Anchin
ACCOUNTANTS & ADVISORS
100 Years

2023 Year-End Tax Planning Guide

Financial Services Practice

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*, *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 relatively quiet year from both a tax standpoint and an overall economic standpoint. On the tax front, 2023 thus far has not seen any major legislation. While the IRS was busy issuing guidance on implementing major pieces of 2022 tax legislation, much of that legislation, and the subsequent guidance, was very narrowly applicable, largely impacting green energy investment and retirement planning and saving. For the most part, 2022 legislation was not broadly applicable to a large swath of taxpayers. What this means is stability and a return to tried-and-true year-end tax strategies from years past. While there are always new strategies to consider, and indeed there are some changes from recent legislation that are in effect for 2023, the simple tactics of deferring income and increasing current deductions will be the order of the day for 2023. 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 2022, 2023 has been relatively dormant, in relation to tax law changes in the financial services industry. The politically divided Congress continues to struggle to pass any kind of legislation, including funding the government via appropriations bills; consequently, prospects for any substantial tax legislation during the remainder of the year appear remote. If we do see tax legislation before year-end, it will likely be comprised of a few bipartisan provisions and attached to an appropriations or other must-pass bill rather than as stand-alone legislation.

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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Examine Your 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: brothers 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.

What About Cryptocurrency Abandonment or Worthlessness?

While one must pay income taxes on income and gains from cryptocurrency investments, the question these days is whether you can deduct losses from abandoned or worthless cryptocurrencies. As discussed above, abandonment or worthlessness happens when one gives up ownership and control over a cryptocurrency because it lost value or due to some other unforeseen circumstances.

According to IRS rules, one can claim a deduction for losses incurred during the taxable year that have not been compensated for by insurance or other means. These losses are eligible for deduction only in the same year they occur, and the loss is treated as a loss from sale or exchange of a capital asset. Unfortunately, cryptocurrency is not currently considered a security by the IRS but as property (under IRS Notice 2014–21).

On January 13, 2023, the IRS issued Chief Counsel Advice 202302011 specifically addressing worthlessness or abandonment with respect to virtual currency. The memorandum addressed the following question and conclusion:

- Question: Section 165 of the Code provides for the deduction of losses sustained during the taxable year. If Taxpayer A owns cryptocurrency that has substantially declined in value, has Taxpayer A sustained a loss under section 165 of the Code due to worthlessness or abandonment of the cryptocurrency?

- Conclusion: No. Section 165 provides a deduction for losses that are evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. Taxpayer A has not abandoned or otherwise disposed of the cryptocurrency, and the cryptocurrency is not worthless because it still has value. Therefore, Taxpayer A has not sustained a loss under section 165 and the corresponding regulations.
  Further, even if Taxpayer A sustained a loss under section 165, the loss would be disallowed because section 67(g) suspends miscellaneous itemized deductions for taxable years 2018 through 2025.

Even though the Chief Counsel Advice is non-binding and subject to change, the information contained therein can be used to gauge the IRS's thinking regarding worthlessness and abandonment of cryptocurrency.

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. With the markets being close to their highs as we enter the last month of trading, short sellers may want to revisit their portfolio and determine if there are any short sale losses that they may want to harvest to reduce potential gains recognized during the year. 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 in more detail later). 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 2023 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 2023. 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 2024, the short-cover capital losses will be deferred until 2024.

**** 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 2023. Note that the last trading day of the year is Friday, December 29, 2023.

Excess Business Loss (EBL) Limitation Refresher

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. The EBL provisions limit the amount of trade or business losses non-corporate taxpayers (individuals, trusts, and estates) can deduct in the current year.

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 2023, trade or business losses are limited to $289,000 for single filers (or $578,000 for joint filers). Therefore, taxpayers expecting large losses from their underlying investment or business should be aware that EBL could potentially limit the loss allowed in the current year. An EBL not allowed in the current year is carried forward as a net operating loss (NOL). A NOL may offset up to 80% of current year taxable income; any unused NOLs may be carried forward indefinitely.

**** 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 not only in the current year but in subsequent years as well. 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). There is a 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.

Tax Loss Harvesting: Turn Investment Losses into Tax Savings

2023 has been a year of double-digit stock market increases, but with dozens of individual stocks in the S&P 500 still down for the 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 some strategies that may be used to achieve your tax-loss harvesting goals:

- ***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"):*** When 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 2023 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 2024. 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 2023.

- ***Convert 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.

- ***Convert 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.

Using Constructive Sales to "Accelerate" or "Defer" Capital Gains

You should consider your tax situation in 2023 as well as your projected tax situation in 2024 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 2023 or defer capital gains recognition to 2024 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 2023.
- If the status of your tax picture for 2023/2024 is clearer towards the end of January 2024, 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 2024 and beyond.
- If the status of your tax picture for 2023/2024 is clearer by early to mid-March 2024, 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 2023.

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*****

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

While there are no anticipated 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 and update of some of the current trends in state and local taxes.

- **Nexus**. This concept is not new and has evolved and broadened its reach over the years. While the 2018 *South Dakota v. Wayfair* decision was not about state income and/or franchise tax nexus, it was a groundbreaking decision that eliminated the physical presence requirement for state sales and use taxes. However, *Wayfair* did empower states to expand and apply this same concept (commonly referred to as economic nexus) for income/franchise taxes.
  What this basically means is that virtually any business activity which seeks and derives income from a customer or market in a given state, may be creating nexus in that state. Where the business is actually located (the old "boots on the ground" logic) is no longer a determining factor in this analysis.

  Market-based sourcing (where revenues are sourced to the location of the customer, or more specifically, the location where the benefit of the service is received rather than where the work is actually performed) continues to expand the economic nexus principles as more states move in this direction.

* ***Anchin Observation:*** If you have not already done so, we recommend that you and your tax advisors perform a state nexus study given the vast changes that have taken place over the past few years. If certain tax exposures are identified, note that most states offer voluntary disclosure agreement (VDA) programs. Eligibility for such programs is generally automatic, unless you had been contacted by the state prior to your application.
A VDA will usually wave any penalties that may be assessed. Many states sometimes will also offer amnesty programs, which are similar to VDAs, but are open to all taxpayers (even those who were already contacted by the state).

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. Convenience of the employer rules and state reciprocity agreements can further complicate payroll tax compliance.

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 specialist advisor 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 with respect to their working location to obtain the necessary information to determine possible state filings.

- **SALT Pass-Through Entity Taxes (PTET)**. To date, 36 states and New York City have enacted a PTET regime. 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 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, 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 the election(s) is paramount to avoid or prevent adverse tax results.

  *** Practice Tip:*** Partnerships that have both resident and non-resident partners, or partners with differing profit and loss percentages, should evaluate whether their partnership agreements have been updated to address special allocations of these tax deductions and corresponding credits. Without such amendments in place, partners may find that their PTET deduction paid by the entity is not equitable in relation to the amount of their partner income taxed in the PTET calculation.

- **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 2023 was 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.

- **New York State Increases Taxes on Hedge and Private Equity Managers**. New York's Metropolitan Commuter Transportation Mobility Tax (MCTMT) is imposed on certain employers and self-employed individuals engaging in business within the Metropolitan Commuter Transportation District (MCTD). As of the July 1, 2023 effective date, New York's 2024 fiscal year budget dictates an increase in the MCTMT for New York City employers to 0.6% for those with a quarterly payroll expense above $437,500; self-employed individuals in New York City will experience an incremental increase from 0.34% to 0.47% through the remainder of calendar year 2023 and then see another increase to 0.6% as of January 1, 2024. New York's new budget changed the definition of a limited partner to ensure that limited partners who are actively engaged in the operations of a partnership within the MCTD are subject to the MCTMT. As per the budget, one is now deemed "a limited partner if the individual, directly or indirectly, takes part in the control, or participates in the management or operations of the partnership such that the individual is not a passive investor." Those that need to be most aware of this change are private equity and hedge fund managers who often earn management fees via limited partnership structures. Please refer to our Anchin alert on this topic (https://www.anchin.com/articles/nys-increases-taxes-on-hedge-and-pe-managers/).

International Tax Considerations – Private Investment Funds Update

The following are highlights of some of the latest trends and developments as well as an update on other existing international tax provisions:

Final 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.).

Effective for foreign taxes paid or accrued in taxable years beginning on or after December 28, 2021, 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 activity, 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, but not all, 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).

Notice 2023-55, released by the IRS on July 21, 2023, provides temporary relief that allows eligible taxpayers to determine whether foreign taxes they paid during the relief period (taxable years beginning on or after December 28, 2021 and ending on or before December 31, 2023) are creditable foreign taxes by effectively reverting to prior rules during this period.

*** *Caution:*** Relief under this notice is limited to what is specifically addressed therein; meaning that other features of the final regulations remain unchanged and will continue to present unwarranted complexity and challenges as well.

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 & Potential Opportunity:*** There is a court case on the Supreme court docket this term (*Moore v. United States*) that is reviewing the constitutionality of the section 965 tax that was levied in 2017-2018 on foreign unrepatriated earnings. Depending on how the court rules, there may be an opportunity to claim a refund for some of the taxes paid by filing protective refund claims as soon as possible in order to preserve the right and keep the statute of limitations open for as long as possible. The full effects of section 965 being declared unconstitutional are nuanced and complex and could result in additional tax being owned on actual repatriations that occurred between 2017 and now. Oral arguments are scheduled for December 2023 and likely we will not have a decision until Q1 or Q2 of 2024.

**** 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 an IRC Sec. 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 Sec. 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 Sec.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 passive foreign investment company (PFIC) regulations. These proposed regulations would no longer allow a domestic partnership or S corporation to make elections on behalf of its shareholders. If finalized in their current form, these regulations would make compliance for U.S. partnerships and S corporations owning stock in foreign corporations far more complicated and burdensome. U.S. partnerships and S corporations would have administrative burdens to track whether and which elections are made by their investors, along with potentially having to assist those investors in computing their pro rata share of PFIC stock on an annual (or more frequent) basis.

*** Anchin Observation:*** The proposed regulations generally apply for tax years of shareholders beginning on or after the date final regulations adopt the proposed rules. Treasury and the IRS received comments on various aspects of the proposed regulations through April 2022 but have not been finalized to date. Taxpayers should work with their tax advisers to stay up-to-date of the latest developments to determine the effect of the final and proposed regulations.

- ***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 is reduced to 21.875% starting in 2026.

    - 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 benefits while also ensuring that the documentation standards for taking the deduction are being met in the event of an audit.

- ***Other Relevant Developments:***

    * On February 28, 2023, the Supreme Court issued its decision in *Bittner v. United States* in which it held that the $10,000 penalty for non-willful failures to file a Report of Foreign Bank and Financial Accounts (FBAR) is determined on a per report basis rather than a per account basis as the IRS had consistently applied and argued.

    * On April 3, 2023, a unanimous Tax Court decision in *Alon Farhy v. Commissioner* held that the IRS lacked the authority to immediately assess penalties for failure to file Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations.

If this decision is affirmed on appeal, the IRS would be required to sue to assess such penalties. The breadth of the decision could apply to other penalties that are not deemed to be Assessable Penalties under the standard set forth in *Farhy*.

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 2024 tax year, and assuming the taxpayer is an individual, the election would need to be made by April 15, 2024 (March 15, 2024 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 2023 (and you qualify as a trader and are therefore eligible to make the IRC Sec 475(f) election), you could benefit by continuing to hold those securities until the following year (2024). You could then make the 475(f) election for 2024 and deduct the mark-to-market losses in 2024 as ordinary losses rather than selling the securities in 2023 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.

- ***<u>475(f) Revocation Procedures</u>***: 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 “IRC Sec 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) Planning Opportunities

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).

When the QSBS gain exclusion was first allowed (enacted into law in 1993), C corporations were subject to federal tax rates of up to 35% as well as double taxation (on both corporate income when earned and on the dividends when the profits were distributed to the shareholders). Although gains could potentially be excluded under this provision upon sale of the stock, many taxpayers found structuring a business as a passthrough entity (such as an LLC, Limited Partnership or an S corporation) as the preferred form of doing business because the total tax paid on the profits of the business was generally meaningfully less than that of a C Corporation.

Although C corporations are still subject to double taxation, the maximum federal tax rate on C corporation earnings is 21% and the maximum QSBS gain exclusion was increased from 50% to 100% of the gain under certain criteria.

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 and assess 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 maximum 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*

- ***What about Simple Agreements for Future Equity (SAFEs)?*** These types of agreements are designed to assist startup entities with funding and expertise by raising money as an alternative to convertible debt or stock issuances. In a typical SAFE, the issuing corporation receives cash from investors in exchange for a promise that the same corporation will issue preferred equity in predetermined (often discounted) amounts in the future upon the occurrence of certain triggering events. While the SAFE is outstanding, it does not pay interest and does not have a maturity date.
  A major tax issue to consider is whether SAFEs should be taxed as debt, equity or some other type of instrument.

  * ***Debt:*** The consensus of industry experts is that SAFEs should not be treated as debt since they generally do not pay interest and have no fixed maturity date. The holding period under IRC 1202 would only begin on the date the stock (if any) is issued.
  * ***Equity:*** If there are provisions relating to payments on a liquidating event and participation in dividends included in the SAFE agreement, the equity argument of the SAFE is strengthened. These provisions improve the argument that the instrument is equity by establishing that the investor has some of the benefits and burdens of equity ownership. However, this argument and result is far from certain. This characterization does solve the IRC holding period issue – where the holding period for the SAFE would be tacked onto the holding period of the stock received.
  * ***Warrant:*** A warrant is a contractual arrangement that generally requires the holder to pay an amount for the warrant which then gives the holder the right to acquire a specified number of shares of stock within a specified time period at a specified strike price. SAFEs do not have the characteristics that a warrant typically has. The holding period under IRC 1202 for property received upon exercising a warrant begins when the warrant is exercised.
  * ***Variable Prepaid Forward Contract (VPFC):*** A VPFC involving stock is a contract between two parties where one party agrees to transfer stock to another party at a fixed date in exchange for an upfront payment of cash. The number of shares can vary based on the stock price at settlement. In 2003, the IRS ruled that a sale did not occur when the contract was entered into but, instead when the shares were transferred. While SAFEs have some similar characteristics of a VPFC, there are also some important differences. With a SAFE, the property to be exchanged does not even exist at the time the cash is transferred and there is therefore no fixed date on which a SAFE investor will receive preferred stock.

However, even with these differences, a typical SAFE would better fit characterization as a VPFC than as debt or a warrant. The holding period under IRC 1202 starts on the date the stock is received and not when the SAFE is entered into.

*** *Caution:*** Tax characterizations of SAFEs remain uncertain. The IRS has not issued any guidance on these agreements to date, and we are not aware of any pending guidance or proposals on the horizon. This uncertainty creates risks that issuers and investors should be aware of and that should be thoroughly discussed with your respective tax and business advisors.

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.

**** Anchin Observations:*** 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. Businesses and their owners should consider whether they will or can potentially qualify for the QSBS exclusion:

- When forming the company
- When considering a restructuring of the existing business
- Prior to raising new capital or issuing new C-Corporation stock
- After the sale of a business
- Prior to the sale of a business

Bonus Depreciation & Section 179 Expense

As the 2023 year-end nears, a part of your year-end tax planning should be to review fixed assets placed in service during 2023 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 January 1, 2024, the percentage of bonus depreciation is scheduled to be reduced from 80% in 2023 to 60% in 2024 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 IRC Sec 179 deduction, bonus depreciation can create a net operating loss (NOL).

For 2023, the Section 179 expensing limit is $1,160,000, with a phaseout for purchases of more than $2,890,000 and a complete phaseout at $4,050,000 of expense-eligible property placed in service in 2023.

For 2024, the limit increases to $1,220,000, with a phaseout for purchases of more than $3,050,000. 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 is 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.

**** 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. Please note that section 1061 would still apply to the carried interest transferred portion.

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.

Choice of Business Entity Considerations

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.

However, with the sun setting of many provisions of the TCJA on December 31, 2025, Section 199A is set to expire, which means this tax advantage will end (unless Congress acts before then).

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 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.

Entity selection involves many factors, both at inception and throughout the life of the business. What has been discussed above only scratches the surface. There are additional tax and non-tax considerations that should be taken into account such as:

- How profits are taxed (including state income taxes, which vary by state)
- The complexity and cost of setting up the business, as well as ongoing governance and administration
- Liability protection (particularly of the owner (or owners) personal assets
- Deductibility of losses

- Tax reporting requirements
- International tax complications and rules
- Access to capital
- Availability of exit strategies and succession planning
- Ability to transfer ownership interests

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 2023 annual gift exclusion is $17,000. 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 $34,000 to an individual in 2023 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 2023 lifetime exemption is $12,920,000 (expected to rise to $13,610,000 in 2024), 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 the 2017 amount of $5,000,000, adjusted for inflation. 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 only $5,000,000 cannot treat those gifts as having come from the increased exemption portion when the exemption drops as of January 1, 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 2023. 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 $12,920,000 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, 2023 to apply 2023 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 2023, you can transfer $85,000 ($170,000 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 $17,000 ($34,000 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. These payments can be made on anyone's behalf and are not limited to immediate family members.

- ***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 the 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 5.03% (in December 2023) and rates on loans for shorter periods can be even lower. While AFRs are generally high today, they are still lower than the average mortgage rate, for example. 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.
  - 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 2023, 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 5.8% in December 2023).

  *** 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 2023.

  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.

IRS Audits and Tax Enforcement Update

On September 8, 2023, the IRS Commissioner announced the rollout of a coordinated enforcement strategy that will involve audits of tax returns filed by 75 of the largest partnerships (including hedge funds, private equity funds, real estate funds, publicly traded partnerships, and law firms) operating in the United States. Other enforcement efforts will focus on compliance issues involving digital assets, as well as continued emphasis on reporting of offshore accounts and collection of back taxes owed by high-wealth individuals. Behind much of the new strategic effort is the use of artificial intelligence (AI) and other investments made possible by the long-term funding approved by Congress through the Inflation Reduction Act of 2022 (IRA).

With both compliance audits (anticipated 500 compliance audits) and field examinations (anticipated 75 field examinations) of large partnerships, the IRS is demonstrating that it is committed to improve the quantity and quality of its partnership audits. Compliance audits will require partnerships to substantiate return items (e.g., reconciliation of balance sheet items to the tax return) and could evolve to full-scale field audits depending on the findings. Field examinations will be similar to research audits and involve a detailed and multi-year review of the partnership's operations and tax positions.

* ***Anchin Observation:*** Taxpayers targeted by this audit initiative should expect that the IRS has conducted a thorough risk analysis prior to issuing the notice of selection for examination, most likely aided by Artificial Intelligence (AI). These partnerships should anticipate that information document requests (IDR) will reflect a more strategic, targeted approach than previously has been the norm in partnership audits. While it is still early in the process, to date we have seen indications that there is national coordination of large partnership audits.

Although the IRS has announced definitive steps to achieve its stated goal of “sweeping, historic efforts to restore fairness in tax compliance,” the success of its initiatives will depend on its ability to conduct effective examinations of a highly sophisticated group of taxpayers who likely have never been audited before.

Constructive Sales – Rules and Reminder

Prior to the enactment of §Sec 259 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, 2023, 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 2023 even though the taxpayer has not sold a position and is still holding both the long and short position at December 31, 2023. If the transaction is unwound utilizing the “short-term hedging exception” described below, then the gain is not taxable in 2023.

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 2023, 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 2023	Net appreciation at date of delivery	2023
Short closed by purchase in market in 2023, 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	2023 Date of disposition of long position
Short closed by delivery of long position by January 30, 2024	Gain on long position at date of short sale	2023
Short closed by purchase in market to settle by January 30, 2024, 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	2024 Date of disposition of long position
Both long and short positions still in place post-January 30, 2024	Appreciation on long position at date of short sale	2023

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.