.

Introduction

On January 13, 2020 New Jersey Governor Phil Murphy signed into law SB3246, the "Pass-Through Business Alternative Income Tax Act." With this legislation, New Jersey joins Connecticut, Louisiana, Oklahoma, Rhode Island and Wisconsin in enacting some type of entity level tax on pass-through entities ("PTEs") in an effort to work around the $10,000 federal cap on individuals' itemized deductions for state income taxes.

Overview

For tax years starting on or after January 1, 2020, PTEs may elect to pay an entity level income tax based on the sum of the distributive shares of the partners. The tax is based on the sum of each partners' "distributive proceeds" as follows (for purposes of this summary the term "partner" includes a shareholder in an S corporation):

- First $250,000 – 5.675%.
- $250,001 - $1 million - $14,187.50 + 6.52% of the excess over $250,000.
- $1,00,001 - $5 million - $63,087.50 + 9.12% of the excess over $1 million.
- Over $5 million - $427,887.50 + 10.9% of the excess over $5 million.

The partners can claim a refundable credit for their pro rata share of the tax paid on their personal return.

The term "distributive proceeds" is defined as the PTE's various classes of income subject to New Jersey's Gross Income Tax "derived from or connected with sources within the State, and upon which tax is imposed and due . . . . For a nonresident, this means New Jersey source income . . . ." Pending further guidance from the Division of Taxation to the contrary, this language may be problematic for New Jersey resident partners as the tax, and corresponding credit, are based on the distributive proceeds derived from New Jersey (presumably the distributive proceeds multiplied by the New Jersey allocation factor), as opposed to the distributive proceeds "taxed" by New Jersey (which for New Jersey resident partners would be the entire distributive proceeds).

By way of illustration, assume a New Jersey resident is a 50% partner in a partnership which is doing business in New Jersey and which makes this election. Further assume the sum of the partners' distributive proceeds are $200,000, and the partnership's New Jersey allocation percentage is 10%. The PTE tax related to this entity is $200,000 x 10% x 5.675% = $1,135. The New Jersey resident will only get a credit of their proportionate share (50%) = $567.50. However, as a New Jersey resident, they will owe New Jersey income tax on their entire distributive share: $100,000 x 5.675% (assuming their New Jersey tax rate mirrors the PTE rate) = $5,675. This results in a net tax due (before credits for taxes paid to other states) of $5,107.50. Presumably, the credits for taxes paid to other states will at least partially offset this remaining liability.

Tax Rates

Effective January 1, 2019, the maximum tax rate imposed by New Jersey is 10.75% for taxpayers that have income in excess of $5,000,000 regardless of filing status. The maximum tax rate for taxpayers with $5,000,000 or less income remains at 8.97%. This rate applies to all types of income since New Jersey does not have lower tax rates for net long-term capital gains or qualifying dividend income.

Note: *For New Jersey, the marginal tax rate for single taxpayers with taxable income in excess of $75,000 but less than $500,000 is 6.37%. Married/civil union partner taxpayers filing jointly are subject to the 6.37% rate on income in excess of $150,000 but less than $500,000. Single and married/civil union partner taxpayers filing jointly with incomes over $500,000 are subject to a top marginal rate of 8.97%.*

Deduction Adjustments

Except as noted below, no deduction is allowed for itemized deductions since New Jersey is a "gross income" state. In addition to the income exclusions noted above, New Jersey allows the following deductions to reduce your taxable income:

- Personal exemptions of $1,000 each for you and your spouse (or domestic partner). New Jersey allows a $1,500 personal exemption for each dependent child or other dependent (who qualifies as your dependent for federal income tax purposes). Taxpayers 65 years of age or over at the close of the taxable year, blind, or disabled, and certain dependents attending college are allowed an additional $1,000 exemption.
- Alimony, separate maintenance, or spousal support payments to the extent they are includible in the gross income of the recipient (regardless of where the recipient lives).
- Medical expenses in excess of 2% of New Jersey gross income.
- Business travel and entertainment expenses for self-employed individuals, business owners, and partners in a partnership: The recent federal changes have no impact on the New Jersey travel and entertainment deduction.
- Property taxes up to a maximum of $15,000 paid on a personal residence.
- Tenants are allowed a property tax deduction based on 18% of the rent paid during the year.

If you are considered a self-employed individual for federal income tax purposes or you received wages

from an S corporation in which you were a more-than-2% shareholder, you may deduct the amount you paid during the year for health insurance for yourself, your spouse/civil-union partner/domestic partner, and your dependents. The amount of the deduction may not exceed the amount of your earned income, as defined for federal income tax purposes, derived from the business under which the insurance plan was established. You may not deduct any amounts paid for health insurance coverage for any month during the year in which you were eligible to participate in any subsidized plan maintained by your (or your spouse's/civil-union partner's/domestic partner's) employer. Note that for federal tax purposes, you may be able to deduct amounts paid for health insurance for any child of yours who is under the age of 27 at the end of 2019. However, for New Jersey purposes, you may deduct such amounts only if the child was your dependent.

Bonus Depreciation

New Jersey has not conformed to federal rules regarding bonus depreciation. See the chapter on business owner issues and depreciation deductions.

IRC Sec. 179 Expense

New Jersey permits a limited IRC Sec. 179 deduction of up to a maximum of $25,000. If you have more than one business, farm or profession, you may not deduct more than a total of $25,000 of IRC Sec. 179 costs for all activities. To the extent higher IRC Sec. 179 deductions were taken for federal purposes, you will need to separately compute your New Jersey deduction.

College Savings Program

New Jersey does not provide for a college savings credit or deduction.

New Jersey Senior Freeze (Property Tax Reimbursement) and Homestead Benefit Programs

These programs provide property tax relief for amounts paid on a principal residence.

Senior Freeze Program: The Senior Freeze Program provides for a reimbursement of the difference between the amount of property taxes paid for the base year and the amount for which you are applying for a reimbursement. Applicants must meet the following conditions to be eligible for a Senior Freeze property tax reimbursement:

- Have been age 65 or older OR receiving federal Social Security disability benefits;
- Have lived in New Jersey for at least ten consecutive years as either a homeowner or renter;
- Have owned and lived in your home for at least three consecutive years;
- Have paid the full amount of the property taxes due on the home for the base year and each succeeding year up to and including the year in which you are claiming the reimbursement; and
- Have met the income limits for the base year and for each succeeding year up to and including the year for which you are claiming the reimbursement. These limits apply regardless of marital/civil-union status. However, applicants who are married or in a civil union must report combined income of both spouses/civil-union partners.

Note: *Under the terms of the State Budget for FY 2020 for application year 2018, only those applicants whose income for 2017 did not exceed $87,268 and whose income for 2018 did not exceed $89,013 will be eligible to receive reimbursements for 2018 provided they met all the other program requirements. The Senior Freeze Program is expected to continue in 2020 for property taxes paid in 2019.*

Homestead Benefit Program: The requirements for the Homestead Benefit are slightly different, have different filings deadlines and are not age-based. It is possible to be eligible for both the Homestead Benefit Program and the Senior Freeze (Property Tax Reimbursement) program, but the amount of benefits received cannot exceed the amount of property taxes paid on their principal residence.

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Veteran's Property Tax Deduction: Beginning in 2019, the annual $250 property tax deduction for honorably discharged veterans was extended to include veterans that are residents in continuing care retirement communities.

Estate Tax

Effective January 1, 2018, the New Jersey estate tax was repealed.

Earned Income Tax Credit

The New Jersey earned income tax credit for 2019 is equal to 39% of the federal credit. The rate will increase to 40% in 2020 and thereafter.

Child and Dependent Care Credit

For tax years beginning in 2018 and thereafter, New Jersey allows a child and dependent care credit for a qualifying individual based on the federal credit. A child under the age of 13 or a spouse/dependent who lived with the taxpayer for more than half of the year and is physically or mentally incapable of self-care is considered a qualifying individual. The credit is non-refundable. The credit cannot exceed $500 for one qualifying individual or $1,000 for two or more qualifying individuals. The credit is a percentage of the federal credit based on New Jersey taxable income as indicated below.

NJ Taxable Income	Amount of the NJ credit
Not over $20,000	50% of federal credit
$20,001 - $30,000	40% of federal credit
$30,001 - $40,000	30% of federal credit
$40,001 - $50,000	20% of federal credit
$50,001 - $60,000	10% of federal credit

Retirement Income Tax

The 2018 retirement income tax exclusion for joint filers is $64,000, and will increase to $80,000 in 2019. The exclusion will continue to increase until it caps out at $100,000 in 2020. For a married person filing separately, the exclusion is $30,000 for 2018 and will increase to $50,000 in 2020, and for a single taxpayer, the exclusion is $45,000 for 2018 and will increase to $75,000 in 2020.

Veterans' Exemption

Veterans who are honorably discharged from active service in the military or the National Guard are eligible for an additional $3,000 exemption. An additional $3,000 exemption can be claimed if your spouse (or civil union partner) is also an honorably discharged veteran. The exemption is available to both New Jersey residents and non-residents. In order to claim the exemption, a copy of Form DD-124, Certificate of Release or Discharge and the Veteran Exemption Submission Form must be submitted prior to the first return for which you are claiming the exemption or with your tax return.

Tax Cuts and Jobs Act Impact

Without New Jersey conforming legislation, which appears unlikely, most of the personal income tax changes contained in the TCJA are expected to have minimal or no impact on New Jersey personal income taxes since the New Jersey "Gross Income Tax" is not based on the federal tax system.

The New Jersey GIT Act does not adopt the Internal Revenue Code nor does it adopt or use a taxpayer's federal adjusted gross income or federal taxable income in the state taxable income calculation. Thus, federal law changes such as the lowering of individual income tax rates, doubling of the standard deduction, limits on deductions for mortgage interest, reduced deductions for property tax and income tax, removal of personal exemption deductions, limiting the deductibility of meals and entertainment, etc. should have no impact on a taxpayer's New Jersey GIT liability.

Similarly, the federal 20% qualified business income deduction, allowable starting in 2018 for certain pass-through entities, does not apply since New Jersey has its own statutory deductions that are not based on a taxpayer's federal deductions. Further, the TCJA's 100% bonus depreciation under IRC Sec. 168(k) and the increased IRC Sec. 179 expense should not apply as New Jersey does not adopt bonus depreciation and limits a taxpayer's IRC Sec. 179 expense to $25,000 per year. The New Jersey real estate tax deduction is limited to $15,000 per year starting in 2018.

Connecticut

Tax Rates

The maximum individual tax rate imposed by Connecticut is 6.99%. This rate applies to all types of income since Connecticut does not have lower tax rates for net long-term capital gains or qualifying dividend income.

Note: *The maximum tax rate for Connecticut is 6.9% for the following individuals:*

- *Filing status is Single or Married filing separately with Connecticut taxable income of over $250,000 but not over $500,000.*
- *Filing status is Head of Household with Connecticut taxable income of over $400,000 but not over $800,000.*
- *Filing status is Joint or Qualifying Widow(er) with Connecticut taxable income of over $500,000 but not over $1,000,000.*

If your taxable income is more than these thresholds, the maximum tax rate is 6.99%.

Recapture Tax Amount for Taxpayers In Higher Income Brackets

A taxpayer whose Connecticut AGI exceeds the income thresholds specified below, after computing his or her Connecticut income tax liability using the applicable tax rates, and after applying the 3% phase-out provision, is required to add the recapture amount of tax as indicated below. The result of the recapture tax is essentially that the entire AGI is taxed at the highest income tax rate, without the benefit of graduated rates.

- Filing status is Single or Married filing separately: If Connecticut AGI is more than $200,000.
- Filing status is Head of household: If Connecticut AGI is more than $320,000.
- Filing status is Joint or Qualifying widow(er): If Connecticut AGI is more than $400,000.

Deduction Adjustments

No deductions are allowed for itemized deductions, as Connecticut is a "gross income" state, as modified by the income exclusions noted above.

Connecticut allows resident individual taxpayers' income tax credits for real estate and personal property taxes paid to Connecticut political subdivisions on their primary residences or privately owned or leased motor vehicles. The maximum credit of $200 cannot exceed your personal tax liability. These credits are phased out for higher income persons. For taxable years through 2020, the property tax credit will only be allowed for a resident who is 65 or older before the close of the

Tax Tip

27. Residency Caution

Your principal residence is in Connecticut but you work in New York City and maintain an apartment there. During the year you were present in New York for more than 183 days. You are a statutory resident of both New York State and New York City for tax purposes. As a result, Connecticut, New York State, and New York City would tax all of your income. A partial credit is available to offset some of this additional tax.

You can eliminate this tax by being present in New York State for 183 days or less or by eliminating the New York City apartment. By statute, a partial day in New York is considered a full day spent in New York with minor exceptions. Also, a day working at your home in Connecticut will be considered by New York to be a day working in New York, while Connecticut will consider it a day working in Connecticut. Therefore, income allocated to these days will be taxed by both New York State and Connecticut with no offsetting credit. Be sure to maintain substantiation to support the days in and out of New York.

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applicable year, or who files a return under the federal income tax for the applicable taxable year validly claiming one or more dependents.

Bonus Depreciation

Connecticut has conformed to federal rules regarding bonus depreciation, with the exception of C corporations. See the chapter on business owner issues and depreciation deductions.

IRC Sec. 179 Expense

Connecticut does conform to the federal rules regarding IRC Sec. 179 depreciation expense as discussed in the business owner issues and depreciation deductions chapter.

College Savings Program

Connecticut taxpayers may deduct contributions to the Connecticut Higher Education Trust ("CHET") from federal AGI, up to $5,000 for individual filers and $10,000 for joint filers. Amounts in excess of the maximum allowable contributions may be carried forward for five years after the initial contribution was made.

The "CHET Baby Scholars" program provides up to $250 toward a newborn's future college costs. For children born or adopted on or after January 1, 2015, CHET Baby Scholars will deposit $100 into a CHET account. A second deposit of $150 will be made if family and friends add at least $150 to the child's enrolled CHET account within four years. The deadline to participate is 12 months after the child's birth or adoption and there are no income limitations.

Tax Cuts and Jobs Act Impact

Connecticut has passed the "Pass-Through Entity Tax" ("PET"), which imposes an "income" tax on pass-through entities. This tax applies and is paid by the business entity, but individuals and corporate members of the effected business entities are entitled to an offsetting credit against their respective income tax.

Pennsylvania

Tax Rates

Pennsylvania imposes a flat tax on all income at a rate of 3.07% (see Chart 15). Pennsylvania has eight categories (buckets) of income, and income/loss from one bucket may not be used to offset income/loss from another. The single flat tax rate of 3.07% applies to all types of income since Pennsylvania does not have lower tax rates for net long-term capital gains or qualifying dividend income.

Chart

15. 2019-2020 Maximum Pennsylvania Tax Rates

State or City	Maximum Tax Rates
Pennsylvania	**3.07%**
Philadelphia	**3.8712% (eff July 1, 2018 and subsequent years)**

See chart 16 for Philadelphia rate of tax withheld on Form W-2.

Income from a business is subject to allocation and apportionment to the extent the business is "doing business" both within and outside of Pennsylvania. The default method is specific allocation if the taxpayer has books and records to substantiate the allocation. However, most taxpayers apportion their business income. The apportionment formula for Pennsylvania Personal Income Tax purposes is an equal weighted three-factor method, and the sales factor utilizes a cost of performance method.

Note: *The Pennsylvania three-factor apportionment method, based upon cost of performance, differs from the corporate tax apportionment method of a single sales factor based upon market sourcing.*

Chart

16. Philadelphia Rate of Tax Withheld on Form W-2 For Wages

Period	Resident	Nonresident
Effective July 1, 2019	3.8712%	3.4481%
Effective July 1, 2018	3.8809%	3.4567%

Philadelphia imposes a Wage Tax on compensation earned by residents of the City and on nonresidents who work within the City. The tax rate may be adjusted mid-year with the implementation of the annual City Budget. As such, wages earned during the first half of the year may be tax at a different rate than for the second half of a year. The School District Income Tax and Net Profits Tax rates are the same as the Wage Tax rates and are also subject to change mid-year. However, the rate in place at the time of the filing of these returns is the rate applied to the entire tax period. The tax rate for compensation paid after July 1, 2019 is 3.8712% for residents and 3.4481% for nonresidents. However, nonresidents may apportion their income based upon duty days spent working within the City of Philadelphia.

Philadelphia imposes an unearned income tax, known as the "School District Income Tax," upon all residents of the City. The tax rate for 2019 and subsequent years is 3.8712%. Some examples of taxable unearned income are dividends, certain rents and royalties, S corporation distributed income, and short-term (held for six months or less) capital gains. Earned income that is otherwise subject to the Philadelphia Business Income and Receipt Tax ("BIRT"), the Net Profits Tax ("NPT") or Wage Tax is not subject to the School Income Tax.

Philadelphia imposes the BIRT (f/k/a the Business Privilege Tax ("BPT")) upon all persons engaged in business within the City. "Persons" includes individuals, partnerships, associations and corporations. Rental activities are usually considered to be business activities. The nexus standard for the BIRT was amended at the start of 2019 to follow the nexus guidance of *Wayfair* and as such, starting January 1, 2019 Philadelphia began imposing BIRT nexus upon all applicable taxpayers with at least $100,000 of annual receipts from Philadelphia customers. Public Law 86-272 still applies for the income tax portion of the tax. The BIRT is the sum of two taxes; one on income and one on gross receipts. For 2019 and 2020, the gross receipts tax rate is 0.1415%, and the income tax rate is 6.25% on net taxable income. For the 2019 and subsequent tax years, the income tax apportionment methodology is a single sales factor. The sales factor and taxable receipts for the gross receipts tax are determined on a cost of performance method for most businesses. Notably, software companies use market-based sourcing of receipts.

Philadelphia imposes the NPT on the net profits from the operation of a trade, business, profession, enterprise or other activity conducted by individuals, LLCs, partnerships, associations or estates and trusts. The tax is imposed on the entire net profit of any self-employed person who is a resident of Philadelphia regardless of the location of the business. It is also imposed on businesses conducted in Philadelphia by nonresidents. Corporations are not subject to this tax. Also, the proportionate amount of partnership, LLC,

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and other association income attributable to corporate partners or members is exempt from the NPT. For residents, the NPT rate is 3.8712% for 2019 and subsequent years, and for nonresidents the NPT rate is 3.4481% for 2019 and subsequent years.

Deduction Adjustments

No deductions are allowed for itemized deductions, as Pennsylvania is a "gross income" state, as modified by the income exclusions noted above.

Tax Cuts and Jobs Act Impact

Because the starting point for computing Pennsylvania corporate taxable income is federal taxable income before net operating loss deduction and special deductions, Pennsylvania generally conforms to the IRC as currently amended, and therefore conforms to the changes in the Tax Cuts and Jobs Act unless specifically adjusted by Pennsylvania law. Pa. Stat. Ann. 72 §7401(3)(1)(a).

For Pennsylvania personal income tax purposes, most of the personal income tax changes contained in the TCJA are expected to have minimal or no impact, in the absence of legislation, because the Pennsylvania personal income tax is not based on the federal tax system.

The Pennsylvania personal income does not adopt the Internal Revenue Code nor does it adopt or use a taxpayer's federal adjusted gross income or federal taxable income in the state taxable income calculation. Thus, federal law changes such as the lowering of individual income tax rates, the deemed repatriation rules under IRC Sec. 965, doubling of the standard deduction, limits on deductions for mortgage interest, reduced deductions for property tax and income tax, removal of personal exemption deductions, limiting the deductibility of meals and entertainment, the QBI deduction, etc. should have no impact on a taxpayer's Pennsylvania liability.

Bonus Depreciation

Pennsylvania requires that taxpayers add back the federal bonus depreciation. For property placed in service before September 27, 2017, the taxpayer may continue to subtract an amount equal to three-sevenths of the taxpayer's ordinary depreciation deduction under IRC Sec 167. The deduction may be claimed in succeeding taxable years until the entire amount of the addback has been claimed. Any disallowed depreciation not claimed as a result of the subtraction may be claimed in the last year that the property is depreciated for federal tax purpose. For property placed in service after September 27, 2017, the taxpayer is required to add back the federal bonus depreciation but may again continue to take ordinary depreciation deduction under IRC Sec. 167 and/or IRC Sec. 168, but not under IRC Sec. 168(k). This new provision generally gets a taxpayer back to the three-sevenths rule historically provided in Pennsylvania.

IRC Sec. 179

Pennsylvania permits a limited deduction of up to a maximum of $25,000 using IRC Sec. 179. If you have more than one business, farm or profession, you may not deduct more than a total of $25,000 of IRC Sec. 179 costs for all activities. To the extent higher IRC Sec. 179 deductions were taken for federal purposes, you will need to separately compute your Pennsylvania depreciation deductions.

College Savings Program

Pennsylvania allows a deduction of up to the maximum federal annual exclusion amount of $15,000 ($30,000 if married filing jointly) for 2019 to any Pennsylvania or non-Pennsylvania 529 plan in computing Pennsylvania taxable income. The deduction amount is tied to the federal annual gift exclusion.

California

Tax Rates

California's top marginal income tax rate is 12.3% for the 2019 tax year. This rate applies to all types of income since California does not have lower tax rates for net long-term capital gains or qualifying dividend income.

The following table shows the 2019 marginal tax rates in effect for married filing joint taxpayers:

Taxable Income:	
Between $115,648 and $590,746	**9.3%**
Between $590,746 and $708,890	**10.3%**
Between $708,890 and $1,181,484	**11.3%**
Over $1,181,484	**12.3%**

The tax rates and brackets for 2020 have not yet been released.

There is an additional Mental Health Services Tax of 1% for taxable income in excess of $1,000,000.

Bonus Depreciation

California did not conform to the federal bonus depreciation provisions.

IRC Sec. 179 Expense

California law only allows a maximum deduction of $25,000. The California maximum expensing amount is reduced dollar-for dollar by the amount of qualified expensing-eligible property placed in service during the year in excess of $200,000. California's $200,000 phase-out threshold is not adjusted for inflation.

Estimated Tax Payments

Installments due shall be 30% of the required annual payment for the first required installment, 40% of the required annual payment for the second required installment, and 30% of the required annual payment for the fourth required installment. No payment is required for the third installment.

You are to remit all payments electronically once you make an estimate or extension payment exceeding $20,000 or you file an original return with a total liability over $80,000 for any taxable year that begins on or after January 1, 2009. Once you meet the threshold, all subsequent payments regardless of amount, tax type, or taxable year must be remitted electronically. Individuals who do not pay electronically will be subject to a 1% noncompliance penalty.

There are limits on the use of the prior year's tax safe harbor. Individuals who are required to make estimated tax payments, and whose California AGI is more than $150,000 (or $75,000 for married filing separately), must figure estimated tax based on the lesser of 90% of their current year's tax or 110% of their prior year's tax including AMT. Taxpayers with current year's California AGI equal or greater than $1,000,000 (or $500,000 for married filing separately) must figure estimated tax based on 90% of their tax for the current year.

Net Operating Loss Carryovers

Net operating losses attributable to taxable years beginning on or after January 1, 2015 and before January 1, 2019, can be carried back in full. A taxpayer may elect to relinquish the entire carryback period with respect to a net operating loss for any taxable year. If the taxpayer elects to relinquish the carryback period, the net operating loss is carried forward only to the years eligible under the applicable carryover period. For tax years after December 31, 2018, net operating losses may only be carried forward.

Child and Dependent Care Benefits

California does not allow the pre-tax deduction of dependent care benefits as a reduction of W-2 wage income. The amount of dependent care benefits deferred by the taxpayer is added back to California income as a separate adjustment to wages.

IRC Sec. 1031 Like-Kind Exchanges

Effective January 1, 2014, taxpayers that exchange a California property for a property outside the state will be taxed on the deferred gain upon the eventual sale of the replacement property. The taxpayer must file Form 3840 for each year as long as they own the out-of-state property. The purpose of the filing is to notify California that the taxpayer continues to hold the replacement property and acknowledges the deferred liability. The annual filing is required regardless of whether the taxpayer has any need to otherwise file a California tax return in any year.

Tax Cuts and Jobs Act Impact

California has only conformed with a few federal tax law

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changes since 2015. Most importantly, many itemized deductions that have been disallowed or limited under the TCJA are not taken into account in determining California taxable income. These nonconforming exceptions are the following:

- Personal residence debt limit is still $1.1 million for deduction of interest
- Second home interest is still deductible
- Real estate taxes are not limited to $10,000 per year
- Miscellaneous itemized deductions are not eliminated
- California does not have a 20% income deduction under IRC Sec. 199A
- Non-meal entertainment expenses are deductible

Effective January 1, 2019, California has conformed with the federal limitation on excess business losses, the application of like-kind exchanges to real estate only, and a few other provisions of the Tax Cuts and Jobs Act of 2017.

Florida

Tax Rates

Florida does not impose a personal income tax.

Property Tax Exemptions

Florida resident property owners may receive an exemption from a portion of Florida property taxes. The homestead exemption provides that the first $25,000 of the value of a taxpayer's primary, permanent Florida residence is exempt from all property taxes, including school district taxes. The second $25,000 of value is fully taxable, and the third $25,000 of value is exempt from all non-school taxes.

In addition to the homestead exemption, there are $500 exemptions from property tax available to widows and widowers who have not remarried and to legally blind individuals. Florida also provides property tax exemptions for military veterans and military members deployed during the previous calendar year.

S Corporations

Florida recognizes the federal S corporation election and does not impose tax on S corporations except for years when they are liable for federal tax. Tax on taxable S corporations is imposed only on built-in gains and passive investment income. Because Florida does not have a personal income tax, other S corporation income is not taxed.

Qualified subchapter S subsidiaries are not treated as separate corporations or entities from the S corporation parent.

Tax Cuts and Jobs Act Impact

For corporate income tax purposes, Florida continues to adopt the IRC as amended annually and did so again in 2019. The IRC (with the TCJA amendments) in effect on January 1, 2019 was adopted, but with specific exceptions which generally remain unchanged by the TCJA amendments.

Bonus Depreciation

C corporations are taxed in Florida.

Florida decouples from the federal IRC provisions related to regular and bonus depreciation. Taxpayers must add-back to taxable income an amount equal to 100% of any amount deducted for federal income tax purposes as bonus depreciation for the taxable year pursuant to IRC Sec. 167, IRC Sec. 168(k) and IRC Sec. 169, for property placed in service after December 31, 2007, and before January 1, 2021. For the taxable year and for each of the six subsequent taxable years, taxpayers must subtract from this taxable income an amount equal to one-seventh of the amount by which taxable income was increased by the addition. It is presumed that Florida will likely continue to decouple from the new federal law related to bonus depreciation and not permit immediate expensing of certain qualified business assets.

IRC Sec. 179 Expensing

For tax years beginning before January 1, 2015, Florida required that taxpayers add back to taxable income 100% of IRC Sec. 179 deductions in excess of $128,000 and deduct one-seventh of the addback each year for seven years. For assets placed in service after 2014, no addbacks are required for IRC Sec. 179 deductions. Florida currently conforms to the IRC as of January 1, 2018, and so it has adopted the changes made by the TCJA related to expensing certain depreciable business assets.

Texas

Tax Rates

There is no state income tax on individuals or businesses.

Texas Margins Tax

There is, however, a franchise tax based on an entity's margin imposed on most business entities. These entities generally include partnerships, limited lability companies, S corporations, C corporations, certain trusts, professional corporations and associations, certain banks, joint ventures, and various other legal entities.

This tax is generally not imposed on sole proprietorships (except single member LLCs), general partnerships owned directly by a single natural person, trusts qualified under IRS Sec. 401(a), trusts exempt except under IRS Sec. 501(c)(9), unincorporated passive entities, certain grantor trusts, estates of natural persons and escrows, unincorporated political committees and certain REIT and insurance companies.

Note that taxable entities that are part of an affiliated group engaged in a unitary business must file a combined franchise tax return using the same method to compute margin for all members.

Franchise tax rates, thresholds and deduction limits vary by report year. Use the rate that corresponds to the year for which you are filing:

Item	2018 and 2019	2020 and 2021
No Tax Due Threshold	$1,130,000	$1,180,000
Tax Rate (retail or wholesale)	0.375%	0.375%
Tax Rate (other than retail or wholesale)	0.75%	0.75%
Compensation Deduction Limit	$370,000	$390,000

The taxable margin is based on total revenue and may be calculated in one of the following ways:

- Total revenue multiplied by 70%;
- Total revenue minus Cost of Goods Sold (as defined below);
- Total revenue minus Compensation (as defined below); or
- Total revenue minus $1 million (effective January 1, 2014).

Total revenue starts with those revenue amounts that were reported for federal income tax purposes which is then adjusted by subtracting the following statutory exclusions:

- Dividends and interest from federal obligations;
- Schedule C dividends;
- Foreign royalties and dividends under IRC Sec. 78 and IRC Secs. 951-964;
- Certain flow-through funds; and
- Other industry-specific exclusions.

The Texas Costs of Goods Sold deduction does not mirror the federal deduction, although it is similar. For Texas purposes, Costs of Goods Sold generally includes those costs related to the acquisition and production of tangible personal property and real property. Taxable entities that only sell services typically will not have a cost of goods sold deduction. Note that other allowances may be available for specific industries.

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The Compensation deduction is based on the amount of Medicare wages that are reported on the W-2 for officers, directors, owners, partners and employees of the taxable entity, subject to the wage limit noted in the chart above.

This deduction also includes those benefits that are provided to all personnel to the extent they are deductible for federal income tax purposes, including workers' compensation and most healthcare and retirement related benefits.

Note that compensation does not include 1099 labor or payroll taxes paid by the employer.

Alternatively, taxable entities with annualized total revenue of $20 million or less may elect to compute the franchise tax using the EZ Computation method at a rate of 0.331%. However, by electing the EZ method, the taxpayer may not take deduct the cost of goods sold or compensation or take any other margin deductions or credits.

There are several credits available against this tax, including credits related to qualified research and development, clean energy projects, and for certified rehabilitation of certified historic structures.

Property Tax Exemptions

Texas has some of the highest property taxes in the country. The property tax in Texas averages almost 2%.

Texas resident property owners may be eligible to receive one or more exemptions from a portion of their property taxes.

The most common exemption is the homestead exemption, which allows homeowners to exempt at least $25,000 of their total primary residence property value from taxation. Note, however, that this exemption is typically only available against the school district property tax, although other types of taxing districts may opt to allow the deduction as well.

Persons who are at least 65 or who are disabled may claim an additional exemption of $10,000. Similar to the homestead exemption, only school districts are required to offer this exemption.

The following property tax exemptions and benefits are also available for certain military personnel:

- A total exemption for fully disabled veterans and their surviving spouses;
- A partial exemption for partially disabled veterans and their survivors;
- Exemptions related to certain veteran's organizations; and
- Penalty waivers for late payments made by active duty military personnel.

On November 5, 2019, Texas voters approved a property tax related Constitutional amendment that provides a temporary property tax exemption of property located in a Governor-declared disaster area.

Estate Tax

Effective January 1, 2005, the Texas estate tax was repealed.

Other Considerations

Build America Bonds

Build America Bonds (tax credit type) provide the bondholder a non-refundable tax credit of 35% of the interest paid on the bond each year. If the bondholder lacks sufficient tax liability in any year to fully utilize that year's credit, the excess credit can be carried forward for use in future years.

Nonresident Taxation

Residents of California, Connecticut, Florida, New Jersey, New York, Pennsylvania or Texas working in other states as nonresidents are taxed by that other state. The income subject to tax is generally based on an allocation of salary and other earned income, using a formula comparing days worked within and outside the state. Also, the sale of real property located in a

nonresident state by a nonresident is typically subject to tax by the nonresident state. This includes the gain on the sale of a cooperative apartment by a nonresident of New York State. However, you are allowed to reduce your resident state tax by a credit amount based on the tax paid to the nonresident state, subject to limitations.

Note: *New York State treats days worked at home for the convenience of the employee as days worked in New York. To qualify as a day worked outside New York, you must prove that there was a legitimate business reason that required you to be out of state, such as meeting with a client or customer. You should keep a diary or calendar of your activities and with supporting documents proving your whereabouts (e.g., airplane tickets, credit card statements, bank statements and your passport).*

New York taxes certain income received by a nonresident related to a business, trade, profession or occupation previously carried on within New York, whether or not as an employee. This income includes, but is not limited to, income related to covenants not to compete and income related to termination agreements.

Note: *Pennsylvania has signed reciprocal agreements with Indiana, Maryland, New Jersey, Ohio, Virginia, and West Virginia under which one state will not tax employee compensation subject to employer withholding by the other states. These agreements apply to employee compensation only and not to income from sole proprietorships, partnerships and other entities.*

Note: *While Texas has no state income tax, its neighbor, Arkansas, does impose personal income tax on Texas residents who work there, with one narrow exception. Texarkana, Arkansas and Texarkana, Texas have a Border City Exemption. Under this exemption, income earned by residents of Texarkana, Arkansas is exempt from Arkansas income tax and income earned by residents of Texarkana, Texas, working in the city of Texarkana, Arkansas is also exempt from Arkansas Income Tax. Any other income earned from Arkansas sources is taxable to Arkansas.*

Note: *Other state tax credits are allowed for California residents for net income taxes paid to another state (not including any tax comparable to California's alternative minimum tax) on income also subject to the California income tax. No credit is allowed if the other state allows California residents a credit for net income taxes paid to California. These reverse credit states include Arizona, Indiana, Oregon and Virginia.*

Residency Caution

Individuals who maintain a residence in one jurisdiction, such as New York City, but also have a residence in another jurisdiction must be very careful to avoid the strict rules that could make them a resident of both jurisdictions for tax purposes (see Tax Tip 27). Generally, if you maintain a permanent place of abode in New York, New Jersey, Connecticut or Pennsylvania and spend more than 183 days in that state, you will be taxed as a resident of that state even if your primary residence is in another state. California applies a similar test using nine months as the threshold, unless you can prove that the time spent in the state was due to a temporary or transitory purpose. In addition, the domicile test treats you as a resident of New York or New Jersey even if you only spend as little as 30 days in the state if you continue to be domiciled there. "Domicile" is generally defined as the place which is most central to your life and is determined using a facts and circumstances test.

State Estate Or Inheritance Taxes

New York, New Jersey, Connecticut and Pennsylvania impose an estate or inheritance tax on persons who are domiciled in the state or have property located in the state. Prior to 2018, New Jersey imposed both an Estate Tax and Inheritance Tax. The Estate Tax was eliminated starting in 2018. California, Florida and Texas do not have an estate or inheritance tax. See the chapter on estate and gift tax planning for a further discussion.

Connecticut is the only state in the country that imposes a state gift tax. The gift tax is imposed if the aggregate amount of Connecticut taxable gifts made on or after January 1, 2005 is $2,000,000. For 2019

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this threshold increases to $3,600,000, and for 2020 through 2023 and after, it will gradually increase to match the federal exemption as follows:

2020 – $5,100,000

2021 – $7,100,000

2022 – $9,100,000

2023+ – Same as federal exemption

The maximum amount of gift or estate tax that a donor or decedent will be required to pay is $15 million for 2019.

Appendicies

Appendix

A. 2020 Federal Tax Calendar for Individual Taxpayers

Date	Deadline To
January 15, 2020	• Pay final installment of 2019 estimated taxes.
April 1, 2020	• Take first IRA required minimum distribution if you reached age 70½ in 2019.
April 13, 2020	• File electronically 2019 Report of Foreign Bank and Financial Accounts (FinCEN114) in time to be received by the Treasury by April 15, 2020.
April 15, 2020	• File individual income tax and gift tax returns (or extension requests) and pay balance of 2019 taxes due. • Make 2019 IRA contributions. • Make first quarter estimated tax payment for 2020 (for individuals and trusts). • File income tax returns for trusts (or extension requests) and pay balance of 2019 taxes due.
June 15, 2020	• Make second quarter estimated tax payment for 2020.
July 31, 2020	• File Keogh plan report (Form 5500) or extension request.
September 15, 2020	• Make third quarter estimated tax payment for 2020. • Make 2019 money-purchase and defined benefit plan contributions.
September 30, 2020	• File 2019 income tax return for trusts, if on extension.
October 12, 2020	• File electronically 2019 Foreign Bank and Financial Accounts (FBAR) in time to be received by the Treasury by October 15, 2020 if on extension.
October 15, 2020	• File 2019 individual income tax and gift tax returns, if on extension. • Make 2019 profit-sharing Keogh plan contributions and SEP contributions, if your tax return is on extension.
December 31, 2020	• Prepay expenses deductible on your 2020 return, if applicable, and if you will be in a lower tax bracket in 2021, and take capital losses to offset capital gains. • Accelerate income if you are in a lower tax bracket in 2020 than you expect to be in 2021. • Establish a Keogh or defined benefit plan for 2020. • Convert a traditional IRA to a Roth IRA. • Take required IRA minimum distribution for 2020.
January 15, 2021	• Pay final installment of 2020 estimated taxes.

Note: *There are additional filing requirements if you have household employees or if you are a business owner and you pay employees and/or independent contractors.*

Appendix

B. 2019 Federal Tax Rate Schedule

If Taxable Income Is:

Over	But Not Over	The Tax Is	+	Of The Amount Over
Married Filing Jointly or Qualifying Widow(er)				
$ 0.00	$ 19,400.00	$ 0.00	+ 10%	$ 0.00
19,400.00	78,950.00	1,940.00	+ 12%	19,400.00
78,950.00	168,400.00	9,086.00	+ 22%	78,950.00
168,400.00	321,450.00	28,765.00	+ 24%	168,400.00
321,450.00	408,200.00	65,497.00	+ 32%	321,450.00
408,200.00	612,350.00	93,257.00	+ 35%	408,200.00
612,350.00		164,709.50	+ 37%	612,350.00
Single				
$ 0.00	$ 9,700.00	$ 0.00	+ 10%	$ 0.00
9,700.00	39,475.00	970.00	+ 12%	9,700.00
39,475.00	84,200.00	4,543.00	+ 22%	39,475.00
84,200.00	160,725.00	14,382.50	+ 24%	84,200.00
160,725.00	204,100.00	32,748.50	+ 32%	160,725.00
204,100.00	510,300.00	46,628.50	+ 35%	204,100.00
510,300.00		153,798.50	+ 37%	510,300.00
Married Filing Separately				
$ 0.00	$ 9,700.00	$ 0.00	+ 10%	$ 0.00
9,700.00	39,475.00	970.00	+ 12%	9,700.00
39,475.00	84,200.00	4,543.00	+ 22%	39,475.00
84,200.00	160,725.00	14,382.50	+ 24%	84,200.00
160,725.00	204,100.00	32,748.50	+ 32%	160,725.00
204,100.00	306,175.00	46,628.50	+ 35%	204,100.00
306,175.00		82,354.75	+ 37%	306,175.00
Head of Household				
$ 0.00	$ 13,850.00	$ 0.00	+ 10%	$ 0.00
13,850.00	52,850.00	1,385.00	+ 12%	13,850.00
52,850.00	84,200.00	6,065.00	+ 22%	52,850.00
84,200.00	160,700.00	12,962.00	+ 24%	84,200.00
160,700.00	204,100.00	31,322.00	+ 32%	160,700.00
204,100.00	510,300.00	45,210.00	+ 35%	204,100.00
510,300.00		152,380.00	+ 37%	510,300.00

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Appendix

C. 2020 Federal Tax Rate Schedule

If Taxable Income Is:

Over	But Not Over	The Tax Is	+	Of The Amount Over
Married Filing Jointly or Qualifying Widow(er)				
$ 0.00	$ 19,750.00	$ 0.00	+ 10%	$ 0.00
19,750.00	80,250.00	1,975.00	+ 12%	19,750.00
80,250.00	171,050.00	9,235.00	+ 22%	80,250.00
171,050.00	326,600.00	29,211.00	+ 24%	171,050.00
326,600.00	414,700.00	66,543.00	+ 32%	326,600.00
414,700.00	622,050.00	97,735.00	+ 35%	414,700.00
622,050.00		167,307.50	+ 37%	622,050.00
Single				
$ 0.00	$ 9,875.00	$ 0.00	+ 10%	$ 0.00
9,875.00	40,125.00	987.50	+ 12%	9,875.00
40,125.00	85,525.00	4,617.50	+ 22%	40,125.00
85,525.00	163,300.00	14,605.50	+ 24%	85,525.00
163,300.00	207,350.00	33,271.50	+ 32%	163,300.00
207,350.00	518,400.00	47,367.50	+ 35%	207,350.00
518,400.00		156,235.00	+ 37%	518,400.00
Married Filing Separately				
$ 0.00	$ 9,875.00	$ 0.00	+ 10%	$ 0.00
9,875.00	40,125.00	987.50	+ 12%	9,875.00
40,125.00	85,525.00	4,617.50	+ 22%	40,125.00
85,525.00	163,300.00	14,605.50	+ 24%	85,525.00
163,300.00	207,350.00	33,271.50	+ 32%	163,300.00
207,350.00	311,025.00	47,367.50	+ 35%	207,350.00
311,025.00		83,653.75	+ 37%	311,025.00
Head of Household				
$ 0.00	$ 14,100.00	$ 0.00	+ 10%	$ 0.00
14,100.00	53,700.00	1,410.00	+ 12%	14,100.00
53,700.00	85,500.00	6,162.00	+ 22%	53,700.00
85,500.00	163,300.00	13,158.00	+ 24%	85,500.00
163,300.00	207,350.00	31,830.00	+ 32%	163,300.00
207,350.00	518,400.00	45,926.00	+ 35%	207,350.00
518,400.00		154,793.50	+ 37%	518,400.00

Appendix

D. 2019 Maximum Effective Rates

	Federal	NYS Resident	NYC Resident	CA Resident	CT Resident	NJ Resident	PA Resident
Maximum Tax Rates	VAR%	8.82%(a)	12.696%	13.3%(b)	6.99%(c)	10.75%(d)	3.07%(e)
Effective Tax Rates If Not In The AMT Ordinary Income							
37% Bracket*	37%	46%	50%	50%	44%	48%	40%
35% Bracket*	35%	44%	48%	48%	42%	42%	38%
32% Bracket*	32%	41%	45%	45%	39%	43%	35%
24% Bracket	24%	33%	37%	37%	31%	35%	27%
22% Bracket	22%	31%	35%	35%	29%	33%	25%
Long-Term Capital Gains And Qualifying Dividends If Not In The AMT							
20% Bracket*	20%	29%	33%	33%	27%	31%	23%
Effective Tax Rates If In The AMT Ordinary Income							
28% Bracket	28%	37%	41%	41%	35%	39%	31%
26% Bracket	26%	35%	39%	39%	33%	37%	29%
Long-Term Capital Gains And Qualifying Dividends If In The AMT							
20% Bracket	20%	29%	33%	33%	27%	31%	23%

* If the maximum ordinary income tax rate for federal is 37%, 35%, or 32% and modified adjusted gross income ("MAGI") exceeds $250,000 for married filing joint, $125,000 for married filing separate taxpayers and 37% or 35% federal income tax rate and MAGI exceeds $200,000 for single, you may be subject to an additional 3.8% Medicare Contribution Tax on net investment income. Similarly, if you meet these MAGI thresholds, long term capital gains may be taxed at 23.8%.

(a) For NYS, the maximum tax rate is applicable for taxable income over $2,155,350 for married filing jointly. If taxable income is under $2,155,350, the rate is 6.85%.

(b) The maximum California rate includes the 1% Mental Health Service Tax. The top rate for married filing jointly taxpayers with taxable income of more than $1,145,960 is 12.3%.

(c) For Connecticut married filing jointly taxpayers with taxable income of more than $800,000, the maximum tax rate is 6.99%.

(d) The maximum tax rate of 10.75% for New Jersey applies to taxable income in excess of $5,000,000. If your taxable income is less than $5,000,000, your maximum tax rate is 8.97%.

(e) The Pennsylvania maximum rate does not include the City of Philadelphia tax on wages and self-employment income of 3.8712% for Philadelphia residents and 3.4481% for nonresidents.

Note: *These effective tax rates do not include payroll and self-employment taxes or the 4% New York City Unincorporated Business Tax.*

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E. 2020 Maximum Effective Rates

	Federal	NYS Resident	NYC Resident	CA Resident	CT Resident	NJ Resident	PA Resident
Maximum Tax Rates	VAR%	8.82%(a)	12.696%	13.3%(b)	6.99%(c)	10.75%(d)	3.07%(e)
Effective Tax Rates If Not In The AMT Ordinary Income							
37% Bracket*	37%	46%	50%	50%	44%	48%	40%
35% Bracket*	35%	44%	48%	48%	42%	42%	38%
32% Bracket*	32%	41%	45%	45%	39%	43%	35%
24% Bracket	24%	33%	37%	37%	31%	35%	27%
22% Bracket	22%	31%	35%	35%	29%	33%	25%
Long-Term Capital Gains And Qualifying Dividends If Not In The AMT							
20% Bracket*	20%	29%	33%	33%	27%	31%	23%
Effective Tax Rates If In The AMT Ordinary Income							
28% Bracket	28%	37%	41%	41%	35%	39%	31%
26% Bracket	26%	35%	39%	39%	33%	37%	29%
Long-Term Capital Gains And Qualifying Dividends If In The AMT							
20% Bracket	20%	29%	33%	33%	27%	31%	23%

* If the maximum ordinary income tax rate for federal is 37%, 35%, or 32% and modified adjusted gross income ("MAGI") exceeds $250,000 for married filing joint, $125,000 for married filing separate taxpayers and 37% or 35% federal income tax rate and MAGI exceeds $200,000 for single, you may be subject to an additional 3.8% Medicare Contribution Tax on net investment income. Similarly, if you meet these MAGI thresholds, long term capital gains may be taxed at 23.8%.

(a) For NYS, the maximum tax rate is applicable for taxable income over $2,155,350 for married filing jointly. If taxable income is under $2,155,350, the rate is 6.85%.

(b) The maximum California rate includes the 1% Mental Health Service Tax. The top rate for married filing jointly taxpayers with taxable income of more than $1,145,960 is 12.3%.

(c) For Connecticut married filing jointly taxpayers with taxable income of more than $800,000, the maximum tax rate is 6.99%.

(d) The maximum tax rate of 10.75% for New Jersey applies to taxable income in excess of $5,000,000. If your taxable income is less than $5,000,000, your maximum tax rate is 8.97%.

(e) The Pennsylvania maximum rate does not include the City of Philadelphia tax on wages and self-employment income of 3.8712% for Philadelphia residents and 3.4481% for nonresidents.

Note: *These effective tax rates do not include payroll and self-employment taxes or the 4% New York City Unincorporated Business Tax.*

Appendix

F. 2019 Federal and State Tax Returns Due Dates*

Not on Extension (Assuming calendar year-end for all entities)

Return Type	Federal	NY	CA	CT	FL	NJ	PA
Individual	April 15	SAF**	SAF	SAF	N/A	SAF	SAF
Trust & Estate (c)	April 15	SAF	SAF	SAF	N/A	Apr 15	SAF
FBAR (a)	April 15	N/A	N/A	N/A	N/A	N/A	N/A
3520	April 15	N/A	N/A	N/A	N/A	N/A	N/A
3520-A	March 16	N/A	N/A	N/A	N/A	N/A	N/A
Partnership (e)	March 16	SAF	SAF	SAF	Apr 1	Apr 15	Apr 15
C Corporation (d)	April 15	SAF	SAF	May 15	May 1	SAF	May 15
S Corporation	March 16	SAF	SAF	SAF	May 1	Apr 15	Apr 15
Tax-Exempt (b)	May 15	SAF	SAF	SAF	June 3	N/A	N/A
Form 5500	July 31	N/A	N/A	N/A	N/A	N/A	N/A

Information Returns (i.e., W-2 and 1099s), Forms W-2 and certain 1099-MISC due to IRS/SSA January 31 (same date they are due to the taxpayer). All other Forms 1099 due February 28; March 31 if filed electronically.

Extension Requested (Assuming calendar year-end for all entities)

Return Type	Federal	NY	CA	CT	FL	NJ	PA
Individual	October 15	SAF**	SAF	SAF	N/A	SAF	SAF
Trust & Estate (c)	September 30	SAF	Oct. 15	Sept. 16	N/A	Sept. 15	Sept. 30
FBAR (a)	October 15	N/A	N/A	N/A	N/A	N/A	N/A
3520	October 15	N/A	N/A	N/A	N/A	N/A	N/A
3520-A	September 15	N/A	N/A	N/A	N/A	N/A	N/A
Partnership (e)	September 15	SAF	SAF	SAF	SAF	SAF	SAF
C-Corporation (d)	October 15	Oct. 15	Oct. 15	Nov. 16	Nov. 2	SAF	July 14
S-Corporation	September 15	Oct. 15	SAF	SAF	Nov. 2	Oct. 15	Sept. 15
Tax-Exempt (b)	November 16	SAF	SAF	Nov. 30	Dec. 1	N/A	N/A
Form 5500	October 15	N/A	N/A	N/A	N/A	N/A	N/A

Information Returns (i.e., W-2 and 1099s)	No extensions available

*Revised due dates resulting from the Surface Transportation & Veterans Health Care Choice Improvement Act of 2015

**"SAF" means the state return due date is the same as the federal return due date.

(a) Note that unlike tax returns, FBARs do not have a next-business-day rule if the deadline falls on a Saturday, Sunday, or legal holiday.

(b) The extension will be a single, automatic six-month extension, easing the administrative burden on exempt organizations by simplifying the process of extending the Form 990 returns, and eliminating the need to request a second extension after three months.

(c) For fiscal year estates, the original due date is the 15th date of the fourth month after the year-end. The extended due date is 5½ months after the original due date. Trusts are always on a calendar-year basis.

(d) For C corporations, the due date is the 15th day of the fourth month following the close of the tax year. For C corporations with fiscal years ending on June 30, this change is deferred until 2026. Corporations will be allowed an automatic six-month extension, except the five-month extension until September 15 will remain for calendar year corporations until 2026, and corporations with a June 30 year-end will get a seven-month extension until 2026.

(e) Partnerships will be required to file their returns by the 15th day of the third month after the close of their tax year, and will have a maximum six month extension.

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