Anchin
ACCOUNTANTS & ADVISORS

Financial Services Practice

2022 Year-End Tax Planning Guide

Tax planning is complex. Cautious planning involves more than just a focus on lowering your taxes for the current and future years. There are many things to think about and rules to navigate when it comes to tax planning. The various items and planning opportunities discussed in this guide are general in nature and may not apply to each taxpayer's situation. However, in most, if not all situations, multi-year modeling may be required to try to maximize the best tax results today and in future years. This guide cannot cover every tax planning opportunity that may be available to you and your business. Therefore, we urge you to meet with your tax advisors who should be able to provide you with a comprehensive review of tax-saving opportunities appropriate for your individual situation and your business. If you would like to discuss any of these techniques or planning ideas, please contact ***E. George Teixeira***, ***Jeffrey Kahn***, ***Jinal Shah*** or any member of ***Anchin's Financial Services Practice*** at your earliest convenience. We stand ready to help you plan effectively and to navigate through the various tax rules that may apply to you, your family, and your fund.

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"Be informed, be flexible and be ready to act"

As we go to press with our annual year-end tax planning guide, we can look back at a challenging year, both economically and in terms of tax planning. This past year has shown how the impact of high inflation and market volatility can alter how we live and how we do business. Staying one step ahead in this environment means ***being informed*** by understanding the current rules, ***being flexible*** by keeping abreast of potential changes, and ***being ready to act*** by starting to prepare for what might come.

After years of new tax law changes from 2017 through 2021, 2022 has been relatively dormant, in relation to tax law changes in the financial services industry. Many had predicted that the Republicans would take control of both the House and Senate, and with that would come roll backs of tax legislation passed by the Democrats over the past two years. However, with the Republicans taking control of the House, while the Democrats held on to the Senate, passing any new legislation over the next two years will be a tough task for President Biden. As 2022 heads to a close, many tax practitioners continue to wait for guidance on tax laws passed over the past five years.

As we head toward a post-election lame-duck congressional session, tax legislation may resurface that targets retirement plans, digital assets and certain tax extenders that either expired at the end of 2021 or will expire at the end of 2022. There are more than 40 temporary tax provisions that expired December 31, 2021, such as an extension of research and development expensing and/or a refundable research credit, an extension of a favorable formula used to compute the business interest expense deduction under IRS Section 163(j) and an extension of the charitable contribution deduction by non-itemizers. There are also some tax extenders expiring at the end of 2022 that may be retroactively reinstated such as the full deduction for business meals provided by a restaurant (otherwise limited to 50%).

This guide offers a variety of strategies for reducing your taxes in the current tax environment. Use it to identify the best strategies for your situation with your tax advisor, who also can keep you apprised of any new tax law developments that might affect you. With many facing difficult and uncertain times, solid financial and tax planning is required now more than ever before. The sooner you focus on your tax situation and the available tax planning opportunities, the more likely you are to put yourself in a better tax position. While we cannot predict the future, we can assist you with your tax planning.

As we continue to monitor the prospects of regulations, guidance and potential new tax legislation, and as the year-end approaches, you should consider the following opportunities as you review your tax picture. However, before taking action with any of these suggested planning ideas and opportunities, taxpayers should completely analyze the proposed transaction(s) and alternative outcomes.

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Tax Loss Harvesting: Turn Investment Losses into Tax Savings

2022 has been a year of market volatility with the stock market experiencing large losses coupled with some sporadic recoveries. Although the stock market may have reversed some of its earlier losses, many investments may still be worth less than they were worth at the beginning of this year. These market conditions present the potential opportunity to recognize built up losses in taxable accounts. Recognizing capital losses is a common strategy to reduce taxable income, but purchases of substantially identical securities can result in the disallowance of those losses via the wash sale rule. In general, this rule disallows a loss resulting from the sale of stock or securities, if, within the restricted period (a 61-day period beginning 30 days before the sale), the taxpayer "acquires," or enters into a contract or option to acquire, ***substantially identical*** stock or securities. In addition, a loss from closing a short sale is similarly disallowed where, within the restricted period, substantially identical stock or securities are sold or another short sale of identical stock or securities is entered into.

**** Reminder:*** Long-term capital losses are first used to offset long-term capital gains before they are used to offset short-term capital gains. Similarly, short-term capital losses must first be used to offset short-term capital gains before they are used to offset long-term capital gains. Individuals may use up to $3,000 of total capital losses in excess of total capital gains as a deduction against ordinary income and may also carry capital losses forward indefinitely. Below is a list of strategies:

- ***Sell long stock at a loss or cover short sale at a loss and wait 31 days to buy back or re-short the same security to avoid triggering the wash sale rule.*** With this strategy (assuming you have not purchased or shorted additional shares within the restricted wash sale period), there is no need to navigate through the complex wash sale rule since you are selling off the position and waiting the applicable 31 days after the sale before repurchasing or re-shorting the same security position.

- ***Sell long stock at a loss and purchase a call option:*** The taxpayer would (1) sell the stock and recognize the loss; (2) the next day, purchase a call option (an at or out-of-the-money call option will suffice) – which triggers the wash sale rule; (3) the following day, repurchase the stock; and (4) sell (either later that day or the following morning) the call to recognize the loss. Note that this last step (4) will not trigger the wash sale rule. Therefore, the taxpayer in this example can buy back the shares in less than 31 days as long as they bought a call option on the same stock in between the two transactions. If this strategy is used it may be beneficial to execute using two trading accounts. If executed in a single account, the normal reporting systems of the broker will likely incorrectly pick up the sale in Step 1 and purchase in Step 3 as a wash sale.

- ***Sell long stock at a loss or cover short sale at a loss and replace the investment with an exchange traded fund (ETF) tied to the company's industry or sector.*** In this way, the ETF effectively serves as a temporary approximate substitute for sold stock(s) and still enables you to recognize the loss on your original position that was sold at a loss without incurring the wrath of the wash sale rule since the ETF will not be deemed substantially identical to the disposed of securities.

  **** Anchin Observation:*** This transaction can be further enhanced using index options, which are marked-to-market under IRC Section 1256 at year-end for tax purposes. One would sell an ETF that they are holding at a loss and then buy an option on the index the ETF references. As discussed earlier, the buying of the option triggers the wash sale rule and the losses from the ETF increase the cost basis of the index options. Said losses are then realized through the mark-to-market of the index options.

- ***(Cover) short sale at a loss and purchase a put option:*** Note that the wash sale rule will apply if the taxpayer (within the restricted period) executes another short sale with respect to substantially identical stock or securities. The wash sale rule in this respect (cover a short and buy a put option) is anything but clear with many practitioners believing this is a wash sale while others believing that it is not.

  Therefore, a cautionary best practice would be to employ a strategy similar to the "Purchase a call option strategy" discussed above where the taxpayer would (1) cover the short and recognize the loss; (2) the next day, purchase a put option – which triggers the wash sale rule; (3) the following day, re-short the stock; and (4) sell (either later that day or the following morning) the put option to recognize the loss. Note that this last step (4) will not trigger the wash sale rule since the selling of a put at a loss will only be deemed a wash sale if the taxpayer buys another put with the same expiration date as the previously disposed of put within the restricted period. If this strategy is used it may be beneficial to execute using two trading accounts. If executed in a single account, the normal reporting systems of the broker will likely incorrectly pick up the short cover in Step 1 and re-short in Step 3 as a wash sale.

- ***Sell long stock at a loss and sell a put option (or "write a put"):*** Where a taxpayer sells a long stock at a loss but seeks to remain economically at risk with respect to the stock, the wash sale rule seems to present an obstacle. Not only is the taxpayer barred from reacquiring the stock during the restricted period, but the law also forbids the acquisition of a call option within this same period.

  A large degree of exposure can be attained if the taxpayer, within the restricted period, sells (writes) a put option; a transaction not covered by the current wash sale rule.

  **** Caution:*** Some care needs to be exercised in writing the put as IRS guidance states that if a taxpayer sells stock at a loss and within the restricted period sells a put option, the sale of the put option ***"may"*** trigger the wash sale rule. The IRS guidance appears to allow the sale of puts only if they are "not likely to be exercised." Given that there are no clear guidelines for this "not likely to be exercised" standard, most practitioners advise the writing of puts that are either at-the-money or out-of-the-money.

- ***Sell long stock at a loss and enter into a total return Basket Swap:*** In this scenario, the taxpayer holds stock with a market value that is lower than the tax basis of the stock and seeks to deduct a capital loss on the sale of the stock while still maintaining economic exposure with respect to the disposed of stock. The following transaction may allow the taxpayer to maintain economic exposure to the stock and to deduct a capital loss without disallowance under the wash sale rules.

  In a proposed transaction, the taxpayer sells (at a loss) the stock in the open market and simultaneously enters into a swap agreement with a counterparty with respect to a ***basket*** of securities that includes the sold stock. The swap will terminate on the 35th day following the date on which the swap is entered into (the "Maturity Date"). The swap will provide that on the Maturity Date, (1) the taxpayer will pay the counterparty an amount equal to the depreciation in the value of the basket over the term of the swap and (2) the counterparty will pay the taxpayer an amount equal to the appreciation in the value of the basket over such term. In addition, the swap will provide that the counterparty will pay to the taxpayer an amount equal to dividends paid during the term of the swap on stocks that comprise the basket. The taxpayer also will make LIBOR-based payments to the counterparty determined with reference to the initial value of the stocks comprising the basket on a weekly basis over the term of the swap.

  The basket should be comprised of 20 or more stocks of unrelated issuers, including the stock(s) sold. On the date the swap is entered into the fair market value, the stock(s) sold should represent (in total) less than 70% of the fair market value of all the stocks comprising the basket. We believe that such a basket will not be deemed substantially identical to the shares sold.

- ***Sell long stock at a loss and enter into a total return swap:*** Where the taxpayer sells a long stock at a loss and, within the restricted period, enters into a total return swap on the same security, we believe that this transaction will trigger the wash sale rule and the loss on the stock sale will be added to the basis of the swap. If the taxpayer or fund is marking to market its swaps, the swap contract in this transaction will be marked to market at year-end and the deferred loss should be recognized.

  **** Anchin Observation:*** Since swaps that are marked to market generate ordinary income or loss, it is conceivable that this transaction allows a conversion of a capital loss (via the original stock loss deferred under the wash sale rule) to an ordinary loss (via the mark to market of the swap at year-end).

Tax Planning using the Wash Sale Rule to your Advantage

As referenced above, the wash sale rule was designed to discourage taxpayers from selling securities at a loss simply to claim a tax benefit. Recall that under the current law, assets that are not stock or securities (such as gold or gold ETF, foreign currencies, crypto currencies) are not subject to the onerous wash sale rule. For example, if you sell bitcoin at a loss, you can buy bitcoin again without running afoul of the wash sale rule. Also, with proper planning and the appropriate facts, the wash sale rule can be used to your advantage. Following are some examples:

- ***Purposely trigger the wash sale rule and postpone loss recognition:*** Assume that you recently sold stock at a loss in 2022 and then realize that the loss is going to offset long-term capital gains (taxed at a preferentially lower tax rate than short-term capital gains) and you want to postpone recognizing the loss until 2023. If the loss is within the restricted period, simply repurchase the shares so that the loss gets deferred under the wash sale rule; the loss will then get included in the basis of the newly repurchased shares and will not be recognized in 2022.

- ***Converting Short-Term Capital Gains into Long-Term Capital Gains:*** Stock that has fallen in value is often sold before attaining long-term holding status in order to benefit from short-term capital loss treatment. If you notice that the stock price has risen shortly after a sale at a loss, you can repurchase the stock within the restricted period, and the holding period you had attained on the previously sold shares will be "tacked" on to the holding period of the newly acquired shares. As a result, if you then find yourself with an overall gain on the repurchased shares, you can take advantage of the long-term capital gains rate assuming the combined holding period of the two lots of stock exceeds one year.

- ***Converting Long-Term Capital Losses into Short-Term Capital Losses:*** The taxpayer would (1) sell the stock and recognize the long-term capital loss; (2) within the restricted wash sale period (perhaps the next day), purchase a call option on the sold stock – which triggers the wash sale rule; (3) exercise the call option – sell the stock received through the exercise of the call. As described earlier, the loss on the initial sale is disallowed as a wash sale due to the purchase of the call option within the restricted wash sale period. The disallowed loss is added to the tax basis of the call option, as is the long-term holding period. The exercise of the call option, however, starts a new holding period of the stock. The tax basis of the call option including the disallowed loss from the original stock sale is added to the basis of the stock received through the exercise of the call. The subsequent sale of the stock, assuming held for less than one year, is a short-term capital loss

What's New with Digital Asset Taxation

On October 17, 2022, the IRS released new draft instructions for the 2022 Form 1040 that provide some limited guidance on reporting digital asset transactions, and a newly expanded definition of digital assets for this purpose. The draft instructions provide some confirmation that the broad term "digital assets" has been incorporated into the existing virtual currency language. In particular, digital assets is defined as "…any digital representations of value that are recorded on a cryptographically secured distributed ledger or any similar technology.
For example, digital assets include non-fungible tokens (NFTs) and virtual currencies, such as cryptocurrencies and stablecoins. If a particular asset has the characteristics of a digital asset, it will be treated as a digital asset for federal income tax purposes."

This expanded definition specifically includes non-fungible tokens (NFTs), which seems to confirm that the IRS may view the asset more like cryptocurrency and less like collectables or traditional art. Further, the last sentence in the definition may also encompass many digital assets that were not previously thought of as reportable, such as "play-to-earn" game tokens where players play games to receive tokens to use as in-game currency.

In terms of when to check "YES" to the Form 1040 question, the draft instructions provide a laundry list of broad transactions that would necessitate reporting and where taxable gain or loss may result from said transactions including, but not limited to:

- Sale of a digital asset for fiat
- Exchange of a digital asset for property, goods or services
- Exchange or trade of one digital asset for another digital asset
- Receipt of a digital asset as payment for goods or services
- Receipt of a new digital asset as a result of a hard fork
- Receipt of a new digital asset as a result of mining or staking activities

- Receipt of a digital asset as a result of an airdrop
- Any other disposition of a financial interest in a digital asset
- Receipt or transfer of a digital asset for free (without providing any consideration) that does not qualify as a bona fide gift
- Transferring a digital asset as a bona fide gift if the donor exceeds the annual gift exclusion amount

The draft instructions further explain, however, that there are certain instances where a taxpayer could have an otherwise relevant transaction and not check "YES," including simply holding a digital asset in a wallet, transferring assets between personally held wallets, and purchasing digital assets.

Lastly, the instructions also note that the tax treatment of digital asset transactions is generally capital (reported on Form 8949), although if received as wages or in exchange for services, digital assets constitute compensation. While the updated instructions provide more clarity and context than prior years, the new draft instructions still do not provide satisfying guidance on tax reporting overall for digital assets and may continue to demand over reporting in an industry where even basic information reporting can be challenging due to the nature of the assets.

**** Reminder:*** Digital Assets owned on a foreign exchange are reportable on form 8938 and subject to penalties, if not properly disclosed.

**** Anchin Observation:*** The recent collapse of global crypto exchange FTX is likely to be one of the most impactful events in the digital asset industry's history. In a spectacular event, billions of dollars of wealth disappeared, entities declared bankruptcy and thousands of users could not access their funds. For FTX users, the situation is dire as it is unlikely that funds deposited at FTX will be recovered. What should an FTX investor do from a tax perspective now that their cryptocurrency investment continues to lose value or is lost forever?

Taxpayers anticipating investment loss deductions from the FTX bankruptcy will need to wait and see how the proceedings conclude, but this will take some time.

- For taxpayers that successfully cashed out and/or withdrew funds from the FTX exchange prior to the news and subsequent bankruptcy, any resulting capital loss may be used to offset their capital gains. Any excess capital loss is not lost since these can be carried forward to offset future capital gains from other trading or investment activities.

- What about taxpayers who find themselves stuck and unable to trade or withdraw funds from the FTX exchange? These taxpayers are in a more complicated tax position as they are unable to realize a loss for tax purposes because a sale or exchange cannot take place.

    - **Worthless Security Deduction:** As referenced later in this alert, the IRS does allow a deduction for worthless securities that are considered capital assets and that are deemed completely worthless. What is unclear right now is whether crypto on the FTX exchange is completely worthless or simply inaccessible due to its illiquidity and subsequent bankruptcy, with a possible recovery in the future.

- **Personal Casualty Loss Deduction:** The TCJA suspended such tax losses until the end of 2025 unless the loss is related to a federally declared disaster. Therefore, unless an FTX investor has lost access to their wallet forever because of a sudden or unexpected event occurring because of a federally declared disaster, or the FTX bankruptcy carries through to 2026 without resolution, a personal casualty loss is unlikely to be available.

- **Abandonment Loss Deduction:** If the investment has lost all value (not due to a sale or exchange), and the taxpayer's initial intent was to make a profit, there is now clear intent to abandon the investment. This means "affirmative actions" have been taken to demonstrate abandonment – a possible path to a write off. However, the burden is on the taxpayer to establish that all these requirements have been met. How can an FTX investor abandon an account that he/she does not control or have access to?

- **Investment Theft Loss Deduction:** Some have already compared FTX's collapse to the Bernie Madoff Ponzi scheme from years ago. If the FTX collapse falls within the definition of a Ponzi, taxpayers may deduct their losses as an investment theft loss, which are deductible immediately, instead of a capital loss. With relief under the Ponzi scheme safe harbor set forth in IRS Rev. Proc. 2009-20, an investor may take a deduction equal to 95% of the amount invested in cryptocurrency if the investor is not seeking or does not intend to seek recovery from a third party. The loss would be deductible in the year of discovery, or the year the Ponzi scheme's orchestrator is (1) charged by indictment for fraud, embezzlement or a similar crime; (2) the subject of a state or criminal complaint and either admits guilt or has assets frozen by court-order; or (3) the subject of the fraudulent arrangement faces no charges, indictment or complaint because of his death. It remains to be seen if charges will be filed against those running FTX and it also may be difficult to establish criminal intent as opposed to just plain incompetence on their part. Investigations are continuing but, considering what we know today, individual investors with money trapped in the FTX exchange are unlikely to be able to take a deduction on their 2022 tax filings. At the end of the day, FTX will be one of the largest crypto bankruptcies to date, with reportedly more than one million creditors, and it will take time to untangle this unfortunate mess.

Using Constructive Sales to “Accelerate” or “Defer” Capital Gains

You should consider your tax situation in 2022 as well as your projected tax situation in 2023 to determine if it would be best to generate additional realized capital gains this year or the next. Varying concerns may prompt some taxpayers to reduce their exposure in some of their stock investments. If planned correctly, the affirmative use of the constructive sale rules may allow a taxpayer to hedge an appreciated position through the end of the year and can give the taxpayer the ability to accelerate capital gains into 2022 or defer capital gains recognition to 2023 and beyond.

Assume that you have substantial unrealized gains in your portfolio which have aged to Long Term (“LT”) and you would like to buy some more time in order to decide when to recognize the capital gain…

- You can enter into an offsetting position and cause a constructive sale and potentially realize the gain in 2022.
- If the status of your tax picture for 2022/2023 is clearer towards the end of January 2023, you still have time to:
    - Unwind the constructive gain(s) by utilizing the “short-term hedging exception” – thereby continuing to defer the LT unrealized gains to 2023 and beyond.
- If the status of your tax picture for 2022/2023 is clearer by early to mid-March 2023, you still have time to:
    - Violate the 60-day un-hedged portion of the short-term hedging exception to recognize the constructive gain(s) in 2022.

In summary, taxpayers seeking to preserve gains in the face of year-end uncertainty may do so in a tax-efficient manner without running afoul of the constructive sale rules.

**** Anchin Observation:*** Properly executed basket swaps could also be used to change economic exposure without causing adverse tax consequences.

***** Please refer to the Constructive Sales–Rules and Reminder section later in this guide*****

Short Sales and Losses

A short sale occurs when one borrows stock from a broker and sells it, hoping to profit by buying it back at a lower price. Short sales are a means to profit from market downturns or to hedge a position. Based on the market volatility so far this year, it may be prudent to examine your portfolios and seek to harvest built-in tax losses. However, short sellers who wish to harvest losses should keep a close eye on the calendar as well as be wary of the wash sale rule (discussed earlier). Investors looking to cover short security positions by year-end should be aware of the trade date rule. The trade date rule governs whether the gain or loss from the disposition of a security is considered on the trade date or on the settlement date. The date that's used for tax purposes depends on whether you have a gain or a loss:

- If you're closing a short position at a profit, the trade date controls the timing for tax purposes.
- If you're closing a short position at a loss, however, the settlement date will control.

If you close a short sale at a loss late in the year in 2022 through the delivery of shares and you must purchase the shares in the market, you need to allow at least two business days for the settlement of the purchased shares in order to be able to deliver them to cover the short position ***and*** to deduct the capital loss in 2022. Therefore, the purchases-to-cover should take place with enough time for them to settle before year-end. Note that if the purchases-to-cover positions are purchased too late in the year and settle in 2022, the short-cover capital losses will be deferred until 2023.

**** Planning Opportunity:*** To avoid running afoul of this settlement rule, be sure to close out your short sales early enough in December to recognize the loss in 2022. Note that the last trading day of the year is Friday, December 30, 2022.

Examine Portfolio for "Worthless Security" Positions

For purposes of potential worthless securities deductions, securities include:

- Stocks, including stock options
- Bonds, and
- Notes, commercial paper or debt instruments for debts owed by a corporation or government.

Securities do not include stocks or debt instruments that aren't offered to the public for purchase or sale, or those issued by individuals.

A capital loss is available in the year a security position becomes totally worthless or is abandoned. The concept of worthlessness is based on facts and circumstances and could have many interpretations. Taxpayers generally can only write-off worthless securities in the year they become worthless. A worthless security loss must be evidenced by a closed and completed transaction, fixed by an identifiable event and actually sustained during the taxable year. One must demonstrate both balance sheet insolvency and a complete lack of future potential value. Balance sheet insolvency entails proving that liabilities exceed assets in the year of worthlessness. Even though the balance sheet may show insolvency, the stock of the corporation could possibly have some value in the future. Therefore, the taxpayer must also demonstrate the destruction of potential future value to establish current worthlessness.

**** Planning Opportunity:*** In many cases, where facts are not available and future potential value is not clear, many taxpayers sell the security position to an unrelated third party, for a nominal amount, to close the transaction, guarantee a capital loss and establish the year of deductibility. Generally, and for this purpose (disallowance of a loss), the IRS defines related parties to be the seller's immediate family: brother or sisters (whole or half-blood), spouses, ancestors and lineal descendants. In-laws, for example, are not considered members of the seller's family. Brokers can also facilitate a taxpayer's loss by purchasing or enabling abandonment of the worthless securities.

**** Caution:*** Note that short positions have a different standard, which has the effect of accelerating gain on the position where the borrowed security is "substantially worthless" as opposed to completely worthless (for long positions).

Abandoning a Partnership Interest – Capital v. Ordinary Loss

Consider the following scenario: a taxpayer has invested in a limited partnership that he/she knows is going bad, and he/she believes the investment will not be recovered. With careful planning, accelerating these losses into the current year to offset income could provide significant tax savings. For tax purposes, losses are characterized as either ordinary or capital. Ordinary losses are generally more beneficial because they can be deducted against regular income without limitation. Capital losses, however, are restricted in use and generally can only offset capital gains.

To the extent a partner has remaining adjusted (tax) basis in the partnership interest, the IRS has ruled that a loss incurred in the abandonment or worthlessness of a partnership interest is ordinary if there is no sale or exchange. However, to the extent the partner receives any consideration for the partnership interest in the form of monies or relief from liabilities, no matter the dollar amount, the abandonment or worthlessness will be treated as a sale or exchange subject to capital loss treatment.

The courts have ruled that a limited partnership can be abandoned if the following occur:

- The owner affirmatively intends to abandon the interest;
- There is an affirmative act of abandonment; and
- The intent and affirmative act are communicated to all interested parties.

If a partner determines that abandonment is the best option, there are only a few steps that must be completed within the current tax year. The IRS has made clear that the abandonment of a partnership interest should be accompanied by the partner's notification of their intent and further documentation that all future rights have been abandoned.

The abandonment of a partnership interest is complex, and many facts need to be considered. In determining whether taxpayers have taken sufficient actions to abandon their interests, courts have noted facts such as a taxpayer having no further dealings with the abandoned partnership, no expectation to receive anything and not actually receiving anything further in later years.

**** Practice Tip:*** It is a good idea to check the partnership operating agreement to see whether it has a process for giving up the interest and withdrawing from the partnership. If not, a letter to the general partner (and to all other partners, if practical) stating the wish to abandon the interest in the partnership, the intent to have no further dealings with the partnership and that there is no expectation of further benefits from the partnership is a good way to establish abandonment. Although not required, the letter should also ask the general partner to send a confirmation that the abandonment was accepted, and that the partnership will no longer treat the taxpayer as a partner.

**** Caution:*** Confirm that state law does not impose any additional requirements upon withdrawing or exiting partners.

Excess Business Loss (EBL) Limitation Developments

The excess business loss (EBL) limitation is here to stay — at least through the 2028 tax year. The provision, codified with Internal Revenue Code section 461(l), limits the amount of trade or business losses noncorporate taxpayers can utilize to offset nonbusiness income. The EBL limitation took effect in the 2021 tax year and, due to the passage of the Inflation Reduction Act (IRA), will remain in effect through 2028.

With the market downturn in 2022, many investors may have losses from underlying investments. Some of these losses may not be deductible in the current year due to these EBL rules, which disallows the deduction of excess business losses by non-corporate taxpayers (individuals, trusts, and estates) and instead forces such taxpayers to carry forward such losses as net operating losses. An EBL is the amount by which the total deductions from your trades or businesses are more than your total gross income or gains from your trades or businesses, plus the threshold amount. The EBL limits the amount of trade or business deductions that can offset nonbusiness income. For 2022, trade or business losses are limited to $270,000 for single filers (or $540,000 for joint filers). An EBL not allowed in the current year is carried forward as a net operating loss.

**** Planning Opportunity:*** Incorporating the application of the EBL rules is critical to tax planning for owners of pass-through entities. The timing of recognizing both business income and losses, as well as non-business income and losses, can have a material effect on a taxpayer's overall tax liability. A lack of proper planning for the EBL limitation when making extension and estimated tax payments can also lead to significant penalties and interest.

**** Anchin Observation:*** To date, the EBL limitation has been used as a revenue raiser on three recent occasions: the Tax Cuts and Jobs Act (TCJA) of 2017 (passed by Congressional Republicans only), the American Rescue Plan Act (ARPA) of 2021 (passed by a bipartisan group) and the Inflation Reduction Act (IRA) of 2022 (passed by Congressional Democrats only). Congressional Democrats did attempt to make significant changes to the EBL limitation as part of the Build Back Better (BBB) package. That proposal would have made the EBL permanent and, more importantly, would have changed how excess business losses are treated in subsequent years. Ultimately, the BBB proposal did not pass. However, the blueprints for change are there as is the possibility for the EBL limitation to be further extended or to become a permanent provision. The fact that it can be seen as a revenue-raiser without having to actually raise rates makes it politically appealing.

Mark-to-Market Election (§475(f))

This election is available to traders in securities and should be considered and discussed where all (or most) of the buying and selling of securities by the taxpayer is short-term. The election generally converts all trading gains and losses (both realized and unrealized) from capital gain or loss to ordinary income or loss. Funds (or other taxpayers) that elect mark-to-market treatment are not subject to wash sale, straddle, constructive sale, and other complex tax rules. The election, in general, eliminates the potential significant tax benefits of long-term capital gain treatment and the deferral of any unrealized gains. However, electing traders can still hold a separate investment securities account to age certain securities to long term which is not subject to the mark-to-market regime discussed above.

The mark-to-market (trader) election must be filed no later than the due date of the tax return (without regard to extensions) for the tax year immediately preceding the election year and must be attached either to that return or, if applicable, to a request for an extension of time to file that return. For example, if the election is to be effective for the 2023 tax year, and assuming the taxpayer is an individual, the election would need to be made by April 18, 2023 (March 15, 2023 with respect to calendar year S Corporations and Partnerships). This, in effect, provides the taxpayer a few months at the start of the year to determine if making the mark-to-market election would be beneficial.

The mark-to-market election has some significant potential benefits. It streamlines the tax reporting process since funds making the election do not have to make adjustments for items such as wash sales, constructive sales and straddles since the portfolio is treated as if sold on the last day of the taxable year. Taxable income typically equals book income. In addition, the election accelerates unrealized losses, and enables taxable individual investors to treat them as ordinary losses, as opposed to capital losses which are subject to annual limitations in certain scenarios.

The mark-to-market election does also carry with it some potential negative consequences, including the fact that unrealized gains are accelerated and taxed as ordinary income at the highest tax rates. Another consideration is if the fund generated significant unused capital losses prior to the year of the election, those losses could only offset future mark-to-market ordinary income on a limited basis ($3,000 per year), assuming an investor does not have other sources of capital gains.

**** Planning Opportunity:*** If you have significant unrealized losses in your trading portfolio in late 2022 (and you qualify as a trader and are therefore eligible to make the §475(f) election), you could benefit by continuing to hold those securities until the following year (2023). You could then make the §475(f) election for 2023 and deduct the mark-to-market losses in 2023 as ordinary losses rather than selling the securities in 2022 and recognizing capital losses, which are subject to limitations on deductibility.

**** Anchin Observation:*** Bond or credit funds should consider making the §475(f) election (assuming they qualify as a trader and are therefore eligible to make the election). This election helps to equalize or match income and expenses since interest income earned and losses recognized upon sale are all treated as ordinary for tax purposes.

475(f) Revocation Procedures: There are provisions allowing taxpayers to revoke a Section 475(f) election. If you've made a valid election under section 475(f), the only way to stop using mark-to-market accounting for securities is to file an automatic request for revocation under Revenue Procedure 2017-30, Section 23.02. Under that revenue procedure, the request for revocation must be filed by the original due date of the return (without regard to extensions) for the taxable year preceding the year of change. This revocation notification statement must be attached to either that return or, if applicable, to a request for extension of time to file that return.

**** Planning Opportunity:*** Taxpayers may wish to revoke a Section 475(f) election to benefit from any future appreciation of long-term capital gains because the 475(f) election does not affect holding period.

**** Caution*:** However, taxpayers revoking this election may not make another mark-to-market election for five years after the revocation.

Foreign Currency Election - Tax Beneficial?

The IRS has special rules for "§988 transactions." These are transactions in which the amount the taxpayer is entitled to receive or required to pay is denominated in terms of a nonfunctional currency or determined by reference to the value of one or more nonfunctional currencies. Transactions covered under §988 include entering into or acquiring any forward contract, futures contract, options or similar financial instrument. By default, foreign currency transactions are treated as ordinary income or loss under Section 988. The good news is Section 988 ordinary losses offset ordinary income in full and are not subject to the $3,000 capital loss limitation.

Taxpayers with significant trading in foreign currency forwards should consider making an election under Section 988(a)(1)(B). Foreign currency forwards are often used and entered into when trading foreign securities in order to offset currency fluctuations in the price of the securities. This election would allow for the treatment of gains (and losses) from these foreign currency contracts as capital gains and losses rather than ordinary income or loss. This election could be especially beneficial for certain foreign currency contracts, which would normally be treated as ordinary income for tax purposes, that now would be taxed at 60% long term capital gain rates and 40% short term capital gain rates, irrespective of how long the foreign currency contract has been held. The 60/40 capital gains tax rates would apply to foreign currency forwards on "major currencies" – currencies for which regulated futures contracts (RFCs) trade on U.S. futures exchanges. This election is required to be made when the foreign currency contract is entered into and cannot be or become part of a straddle.

Qualified Small Business Stock (QSBS) Tax Exemption

One of the significant changes included in the TCJA was the reduction in the C corporation tax rate to 21%, thus making C corporations more prevalent in use for various business owners. In addition to the lower tax rate, C corporation stock can potentially qualify as QSBS under Section 1202 of the Internal Revenue Code (IRC). The QSBS tax exemption allows taxpayers to exclude from gross income a percentage of the capital gain recognized on the sale of QSBS if it is held for more than five years. If qualified, investors can avoid tax on some or all the gain upon the sale of the stock. Depending on the date of acquisition, the current exclusion can be anywhere from 50% to 100% (if acquired after September 2010).

There has been discussion and recent tax proposals in Washington about Congress potentially reducing the exclusion benefit to 50%. While we continue to monitor the potential tax law changes closely, we believe tax planning using this powerful opportunity is now more important than ever. Regardless of any changes to the rules surrounding QSBS, this provision can provide some incredible opportunities for investors, employers, entrepreneurs and employees. If qualified, the excludable gain from federal tax is the greater of $10 million or 10 times basis, providing significant tax savings. Note that many states conform to the federal law, but some states do not, so it is important to consult with your tax advisor to determine any state tax implications. The requirements to be eligible for this exclusion are as follows:

1. the stock was issued by a domestic C corporation after August 10, 1993,

2. the C corporation must be a qualified small business with a max of $50 million of gross assets when the stock was issued and immediately after the date of issuance,

3. the stock must be ***original issue stock*** as opposed to having been acquired from an existing shareholder

4. the corporation must be an active business that uses at least 80% of its assets in a ***qualified trade or business***

- ***Complexities around Original Issue Stock***. When does original issuance occur? The answer appears to be straightforward – when the C corporation issues shares directly to the investor. If the stock was purchased in the secondary market, the shares purchased would not be QSBS eligible even if the criteria referenced above is met. However, determining original issue proves more complicated when the corporation grants stock options, restricted stock or restricted stock units or when the invested capital is structured as a convertible note. All these methods are quite common in venture capital and start-up businesses. Therefore, determining when the five-year holding period begins varies (see chart below) and is relevant for QSBS exemption purposes.

Type	QSBS Qualification Test	QSBS Holding Period Test
Stock Options	Upon date of exercise for vested options *(1)*	5 years from the date of exercise
Restricted Stock	Upon §83(b) election *(2)* or vesting date	5 years from the date of the §83(b) election or vesting date
Restricted Stock Units	Upon vesting date	5 years from the date of vesting
Convertible Preferred Stock	Upon date of preferred investment *(3)*	5 years from the date of preferred investment
Convertible Debt	Upon date of conversion *(4)*	5 years from the date of conversion

(1) For unvested options, the company must allow these to be exercised early and the taxpayer must make an §83(b) election within 30 days of exercise.
(2) §83(b) election to be made within 30 days of restricted stock grant or option exercise into restricted stock.
(3) §1202(f) – if any stock in a corporation is acquired solely through the conversion of other stock in such corporation which is QSBS in the hands of the taxpayer – (1) the stock so acquired shall be treated as QSBS in the hands of the taxpayer and (2) the stock so acquired shall be treated as having been held during the period which the converted stock was held
(4) §1202(i)(1)(A) – in the case where the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation – (A) such stock shall be treated as having been acquired by the taxpayer on the date of such exchange

For those who qualify, the amount of gain eligible for exclusion - from 0% to 100% - depends on the acquisition date and the holding period. QSBS acquired between August 9, 1993 and February 17, 2009 is eligible for a 50% exclusion, increasing to 75% for QSBS acquired between February 18, 2009 and September 27, 2010 and 100% for QSBS acquired on or after September 28, 2010. To qualify for any of these exclusions, the stock must be held for at least 5 years. The gain eligible to be considered for purposes of this exclusion is limited to the greater of $10 million or 10 times the taxpayer’s basis in the stock.

**** Anchin Observation:*** If you own a stake (or plan to invest) in a startup or small business, you need to know about the QSBS exemption as it is an important tax planning tool. We often advise clients to think about these provisions if and when they are initiating a startup or small business investment. The QSBS exclusion is most commonly applied in situations when an entrepreneur sells his or her company, or when investors in a private equity fund receive an in-kind distribution of post-IPO shares after a portfolio company in the fund goes public. Note that there are many dimensions to this rule and to any startup or small business owner's situation. We frequently work with our clients and their advisors to develop plans that make sense for each client.

***Caution:** As discussed above, the stock must be original issue stock. Therefore, the conversion of an S corporation to a C corporation will not meet this definition since the stock was originally issued by an S corporation. However, the newly converted shares in this scenario could qualify for QSBS if structured properly. Converting a partnership to a C corporation could qualify since a partnership does not issue stock.

***Planning Opportunity – Section 1045 Rollover:** Section 1045 complements Section 1202, allowing taxpayers who haven't achieved a five-year holding period for their QSBS to roll otherwise taxable gain on the sale of their QSBS on a tax-deferred basis into replacement QSBS. The section 1045 gain deferral on the sale of QSBS, like the section 1202 gain exclusion, is a provision intended to incentivize investors to invest in small businesses. Section 1045 may be of significant benefit to many investors, but its requirements must be followed carefully to ensure eligibility for the gain deferral. The nuances of the section 1045 rules are complex. Taxpayers should consult with their tax advisors when considering deferring gain under section 1045.

***Planning Opportunity - QSBS Stacking:** With early and proactive tax planning, this exemption can potentially be used multiple times. This strategy is often referred to as "stacking and packing." Because the first $10M of gain can be free from federal tax (and in some cases state income tax), this can be a powerful tax savings tool for founders, entrepreneurs, and investors with gains of far more than $10 million. The strategy provides an opportunity to multiply the exclusion, increase tax savings, and create generational wealth for you and your family.

As discussed earlier, a taxpayer can exclude the first $10 million of gain from federal taxes upon the sale of the shares, but gains above that will likely be subject to the highest capital gains tax. The QSBS exemption is per taxpayer, with each separate taxpayer eligible for their own $10 million exclusion. For example, assume a founder plans to sell his company and is holding QSBS shares that are valued at $45 million with no basis. While he can exclude his own $10 million gain, he would be subject to capital gains tax on the remaining $35 million gain. However, assume also that he is married with two young children. With the right planning, trusts could be set up and if qualified as separate taxpayers, each would get its own $10 million exclusion. Instead of paying capital gains tax on $35 million, the founder will only pay tax on the last $5 million, while also shifting generational wealth to his family.

With the complexity and rules around QSBS, it is never too early to start planning with this valuable tax exemption. The earlier you start planning and exploring, the higher the potential tax savings.

Bonus Depreciation & Section 179 Expense

As the 2022 year-end nears, a part of your year-end tax planning should be to review fixed assets placed in service during 2022 to ensure you are claiming the most favorable depreciation deduction and, if considering additional fixed asset purchases, to acquire and place the assets in service before year-end. All businesses should benefit from the rules increasing the amount of fixed/capital assets that can be expensed. There are specific rules for both section 179 and bonus depreciation that should be considered during tax planning as well as the interplay with the Excess Business Loss rules discussed earlier.

For assets acquired after September 27, 2017 and before January 1, 2023, bonus depreciation of 100% is allowed. The percentage of bonus depreciation is scheduled to be reduced to 80% in 2023 and 20% each year after. Property qualified for the bonus depreciation includes computer software, water utility property, qualified film, television, and live theatrical productions. Additionally, used property is now eligible for bonus depreciation. Qualified Improvement Property is treated as 15-year property and therefore eligible for bonus depreciation.

In general, asset acquisitions that are new or used with a recovery period of 20 years or less qualify for bonus depreciation. Unlike the §179 deduction, bonus depreciation can create a net operating loss (NOL).

As of January 1, 2018, Section 179 expensing increased to $1 million for tax years 2018 to 2022, with a phase-out threshold when acquisitions of section 179 property exceed $2.5 million for the tax year. These dollar amounts are indexed for inflation after 2018 (for 2022, Section 179 expensing increases to $1,080,000 and the phase-out purchase limit is now $2,700,000). Property eligible as section 179 property includes property used to furnish lodging and qualified real property improvements including roofs, heating, ventilation, air conditioning, fire, and security systems.

The immediate expensing of qualified assets may create current-year tax savings, but as part of tax planning discussions with your tax advisors, taxpayers should determine if immediate expensing is the right answer, especially considering the effects of other tax reform changes as well as from states decoupling from federal bonus depreciation rules and states that have not yet conformed to all aspects of recent federal tax changes.

**** Caution:*** Despite the many benefits of bonus depreciation, recall that this tool only accelerates deductions. As the percentage of depreciation decreases, future taxable income would be higher as a result of taking bonus depreciation in current and prior years.

**** Caution:*** With the loss of the depreciation addback to compute adjusted taxable income under Section 163(j) (the business interest expense limitation), taxpayers should model out the impact of bonus depreciation.

Expense Lower Cost Purchases. In addition to Section 179 and bonus depreciation elections, also consider the election that is available for “de minimis” asset purchases if certain requirements are met. With this election in place, your business may simply expense costs that fall below a specified level to the extent that the amounts are deducted for financial accounting purposes or in keeping with your books and records. The de minimis threshold can be up to $5,000 if your business has financial statements audited by an independent certified public accountant (CPA) or issued to a state or federal agency; the threshold is $2,500 for businesses without such financial statements.

> **** Safe Harbor Election:*** Eligible small businesses can currently deduct the cost of repairs, maintenance and improvements to a building by taking advantage of an IRS “safe harbor” election. Note that this is an annual election that can be made on a building-by-building basis. To be eligible for the election:
>
> - The property owner’s average annual gross receipts for the three prior tax years must be $10 million or less;
> - The building’s cost or other unadjusted cost basis must be less than $1 million; and,
> - The annual total cost of repairs, maintenance, or improvements to the building may not exceed the lesser of (1) $10,000 or (2) 2% of the building’s unadjusted cost basis.

Cost Segregation. Allows companies that recently built, renovated, expanded or purchased a building to identify, segregate and reclassify building-related costs that are currently classified as real property to shorter, depreciable lives. A cost segregation study identifies the portion of the building’s cost that can be considered personal property or a land improvement and depreciate it over a shorter period of time than the standard depreciation life or 39 years (commercial building) or 27 ½ years (residential building). This could afford business owners several benefits, including larger tax deductions, accelerated depreciation options and increased cash flow.

Carried Interest Tax Considerations

The TCJA added Section 1061 to the Internal Revenue Code to address carried interests. Section 1061 applies to certain items with respect to "partnership interests held in connection with performance of substantial services" in investment management. For carried interest, the holding period for long-term capital gain treatment is more than 3 years (rather than 1 year); capital gain from an asset with a holding period of 1-3 years is re-characterized as short-term capital gain. On January 7, 2021, the IRS and Treasury Department issued final regulations.

Managers of private investment funds receive two forms of compensation: a management fee for managing the fund (frequently 1-2% of the value of the fund's assets) plus carried interest. Carried interest is the portion of a private investment fund's profits that are allocated to the fund manager for achieving certain rates of return on the underlying assets of the fund. Fund managers often hold the carried interest in a general partnership that generally also includes ownership of a capital interest in the fund.

The management fee is taxed to the fund managers as ordinary income. The carried interest is a "profit interest" in the fund's underlying assets. This income allocated to the fund managers, but the character of the income is determined by the underlying assets in the fund and may be taxed at the favorable long-term capital gains rate. Also, the carried interest is capable of large appreciation depending on the performance of the fund, which allows fund managers to significantly reduce their effective income tax on their interests in the fund.

On November 3, 2021, the IRS released a set of "frequently asked questions" (FAQs) providing detailed reporting directions for certain pass-through entities and taxpayers reporting partnership interests held in connection with the performance of services – often referred to as "carried interests." The IRS release stated that the purpose of the FAQs is to provide guidance relating to both pass-through entity filing and reporting requirements, as well as owner taxpayer filing requirements in accordance with the final regulations. The FAQs provide two sample worksheets and instructions for applicable pass-through entities and taxpayers to use with returns filed after Dec. 31, 2021, in calculating and reporting the amount of certain net long-term capital gains of Applicable Partnership Interest (API) holders that must be recharacterized as short-term capital gains. A pass-through entity must attach Worksheet A to an API holder's Schedule K-1, Partner's Share of Income, Deductions, Credits, etc., reporting the pass-through entity's API one-year distributive share amount and API three-year distributive share amount. An API owner taxpayer calculates the amount that is treated as short-term gain and applies the final regulations using Worksheet B to determine the owner taxpayer's recharacterization amount and attaches it to the owner taxpayer's return. The FAQs also describe how the owner taxpayer reports these amounts on Schedule D, Capital Gains and Losses.

**** Planning Opportunities:***

- At the Portfolio Company (PC) level, use dividends to reduce the exit proceeds that will be subject to the new 3-year carry rule.
- At the Fund level, distribute the PC stock to the carry vehicle; whereby the carry vehicle will hold the stock until the gain is eligible for the preferred tax rate.
- For add-on investments to portfolio companies, consider making such investments through loans rather than through equity or, if debt needs be avoided or is not a viable option, consider a special class of preferred equity in order to limit potential future appreciation to the newly issued stock, thus minimizing the potential exposure to section 1061.
- Adjust carry allocations (i.e., hard-wired waiver) whereby no carried interest is earned from assets with a holding period that is not greater than 3 years. Should include a catch-up provision for future allocations from assets with holding periods of more than 3 years.
- Structure the carry vehicle as a Corporation – either U.S. or non-U.S.
- Change your incentive allocation to an incentive fee. There are many factors to consider in making this change so be sure to plan this out with your service providers and to model out the tax effects over multiple years to determine the viability of this change.

**** Estate Planning with Carried Interest:*** A primary goal of estate planning is to remove substantial appreciation from the client's estate before the appreciation occurs. Because the carried interest is a profit interest (basically an interest in a contingent future return) the value of the carried interest is generally low in the beginning stages of a private investment fund but may appreciate considerably over time compared to the initial value.

In a best-case scenario, making gifts of a portion of only the carried interest in the early stages of the fund would allow the client to transfer significant appreciation at a relatively low gift tax cost. Unfortunately, the Internal Revenue Code (IRC) has provisions that will typically prevent this efficient transfer by causing the deemed value of the gift to be the value of the carried interest plus the value of the retained interest (the value of the capital interest in the fund). For example, assume that at the time the fund manager desires to make a gift to a family member, the value of the manager's carried interest is $10,000 and the value of the manager's capital interest in the underlying fund is $10 million. The IRC provision (Section 2701) would cause the value of the carried interest gift to be $10,010,000 for gift tax purposes and thus utilize a significant portion of the fund manager’s applicable exclusion amount or even cause gift tax if the fund manager has used up his/her applicable exclusion amount.

To avoid the application of Section 2701, the fund manager may make a proportional gift of the carried interest and the capital interest. Again, assume that the value of the manager’s carried interest is $10,000 and the value of the capital interest is $10 million. Also, assume that the goal is to transfer 50% of the carried interest to family members of a younger generation. If the manager makes a gift of 50% of the value of the carried interest, the fund manager will also make a 50% gift of the capital interest. By making proportional gifts of the carried interest and the capital interest, the fund manager would be able to remove 50% of the appreciation in the carried interest from the manager’s estate at a total gift tax cost of $5,005,000. This transfer technique is sometimes referred to as the “vertical slice” transfer method – meaning that the transfer should capture a “slice” of all interests in the fund to adequately make a true vertical slice transfer.

Another option to avoid some of the administrative burdens and hurdles of a vertical slice approach would be to implement a derivative contract approach. Under the derivative contract approach, a financial instrument can be prepared to structure a right to payment to an individual. Typically, the right to payment only occurs if certain financial hurdles are met. The hurdles can be related to a period of time, how well an asset performs, or for other reasons. After the derivative is created, it can be valued as an asset. The asset can then be transferred by gift or sold, usually to a trust. Because the derivative contract is based on the performance of the underlying fund, and because the derivative contract (asset) is what is to be transferred, Section 2701 should not apply. Great care and planning should be taken when drafting the derivative contract. This is a complex document that can be prepared with tremendous flexibility to fit virtually any estate and financial goal situation.

State & Local Tax (SALT) Updates and Tax Planning Opportunities

While we do not anticipate any major changes in the federal tax landscape in the near future, the state and local tax world is constantly evolving to meet the needs of taxpayers while adapting to conform or decouple from the various past federal modifications. The following is a brief review of some of the current trends in state and local taxes.

- **SALT Pass-Through Entity Taxes (PTET)**. During 2022, 12 additional states enacted a PTET regime which brings the total number of states to 29 plus New York City. As a reminder, the Tax Cuts and Jobs Act of 2017 (TCJA) limited an individual's federal itemized SALT deduction to $10,000, thereby causing states to explore PTET workarounds. The following states (and New York City) currently have a PTET election: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Georgia, Idaho, Illinois, Kansas, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, New Jersey, New Mexico, New York, North Carolina, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Utah, Virginia and Wisconsin.

  The PTET allows the entity to pay state taxes and deduct them for federal income tax purposes thus reducing the taxpayer's overall federal tax liability. However, not every state PTET regime is the same. Careful analysis and planning of owners' tax attributes, the mechanics of calculating the PTET liability and limitations for taking credit for other state taxes paid, including the PTET as well as other implications to the owners' state income tax filings, must be completed. When owners of a pass-through entity are residents of different states, the outcome of these elections can yield some odd results with some owners paying more tax while other owners pay less. While the various state PTET regimes can be great for reducing overall tax liabilities, the importance of analyzing the implications of these elections on the owners' overall income tax picture prior to making election(s) is paramount to avoid or prevent adverse tax results.

**** New York State (NYS) / New York City (NYC) PTET reminder and update:*** In 2021, NYS joined the list of states that enacted a PTET regime. For 2022, the election was due by September 15, 2022. Businesses that did not make the election, but are considering it for 2023, must make the election by March 15, 2023. Please refer to our earlier Anchin Alert for more details on the NYS PTE Tax. https://www.anchin.com/news/anchin-alert-new-york-provides-clarity-on-the-new-pass-through-entity-tax-an-opportunity-for-tax-savings

In order to elect into the newly enacted NYC PTET regime for tax year 2022, you must have made a valid NYS PTET election by September 15, 2022. The NYC PTET is only available for partnerships and limited liability companies (LLCs) with NYC resident partners or members, and S corporations of which all shareholders are NYC residents. Nonresidents of NYC will not receive any benefit under the regime because the NYC personal income tax only applies to NYC residents. Please refer to our earlier Anchin alert regarding the NYC PTET for more details. https://www.anchin.com/articles/official-guidance-on-the-nyc-pass-through-entity-tax/

- **Telecommuting and Residency Changes**. Inquiries from clients about moving out of high-tax states have increased each year since the early days of the COVID-19 pandemic, and 2022 is no different. The COVID-19 pandemic has proven that we can work remotely and has prompted many to explore and think about where they want to live and work. Moves from high-tax states such as New York, New Jersey and California certainly pose residency audit risks due to the respective state's loss of anticipated tax revenues. Generally, in order to change residency status, taxpayers must change their domicile. Taxpayers who are attempting a domicile change should be aware that several factors are considered in the determination.

  **** Caution:*** A temporary relocation will not change a taxpayer's domicile. However, statutory residency issues may be triggered due to a temporary relocation, where some states will treat taxpayers who exceed a certain in-state presence threshold, such as 183 days, and have a place of abode as a resident in their state for tax purposes. It is therefore possible that a taxpayer can be treated as a resident of two states – one based on domicile and the other based on statutory residency. In most cases, the resident state tax credit will protect the taxpayer from double taxation of wages and other business income, but depending on the state, double taxation could apply to other types of income, such as investment income (i.e., interest, dividends and capital gains) and other intangible income.

  Advanced planning is central to managing and mitigating this risk. Understanding each individual's facts, circumstances and intent are critical factors as well as researching and understanding each state's specific residency and domiciliary laws.

- **Nexus**. Employees working in multiple states create payroll withholding and state tax nexus issues for the employer and employee. Failure to properly withhold and/or remit payroll taxes can come at a high price if a state imposes a penalty on the employer. If a state considers the employer's failure to do so intentional, it may have the power to impose a penalty as high as 100% of the amount not withheld. Considerations must be given to employees that have transitioned to teleworking permanently or that have relocated during the pandemic as those work arrangements are no longer deemed temporary and will most likely require a change in reporting. This, of course, assumes the employer is knowledgeable of such changes on a timely basis.

States are continuing their attempts to implement and enforce their laws to find nonresident, non-filing taxpayers. Nexus remains a crucial element of managing a business's state tax risk. A nexus is a relationship or connection between two or more entities. In tax law, it is a relationship between a taxing authority, such as a state, and a business. A nexus must exist before a taxing authority can impose a tax on the enterprise, and it requires that there be a definitive link between the jurisdiction and the business. With state budget shortfalls expected to continue into 2023 and beyond, taxpayers should expect to receive nexus inquiries from various state and local taxing authorities.

**** Practice Tip:*** For those employers allowing employees to work remotely, nexus implications need to be thought out not only for income, non-income and sales taxes but also for state payroll withholding taxes and unemployment insurance. Both physical presence and economic presence must be thoroughly analyzed for all potential state taxes when undergoing a nexus study to understand and better manage risk.

**** Caution:*** Due to significant fiscal constraints as a lingering result of the pandemic, all signs point to an increase in state audit activity. State letters with an intention to audit as well as nexus questionnaires and notices should be taken seriously and should be addressed timely. We stand ready as your expert partner to assist you in handling such communications and to help you proactively plan.

**** Anchin Observation:*** Businesses should, if they have not already done so, communicate with their employees to obtain the necessary information to determine possible state filings.

International Tax Focus – Private Investment Funds Update

This year produced some significant changes to existing foreign tax credit rules, as well as enhanced foreign reporting requirements for partnership and S corporations. A corporate minimum tax was also imposed for large corporations. The following are highlights of some of these new provisions as well as an update on other existing international tax provisions:

New Foreign Tax Credit (FTC) Regulations: Current U.S. tax law allows taxpayers to claim a credit or deduction for foreign income taxes imposed by foreign countries. The FTC may not exceed the foreign taxes paid multiplied by the fraction of the taxpayer's income sourced outside the U.S. over the taxpayer's total taxable income from all sources (outside and inside the U.S.).

On January 4, 2022, new final FTC regulations were released by the IRS and the U.S. Department of the Treasury providing guidance on whether a foreign tax is eligible for an FTC. These regulations substantially modify prior regulations and impose a new requirement (the "Attribution Requirement") that may restrict U.S. taxpayers from claiming FTCs with respect to certain foreign withholding and other taxes that were creditable under the prior rules.

The Attribution Requirement provides that a foreign tax must be based on either activities, source of income or situs of property arising in the foreign country that imposes the tax. These determinations are based on principles reasonably similar to U.S. domestic law. The complexity of the regulations will require taxpayers to spend additional time and resources analyzing whether a foreign tax is creditable in the U.S. On November 18, 2022, the IRS issued proposed regulations that, if finalized, would relax some of the stringent creditability requirements imposed by the final regulations and provide some flexibility in the rules to take account of the wide variety in foreign countries' income tax laws.

For creditability, a foreign income tax must satisfy the net gain requirement, which includes tests to establish realization, gross receipts and cost recovery. Under the net gain test, foreign income taxes were required to meet the following three requirements to be considered creditable:

- Realization Requirement: Imposed on certain realization events or pre-realization events.
- Gross Receipts Requirement: Imposed on the basis of gross receipts or a measure of deemed gross receipts that is not likely to exceed actual gross receipts.
- Cost Recovery: Allows the recovery of significant costs attributable to the gross receipts or a measure of significant costs that is likely to approximate actual costs.

The final regulations contain special rules for (1) foreign withholding on outbound payments to nonresidents; (2) taxes deemed directly paid by a nonresident under a U.S. income tax treaty; and (3) taxes deemed paid by a controlled foreign corporation (CFC).

Corporate Minimum Tax: On August 16, 2022, President Biden signed into law the Inflation Reduction Act (IRA). For companies that report certain income thresholds of over $1 billion over a three-year period, the IRA includes a 15% corporate alternative minimum tax based on book income. The IRA exacts a new 15% minimum book tax on adjusted financial statement income (AFSI) of an applicable corporation. An applicable corporation is generally any corporation (other than an S-corporation, regulated investment company or real estate investment trust) with a three-year average annual AFSI exceeding $1 billion. This new minimum tax is effective for taxable years beginning after December 31, 2022.

Global Intangible Low-Taxed Income (GILTI): The GILTI rules were originally introduced under the TCJA on the heels of the section 965 repatriation tax, with additional regulations released this past year in hopes of providing clarity to those U.S. taxpayers that were caught up in the TCJA's revamped international tax regime. This provision was designed to deter the deferral of offshoring earnings and functions as a current income inclusion (similar to a consolidated return concept) on undistributed foreign earned income, equal to the income earned by certain foreign corporations with U.S. shareholders that exceeds 10% of that foreign corporation's depreciable tangible property. Although the word "intangible" is part of the GILTI acronym, this provision can potentially apply to all offshore operating income that is not subject to Subpart F rules or other specified income (i.e., shipping, insurance, oil & gas, etc.). Currently, only domestic corporations are generally allowed a deduction of 50 percent of their GILTI inclusion and can additionally claim a foreign tax credit of up to 80 percent of foreign corporate income taxes paid or accrued on GILTI inclusions. GILTI high-tax exception regulations were finalized in July 2020, which provides retroactive (to 2018) and prospective relief to taxpayers conducting business in foreign high-tax jurisdictions. Under this exception, income subject to tax in a foreign country at an effective rate greater than 18.9 percent would not be included in GILTI, at the election of the taxpayer. The election must be made annually and when elected, would apply to all CFCs of the U.S. shareholder making the election.

**** Anchin Observation:*** The high tax exception and the rate that would have qualified would have been impacted by any U.S. corporate tax rate change, however this seems to be off the table in view of the current democratic proposals and the change in control of the House of Representatives.

**** Anchin Observation:*** The discussion above by which taxpayers can minimize the effect of the GILTI inclusion are generally only available to domestic C corporations. For pass-through entities (and ultimately individual taxpayers) that own controlled foreign corporations (CFCs), who would otherwise be subject to ordinary tax rates on their GILTI inclusions and potentially double taxed due to disallowed foreign tax credits, making a §962 election provides a path through which they may reduce the effect of their GILTI inclusion, by lowering their effective tax rate overall until distributions from the CFC are made which may provide a tax deferral opportunity.

- ***IRC Section 962 Election:*** This election allows certain U.S. individuals to elect to be treated as a domestic C corporation for federal income tax purposes with respect to Subpart F and GILTI income. Treatment as a domestic C corporation through a §962 election allows U.S. individual shareholders to be taxed at corporate rates on their GILTI inclusions, and to take advantage of the 50% GILTI deduction, while affording them the ability to utilize foreign tax credits that would otherwise be unavailable without the §962 election. The election can lessen the U.S. tax on GILTI inclusions if the foreign income tax rate on such income is at least 13.125%. This result can be achieved by an annual election, without the need to interpose a U.S. C-corporation in the structure.

  **** Anchin Observation & Caution:*** After the 962 election is made and any residual U.S. tax is paid on the GILTI income, eventually, when a distribution is made from the CFC to the U.S. shareholder, it will be taxed as an ordinary dividend (and qualified, if applicable) with ability to claim foreign withholding tax credits. Thus, any reduction in taxes as a result of the 962 election are temporary until a distribution is made. The timing of the distribution may result in a mismatch of foreign withholding tax credit usage if the taxpayer does not have sufficient foreign sourced income from similar sources in the year the withholding tax is imposed. In such case, the election ultimately may increase the overall tax burden. As a result, planning for deferral of distributions may be a key element to managing the overall tax burden appropriately.

- ***Corporate Shareholder:*** Certain U.S. individual shareholders owning shares of foreign entities operating in non-treaty countries, may find that interposing a domestic C corporation to own their foreign entities may provide a more attractive tax-planning alternative than the §962 election discussed above. While both the §962 election and use of a C corporation intermediary may grant taxpayers the ability to lessen the effect of GILTI inclusions, using a C corporation provides taxpayers with an important benefit that the §962 election does not where the CFC is organized in a non-treaty jurisdiction. As C corporations pay qualified dividends, the use of an actual C corporation allows distributions from that corporation to be taxed at qualified dividend rates (capped at 20%). Without interposing a domestic corporation in the structure, dividend distributions from non-treaty corporations would not be eligible for qualified dividend treatment and thus would be taxed at ordinary individual income tax rates.

    - ***Dividends Received Deduction (DRD):*** Under the TCJA, domestic C corporation shareholders are entitled to a DRD for dividends received from foreign corporations that are greater than 10% owned and for which certain holding period requirements are met. U.S. taxpayers utilizing a domestic corporation in the ownership chain can have such corporation receive dividends from its foreign subsidiary without U.S. tax by virtue of the DRD. Additionally, once income is distributed from the corporation to its shareholders, such income will be taxed to the U.S. individuals at qualified dividend rates, which potentially reduces the income tax rate imposed on foreign subsidiary income from ordinary tax rates to a maximum (qualified dividend) rate of 20%.

      **** Caution:*** Careful planning and analysis should be undertaken to determine the viability of this alternative since the use of a domestic holding corporation may involve various state corporate taxation issues as well as added foreign tax consequences. One should also pay attention to Personal Holding Company tax rules that would negate any benefit if the income is not distributed.

**** Planning Opportunity:*** If a U.S. Shareholder has mostly foreign sourced low/no taxed income from a direct CFC, then through the use of a C corporation it may be possible to pay an effective tax rate that is less than the rate if applied to a U.S. Shareholder making a §962 election.

- ***Final Subpart F Regulations:*** On January 25, 2022, final Subpart F Regulations were published. Generally, the regulations will conform the historic Subpart F high tax exception rules to the GILTI high tax exception rules and coordinate the two in a unified way so that Taxpayers cannot receive any undue benefit by planning into one set of rules versus the other.

- ***Proposed PFIC Regulations:*** As part of the January 25, 2022 subpart F regulations, treasury also released proposed PFIC regulations. These proposed regulations, would no longer allow a domestic partnerships or S-Corps, to make elections on behalf of its shareholders. The proposed rules would greatly impact the numbers of filings with the IRS, as each shareholder would have to file a Form 8621 for each PFIC it is indirectly invested in.

- ***Foreign-Derived Intangible Income (FDII):*** Also introduced under the TCJA, a U.S. C corporation that provides services or makes sales of tangible property to foreign customers located outside of the U.S. now has the ability to take a deduction on its foreign-derived intangible income (FDII). The FDII deduction is not eligible to financial services companies and is intended to encourage onshoring of intellectual property (IP) by providing an incentive for U.S. entities to develop their intangibles or export sales operations inside the U.S. rather than in foreign localities. While mechanically the FDII deduction can be quite complex, the framework for calculating the deduction amount generally works as follows:

    - FDII-eligible income constitutes net income earned by domestic C corporations from the sale of property or provision of services to foreign persons or entities over a certain threshold.

    - The threshold is 10% of the corporation's U.S. depreciable tangible property. The excess income over the threshold is multiplied by the applicable current year deduction rate of 37.5%, and the result is the corporation's FDII deduction.

    - The FDII deduction can effectively reduce the corporate tax rate on applicable earnings from 21% to 13.125%. Notably, this deduction is available only to domestic entities taxed as C corporations and is effective for tax years beginning on or after January 1, 2018 (and the effective rate will change from 13.125% to 16.4% in 2026).

    - The FDII deduction may be reduced if a GILTI deduction or NOL deduction is being used against Taxable Income.

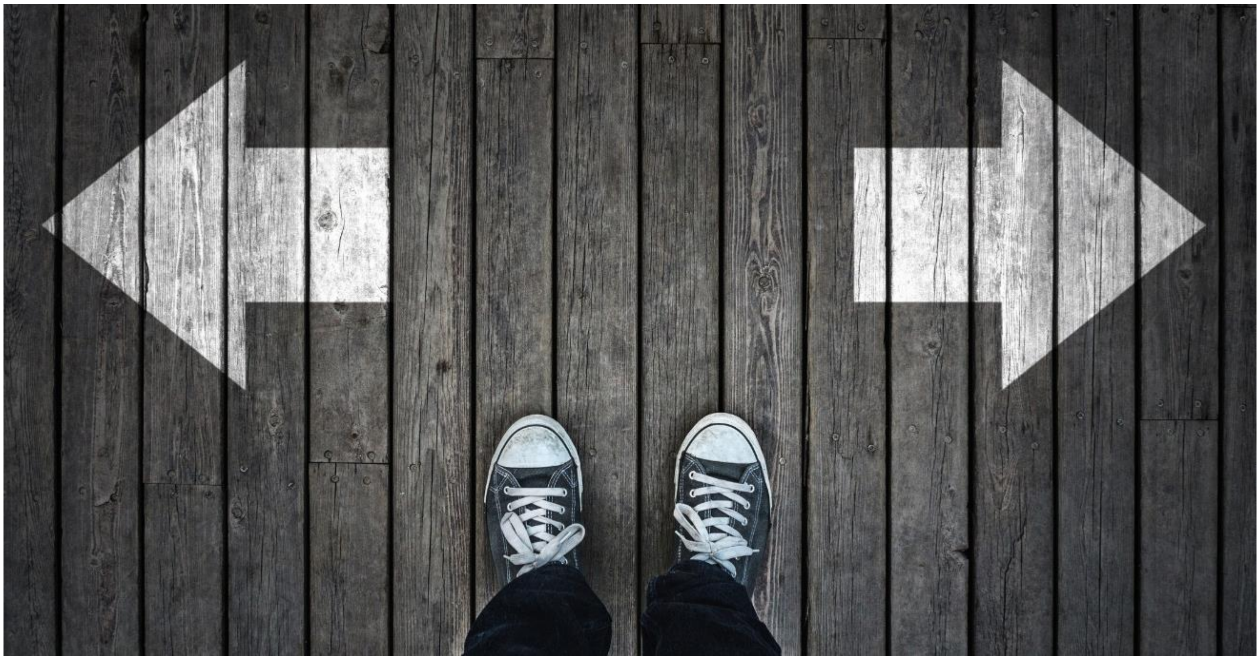
**** Planning Opportunity:*** The allocation of expenses to FDII eligible income may present an opportunity for some companies to maximize the deduction. Performing an FDII allocation study akin to an R&D study can yield substantial benefit while also ensuring that the documentation standards for taking the deduction are being met in the event of an audit.

- **International tax reporting for tax year 2022.** Tax year 2021 saw the IRS introduce two new sets of forms to disclose foreign activities of partnerships and S corporations, the Schedule K-2 and K-3. While these schedules were designed to standardize the reporting of international tax information flowing to owners of pass-through entities, the implementation of this reporting was challenging in tax year 2021, due to the late release of IRS guidance particularly regarding the filing requirement of domestic pass-through entities with little or no foreign partners or foreign activity. As we head into tax year 2022, the IRS has released draft instructions for the 2022 Schedule K-2 and K-3 which provide tax practitioners and taxpayers clarity and guidance regarding who is exempted from the Schedule K-2 and K-3 filing requirement. While some of the parameters are similar to the 2021 exemptions, there are subtle and distinct differences to be aware of for the coming year.

  The IRS released draft 2022 Schedules K-2 and K-3 instructions for partnerships on October 25, 2022, which includes a "Domestic Filing Exception." Shortly thereafter, the IRS released the draft 2022 Schedules K-2 and K-3 instructions for S corporations which closely mirrors the partnership instructions. The "Domestic Filing Exception" would exempt pass-through entities from filing the Schedules K-2 and K-3 if they meet certain criteria. As of December 2, 2022, the IRS has updated the draft instructions for Schedule K-2 and K-3 for additional modification to the "Domestic Filing Exception" that would ease some of the proposed exemption rules in earlier draft instructions by deferring the dates that which certain required actions need to be taken and potentially reducing the steps that must be undertaken to aces the exception and the information that must be provided.

  If a pass-through entity does not meet the domestic filing exception, there is also a "Form 1116 Exemption exception" that pass-through entities may qualify for if all of its partners/shareholders are individuals that are not required to file Form 1116 to claim the foreign tax credit on their personal tax return (all their foreign income is passive category income reported on Forms 1099, Schedule K-1s, or Schedule K-3s and the tax credit is not greater than $300 ($600 for joint filers)). The pass-through entity would need to receive affirmative confirmation of the above from all its partners/shareholders by one month before the due date of the tax return (without extensions).

**** Anchin Observation:*** While the "Domestic Filing Exception" would exempt pass-through entities from the Schedule K-2/K-3 filing requirement, many investment partnerships will not be able to meet the criteria needed to be eligible for this exemption. In addition, it may be difficult to meet and attain the affirmative confirmation needed to qualify for the "Form 1116 Exemption exception." Both these exemptions will probably be most relevant for management companies and general partner entities as opposed to the investment partnerships themselves.



Choice of Entity Considerations – Which Entity Makes the Most Sense for you?

The choice of entity is among the most important decisions facing taxpayers when starting a business or investment activity. Choosing the appropriate type of entity is a complex analysis and is generally dependent upon many factors, such as business objectives, type of business, cash needs, and ease of obtaining new capital. The TCJA included many changes that affected this analysis. One of the headline changes was the top C corporation tax rate "permanently" decreased from 35 percent to a flat 21 percent. Taxpayers should keep in mind that current tax proposals would raise tax rates and make other changes to the federal income tax system for corporations and high-wealth individuals. These proposals should be monitored, and their potential effects should be considered when evaluating the short and long-term benefits of a particular entity choice.

C Corporation: While the TCJA reduced the federal corporate rate from 35 percent to 21 percent, it did not change the tax rate on distributions from a corporation to its shareholders. Qualified dividends received by non-corporate taxpayers are still taxed at a maximum rate of 20 percent (plus an additional 3.8 percent for taxpayers subject to the net investment income tax). The combined effective federal tax rate for non-corporate shareholders on distributions classified as ordinary dividends from a C corporation is 40.8 percent.

Pass-Through Entity: The TCJA also provided a rate reduction for non-corporate taxpayers on income from flow-through entities. Income of flow-through entities is not taxed (federally) at the entity-level but is instead included by the owners on their respective income tax returns. The TCJA reduced the top non-corporate tax rate on ordinary income from 39.6 percent to 37 percent while also providing a 20 percent deduction (via Section 199A) for certain business income for non-corporate taxpayers that own flow-through entities. This 20 percent deduction reduces the effective federal tax rate on flow-through income from 37 percent to 29.6 percent. To the extent the owners of a flow-through entity have included these amounts as taxable income, the cash can generally be distributed from the flow-through entity without additional tax. Note that there are various other factors that need to be weighed when planning for the 20 percent deduction such as payroll. In addition, not all pass-through income is eligible for the 20 percent deduction; therefore, taxpayers should consult their tax advisors to verify, discuss and analyze.

Individual partners in a partnership may also be subject to self-employment taxes or the 3.8 percent net investment income tax, depending on how the partnership is structured (limited liability company versus limited partnership) and on their involvement with the business. In addition, shareholders of S corporations who work in the business are required to pay themselves reasonable compensation, which is taxable at ordinary income rates. This compensation is not eligible for the 20 percent deduction for certain business income. The S corporation is responsible for paying half of the employment taxes, and the S corporation shareholder pays the other half. Accordingly, the effective rate of tax on income from a flow-through entity will depend on whether the income is subject to self-employment taxes, employment taxes or the net investment income tax.

***** *Practice Tip:*** When modeling this out and comparing different effective tax rates, entity distributions should be considered. If a business plans to reinvest all of its after-tax proceeds and not make any distributions, a C corporation would likely provide a greater opportunity for growth because the after-tax proceeds (which are subject to federal tax at a 21 percent rate) generally are higher than those of a flow-through entity (assuming the flow-through entity makes distributions to enable its owners to pay taxes). Conversely, if a business plans to distribute all of its income, a flow-through entity likely is more efficient.

***** *Caution:*** Major issues can arise under various state and local tax and/or foreign country tax systems that would need to be factored into any choice of entity analysis. It is also important to note that a C-corporation cannot avoid paying shareholder distributions (dividends) without having a reasonable business need to retain the cash. Otherwise, it risks becoming subject to a 20 percent Accumulated Earnings Tax (AET). Such reasonableness of anticipated cash needs should be assessed based on facts existing at the close of the tax year and, because the burden of proof rests with the taxpayer, proper documentation is recommended.

***** *Reminder - Net Operating Losses (NOLs):*** The Tax Cuts and Jobs Act (TCJA) of 2017 eliminated the carryback of net operating losses (NOLs) for individuals and corporations for tax years ending after December 31, 2017. Starting January 1, 2021, NOLs arising in tax year 2021 and beyond may only be carried forward indefinitely. In addition, for tax years 2021 and beyond, a NOL may not exceed 80% of taxable income computed without regarded to the NOL deduction.

Estate & Gift Tax Planning Reminders & Opportunities

Whether or not you would be subject to estate taxes under the current exemptions, it's a good idea to consider whether you can seize opportunities to potentially lock in tax savings today. Well-thought-out estate and gift planning helps preserve your wealth and pass it on to your beneficiaries at a minimal tax cost. Proper planning can result in your family and other beneficiaries' receiving what you had intended.

Before describing specific strategies, a recap of the current law with respect to the annual exclusion and lifetime exemption is in order. Recall that the current federal gift and estate tax rate maxes out at 40%.

- ***Annual Exclusion:*** The 2022 annual gift exclusion is $16,000. This exclusion is the amount that can be gifted per donee per year tax-free. In addition, married couples can elect to split gifts. Utilizing this strategy, married taxpayers can gift up to $32,000 to an individual in 2022 before a gift tax return is required. Annual Exclusion gifting is an excellent way to reduce the value of a taxpayer's gross estate over time (without utilizing one's lifetime exemption), thereby lowering the amount subject to estate tax.

    **** Caution:*** Each year you need to use your annual exclusion by December 31st of that year. The exclusion does not carry over from year to year if not used.

- ***Lifetime Exemption:*** The 2022 lifetime exemption is $12,060,000 (expected to rise to $12,092,000 in 2023), is indexed for inflation and is currently based on an expanded base which is scheduled to sunset at the end of 2025, when it will revert back to approximately $6,000,000 in 2026. This exemption is the total amount that can be gifted over the course of a donor's entire lifetime tax-free. For those considering using the increased exemption now, the IRS has issued regulations that confirm that gifts made utilizing the lifetime exemption will not be clawed back if the exemption is reduced through subsequent legislation. The increased exemption amount is a "use it or lose it" proposition – a taxpayer who made lifetime gifts of $5,000,000 cannot treat those gifts as having come from the increased exemption portion when the exemption drops in 2026.

**** Anchin Observation:*** Taxpayers living in states with no current state gift tax may wish to accelerate or focus on additional gifting of assets in 2022. Of course, your financial security and long-term objectives should be assessed and discussed before proceeding with such a gifting strategy.

- ***Portability Election:*** This election remains in effect under current law. It is a vital planning tool for taxpayers, especially if the death of a spouse occurs while the increased exemptions are in place. Portability allows the surviving spouse to have the benefit of the deceased spouse's $12,060,000 exemption, even if the surviving spouse dies when a lower exemption amount is in effect.

  **** Caution:*** An estate tax return will need to be filed when the first spouse dies in order to make the portability election, even if the gross estate is under the filing threshold. States may have different rules related to portability; therefore, it is important to consider these rules as well to avoid wasting this election.

- ***Basis Step-up:*** Current law continues to allow a step-up in tax basis for most inherited appreciated assets (excluding retirement accounts and annuities). Generally, basis is the amount paid for an asset. Upon death, the beneficiaries are allowed to increase the tax basis of an inherited asset to the fair market value at the date of the decedent's death. This is a taxpayer-friendly provision that allows beneficiaries to be taxed on a much smaller capital gain, or none at all, should the inherited assets be greatly appreciated and the new owner desires to sell.

Some gift and estate tax planning strategies to consider:

- ***Funding education through 529 plans*** by December 31, 2022 to apply 2022 annual gift tax exclusion treatment to the contributions. You can "front-load" 529 plans by making five years' worth of annual exclusion gifts to a 529 plan. In 2022, you can transfer $80,000 ($160,000 for a married couple splitting gifts) to a 529 plan without generating gift tax or using up any of your gift tax exemption. Also note that front-loading 529 plans may limit available state credits.

  **** Caution***: Contributions to 529 plans are gifts to the beneficiary of the plan. Cash gifts and 529 contributions to the same beneficiary which total more than $16,000 ($32,000 for a married couple splitting gifts) will result in taxable gifts. Similarly, front-loading 529 plans limits the available tax-free gifts to that beneficiary for four additional years.

- ***Pay tuition and medical expenses.*** You may pay these expenses without the payment being treated as a taxable gift to the student or patient, as long as the payment is made directly to the provider.

- ***Loans to Family Members.*** Intra-family loans can be a solution for parents who would like to help a child achieve specific goals, such as buying a home or starting a business, but would also like to child to have some "skin in the game" rather than simply gifting the funds to the child. Note that these loans could also be from the child to the parents or between other family members or family trusts.

  The minimum interest rate charged between family members is known as the Applicable Federal Rate (AFR) where long-term (more than 9 years) loans can be made at rates as low as 4.34% and rates on loans for shorter periods can be even lower. It is a simple and effective estate planning mechanism for providing capital to children or grandchildren without gift tax. Note that when you make a loan to a family member, you must charge interest in order to avoid having the transaction treated as a gift. To the extent that the family member earns a higher rate of return on the borrowed funds than the very low-interest rate being paid, the excess or difference is effectively transferred free of gift taxes.

  **** Anchin Observation:*** A family loan ideally creates a win-win situation for the borrower and the lender. However, if the family loan goes sideways, it may hurt your relationships as well as your credit scores. Before borrowing from or lending to family members, think through all of the possible consequences. If the loan still makes sense for both parties, be sure everyone is on the same page by putting the loan provisions in writing and carefully tracking the repayments.

- ***Spousal Lifetime Access Trusts (SLAT).*** Married taxpayers may want to make lifetime gifts to use the balance of their exemption but may be wary of not having access to the gifted funds. The SLAT is an irrevocable trust which has the benefit of removing assets by gift from the estate but allowing the spouse and other beneficiaries to have access to the assets and their related income. The income from a SLAT is taxable to the creator of the trust (a "grantor" trust), whether or not there are distributions to beneficiaries. The creator's payment of the trust's tax might seem like an additional gift to the trust, but IRS rules do not count it as such, making this feature an added benefit as it allows the trust assets to grow without being depleted through the payment of taxes.

  **** Anchin Observation:*** This type of trust can be structured to benefit multiple generations while not being subject to estate tax in subsequent generations.

- ***Sale of Assets to an Intentionally Defective Grantor Trust.*** Using this strategy, the taxpayer sells assets to a grantor trust in exchange for a promissory note. The use of a grantor trust allows the sale(s) to not trigger a gain or income tax on the sale. The payment of interest on the promissory note is not taxable (nor a deductible expense) for the grantor. In addition, the grantor will continue to pay the income taxes on the trust income, thereby allowing the trust assets to grow tax-free. This type of planning is perfect for assets with high appreciation potential.

- ***What about Grantor Retained Annuity Trusts (GRATs)?*** With market volatility and many assets (particularly real estate) trading at depressed values, a GRAT may be a great option for certain assets. It provides you with a fixed annual amount (an "annuity") from a trust for a term of years (as short as two years under current law). The annuity retained may be equal to 100% of the amount that you use to fund the GRAT, plus the IRS-prescribed rate of return (known as the 7520 rate) applicable to GRATs. After the trust term ends, the amount of assets (if any) left in the trust after the annuity payments have been made remain in the trust, free of gift or estate taxes. Because your beneficiaries will retain the full value of the GRAT assets at the end of the trust's term, if you survive the annuity term, the value of the GRAT assets in excess of your retained annuity amount will then pass to the beneficiaries with no gift or estate tax, either outright or through a continuing trust vehicle. If the grantor dies during the term of the GRAT, the entire balance will revert to the grantor as if the GRAT transaction never took place. In addition, if the value of the GRAT assets fall below the amount required for the requisite annuity payments, the GRAT pays everything in it back to the grantor as if the GRAT transaction never took place.

    **** Planning opportunity:*** Consider using a "zeroed-out GRAT" - structured so that the value of the gift transferred to the beneficiary is *de minimus, resulting in near* zero gift tax.

    **** Caution:*** Although no changes to the GRAT rules have yet been made, various proposals have been set forth over the years that, if enacted, would make GRATs less beneficial. Among other things, some of the proposals would have required a 10-year minimum term for GRATs and a remainder interest greater than zero, effectively eliminating the ability to create a "zeroed-out" GRAT. For this reason, it may be wise to consider establishing a GRAT sooner rather than later.

    **** Planning opportunity:*** Instead of setting up one GRAT containing all transferred assets, why not set up multiple GRATs for different asset types – some conservatively invested and others with more risk? The winners, or appreciated GRATs, do their job of transferring wealth to the next generation; the losers collapse, as if the GRAT for these assets never took place.

- ***Charitable Lead Trust (CLT):*** CLTs are a powerful planning tool that can prove to be a tax-efficient way for a taxpayer to fulfill goals of both charitable giving and family wealth transfer. A CLT is a charitable split-interest trust that can be created during life or at death, under a revocable trust or will. The lead income interest is paid to the charitable organization, and the remainder interest is transferred to a noncharitable beneficiary such as the donor or donor's family. The income interest can be in the form of a “guaranteed annuity” interest (a charitable lead annuity trust (CLAT), more on this in the Charitable Contribution section below) or it is a “unitrust interest” (a charitable lead unitrust (CLUT)).

- ***Charitable Remainder Trust (CRT):*** In a period of rising interest rates and record inflation, there are a couple of wealth transfer tax strategies that are more powerful and useful than others. One such strategy is the CRT. A taxpayer with an asset that has a large unrealized gain can effectively contribute that asset to this type of trust. The trust is tax-exempt (state tax laws may differ) and can effectively sell that asset on a tax-deferred basis. The taxpayer will also get a charitable income tax deduction on their personal tax return in the year of funding.

Charitable Contributions: Tax Strategies

The charitable deduction continues to be a flexible and beneficial option for philanthropically minded people to support the causes they hold dear and to also reap tax benefits for doing so. Developing a charitable giving strategy can help you achieve the meaningful impact you envision and take advantage of tax benefits along the way.

- **Gifts to public charities**. Contributions of cash to qualified public charities can be deducted in an amount up to 60% of the taxpayer's adjusted gross income (AGI) in a given year. For contributions of appreciated publicly-traded securities, the full fair market value (FMV) of appreciated property held over one year can generally be deducted up to 30% of AGI.

- **Gifts to private foundations**. Contributions of cash can be deducted up to 30% of AGI, and the full FMV of publicly traded securities (if owned for over a year) can be deducted up to 20% of AGI. The deduction for gifts of other appreciated property may be limited to the taxpayer's cost basis.

  **** Caution:*** Deduction of contributions subject to the 30% and the 20% limitations are first reduced by the amount of cash contributions subject to the 60% limitation. Excess amounts not currently deductible can by carried forward for 5 years.

Understanding the tax strategies related to charitable contributions can help you decide how much to give, what asset to give and when to give, so you can provide the maximum amount to charity—and receive the maximum tax advantages for yourself. Some viable strategies are outlined below.

- ***Bunching Charitable Donations***: Prepaying charitable contributions on an alternating or every few years basis allows taxpayers to itemize deductions in the year contributions are made and use the standard deduction in years when there is little or no charitable giving. For 2022, consider bunching donations to take advantage of the tax deduction limits reduced by the CARES Act (discussed above).

  - A **Donor Advised Fund (DAF)** is a vehicle that could be used and makes it easy for taxpayers to bunch donations. Using a DAF, the taxpayer is able to claim the charitable deduction in the year of funding and can make grants from the DAF to desired charities over a period of years.

    - If you would like to create a donor advised fund in 2022, you can establish one as late as December 31st; however, additional time may be required if you are planning on funding the account with anything other than cash. Our Firm has established a donor advised fund as an accommodation to our clients and friends.

- ***Charitable Lead Annuity Trusts (CLATs).*** CLATs are charitable trusts designed to pay an annuity to charitable beneficiaries during their term, after which the remaining assets are returned to the grantor or distributed to family members. CLAT creators can enjoy a current income tax deduction for the present value of the payments expected to go to charity over the term of the trust. The discount rate is the IRS 7520 rate (currently 5.2% in December 2022).

**** Planning opportunity***: CLATs can be used to offset current income with charitable deductions, with the possibility of the remaining assets returning to the taxpayer or to family members. The CLAT can be designed to reduce current income tax and have little or no gift tax (depending on who gets any remainder and the terms of the trust). The value of the remainder depends on the performance of the CLAT's assets. Performance returns in excess of the IRS prescribed rate (the 7520 rate) result in remainder assets that can be returned to the taxpayer or be passed to family members.

- **Qualified Charitable Distribution (QCD) from an IRA.** If you are at least age 70½, have an IRA, and plan to donate to charity this year, another consideration to make a QCD from your IRA. This strategy can satisfy charitable goals and allows funds to be distributed from an IRA without any tax consequences. A QCD can also be appealing because it can be used to satisfy your required minimum distribution (RMD)—up to $100,000 - for tax year 2022.

  QCDs may be attractive if you have few other deductions or if you are already close to your charitable deduction limitations. Because the tax-free QCD is never reported as a deduction, it is not counted against the charitable limits and does not require you to itemize deductions to be effective.

  Alternatively, if you are required to take an RMD and have a desire to contribute to a charity, you could use the RMD proceeds to make a charitable donation. Your IRA distribution would then be reported as income, but the subsequent charitable contribution using the proceeds from the RMD would generally offset the tax consequences—to the extent that the limits allow it.

What about Securities?

If you are contemplating making charitable contributions before year end, the most tax-efficient way to do this is to give appreciated publicly traded stock that has been held for more than a year. Doing so, donors receive a charitable contribution deduction equal to the fair market value of the securities contributed and escape paying capital gains tax (and the 3.8% surtax on net investment income) on their built-in appreciation. Also, the donation of appreciated, publicly traded securities does not require you to get a qualified appraisal to establish the value of your deduction. Note that this is a much better result than selling the stock, paying a capital gains tax, and then deciding to use the proceeds to make cash contributions to charity.

****** Caution & Reminder:*** Do not donate depreciated securities to charity. If this is the case, sell the securities first and then donate the proceeds to charity so that you can take the capital loss on the sale and get a charitable deduction for the donated cash.

****** Caution & Reminder:*** If you are planning on donating a non-publicly traded stock to a public charity, you are ***required*** to get a qualified appraisal to establish its value. Otherwise, you will only be entitled to a charitable deduction equal to your basis in the stock.

***** Caution & Reminder:*** The value of a donation of publicly traded securities held for a year or less is limited to the donor's cost basis.

**** Planning opportunity:*** Consider a partial non-liquidating distribution from investment partnership interests consisting of long-term appreciated securities in order to make charitable contributions. This planning opportunity may also be advantageous for securities received from an investment partnership subject to the carried interest rules discussed earlier.

Before undertaking any of the above giving strategies, you should consult your legal, tax or financial advisor. Nonetheless, each of the strategies, properly employed, represents a tax-advantaged way for you to give more to your favorite charities.

Constructive Sales – Rules and Reminder

Prior to the enactment of §1259 of the Internal Revenue Code by the Taxpayer Relief Act of 1997, taxpayers could lock in gains on appreciated financial positions, without the immediate recognition of income, by using such hedging strategies as short sales against the box. Effective for transactions entered into after June 8, 1997, such a transaction is deemed to be a constructive sale and the taxpayer must recognize gains (not losses) as if the position was sold, assigned, or otherwise terminated at its fair market value.

> For example, assume a taxpayer holds a long (appreciated) security position. On July 1, 2022, the taxpayer shorted the same security ("short against the box"). If the transaction is a constructive sale, the gain is deemed to have arisen on July 1st and is taxable in 2022 even though the taxpayer has not sold a position and is still holding both the long and short position at December 31, 2022. If the transaction is unwound utilizing the "short-term hedging exception" described below, then the gain is not taxable in 2022.

A short against the box will **not** be considered a constructive sale provided:

1. the offsetting position (in our example above, the short sale) is closed within 30 days after the year-end and
2. the appreciated long position is held "naked" for an additional 60 days (after the short offsetting position is closed).

Note: To avoid the constructive sale rules **both** tests must be met.

Caution: The closing of a short sale requires delivery. Accordingly, the short sale must be delivered or settled, and not just covered by January 30th of the succeeding year. When a short sale occurs in 2022, against an appreciated long position – the table below illustrates the tax result.

Transaction	Amount Taxable	Year Taxable
Short closed by delivery of long position in 2022	Net appreciation at date of delivery	2022
Short closed by purchase in market in 2022, and long position held for an additional 60 days	Gain or loss on closing of short position Gain or loss on long position is deferred	2022 Date of disposition of long position
Short closed by delivery of long position by January 30, 2023	Gain on long position at date of short sale	2022
Short closed by purchase in market to settle by January 30, 2023, and long position held "naked" for at least 60 additional days	Gain or loss on closing of short position Gain or loss on closing of long position	2023 Date of disposition of long position
Both long and short positions still in place post January 30, 2023	Appreciation on long position at date of short sale	2022

Holding Period of Capital Assets – A Refresher

The holding period begins on the day after the acquisition date and ends with the date of sale. The dates on which securities are traded control, not the settlement dates. There are numerous transactions that will either terminate or suspend the holding period of a capital asset. These are summarized on the following page:

Long Position Held	Offsetting Transaction [1]	Effect on Holding Period
Short-term	(a) Short the stock	Terminated [2]
	(b) Buy put option	Terminated [2]
	(c) Sell deep-in-the money call option [5]	Terminated [2]
Long-term	(a) Short the stock	No effect [6]
	(b) Buy put option	No effect
	(c) Sell deep-in-the money call option [5]	No effect
Short or long term	Sell qualified call not in-the-money [3]	No effect
Short or long term	Sell qualified call in-the-money [3]	Suspended [4]

Notes:

(1) The effect of an offsetting transaction described above only applies to the extent of an equal amount of shares held long.

(2) The holding period of the long position terminates on the date of the specified transaction. A new holding period of the long position begins on the date the offsetting instrument expires or is sold.

(3) A qualified covered call must meet the following criteria: exchange traded, term of more than 30 days, not an ordinary income or loss asset, and not "deep-in-the-money."

(4) The holding period of the long position is merely suspended on the date of the specified transaction. The holding period begins to toll again once the offsetting instrument expires or is sold. There is a tack on of the holding period - the new holding period includes the old holding period.

(5) A deep-in-the money call option is generally where the call price is significantly less than the current market price of the underlying stock.

(6) A loss on the short position should be reclassified to long-term.