



2020 essential tax and wealth planning guide

Part 2

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Welcome

Dear Reader,

How are you doing in these unprecedented times? We hope you and your loved ones are safe and healthy and finding new ways to thrive in today's environment. So far, 2020 has been a bumpy ride, and there may be more obstacles ahead. However, just as experience and reflexes help a driver navigate around a fallen tree in the road, with knowledge and resilience, you can prepare yourself to adjust to the ever-changing tax and economic circumstances.

In the first installment of Deloitte's *2020 essential tax and wealth planning guide*, we offered valuable insights on tax policy, philanthropy with private foundations, and wealth transfer considerations. In our second and final installment for this year, we continue to prepare for what may lie ahead with the following chapters:

- First, our tax policy section, **Tax policy in the new year: Voters opt for a change in course**, shares the latest information on continuing legislative guidance and relief in response to the COVID-19 pandemic, including observations from the recent presidential election.
- Our year-end wealth transfer planning section, **Wealth transfer: Staying the course and seizing the day**, pinpoints areas on your wealth transfer road map that may require attention before the close of 2020.
- Next, our interest tracing section, **The complexity and flexibility of interest tracing**, provides the rules of the road to deductibility of interest expenses, including insights from recently released proposed regulations.
- Lastly, our deductibility of losses section, **The 2020 reboot of individual loss limitations**, will help you determine whether there is a silver tax lining to any losses sustained in recent months.

We hope that the second installment of the *Guide* provides you with informative maps and milestones to guide you, your family, and perhaps your family business along the road and over hurdles as you continue on your journey to meet your goals. As 2020 winds to a close and you reflect on the roads you have traveled and plan for the journeys ahead, we thank you for allowing us to come along for the ride.

To find a member of the Deloitte Private Wealth practice who specializes in your area of interest, please contact us at ustaxprivatewealth@deloitte.com.

Regards,

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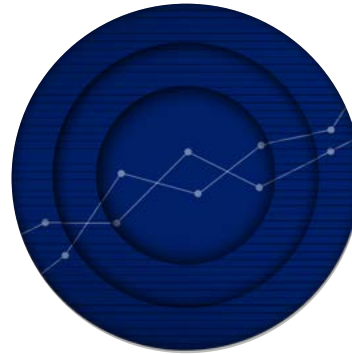
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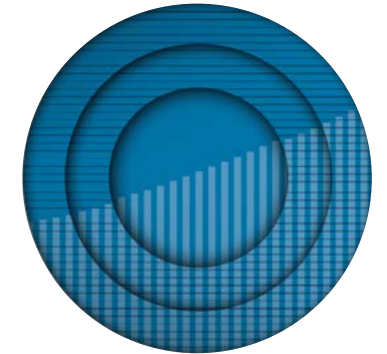
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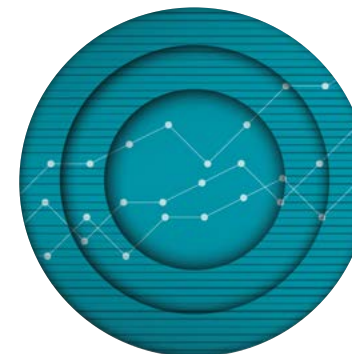
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Tax policy in the new year: Voters opt for a change in course

The nation has voted, the results are now in, and former Vice President Joe Biden has been elected to serve as the nation's forty-sixth president and will assume responsibility for the nation's fiscal policy beginning in January 2021.

Although the economic impact of the coronavirus pandemic (and the federal response to it) dominated the fiscal policy debate during the campaign, one of the issues implicitly on the ballot in 2020 was the fate of President Trump's signature 2017 tax code overhaul—known informally as the Tax Cuts and Jobs Act (TCJA)¹—which, among other things, lowered the tax burden for many businesses, whether structured as corporations or passthrough entities, as well as for individuals, trusts, and estates. (For budgetary and procedural reasons, the individual and passthrough provisions generally are scheduled to expire at the end of 2025, with certain other business tax changes phasing in or out even sooner.)

Biden campaigned on the premise that TCJA's benefits are skewed to large corporations and wealthy individuals and that the federal income tax system needs to be retooled to ensure that these taxpayers are paying "their fair share." To that end, he has proposed increasing top income tax rates, along with "base broadeners," such as eliminating or limiting various incentives currently available to these taxpayers.

Under Biden's plan, revenue generated from these proposed changes to the tax code (as much as \$4 trillion over 10 years,

according to some unofficial estimates) would be used to provide tax relief for lower- and middle-income taxpayers and pay for spending priorities such as improving the nation's infrastructure, developing alternative energy sources, and building up the US manufacturing sector.

But the immediate challenge facing Biden once he takes office will be to address the ongoing economic and health impacts of the coronavirus pandemic. Thus, tax policy in the near term may be shaped by the status of a viable vaccine for COVID-19 and the need for economic recovery.

On the regulatory front, meanwhile, the Treasury Department and Internal Revenue Service continue to issue guidance regarding the provisions enacted in the TCJA.

[*A change in course*](#), a new publication from the Deloitte Tax Policy Group in Washington, D.C., considers Biden's tax policy proposals, how they compare to current law, and how economic factors and the makeup of the next Congress may influence his agenda going forward.

Tax policy in the near term may be shaped by the status of a viable vaccine for **COVID-19** and the need for **economic recovery**.

¹ P.L. 115-97, *An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*.



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Wealth transfer: Staying the course and seizing the day

The beginning of every year is often a time for setting goals and reconsidering priorities. While 2020 may have started off on a familiar path, there have been many unexpected turns. In the prior installment, "[When given lemons, make lemonade](#)," we discussed that, if one buys into the notion that recovery follows a correction (one simply doesn't know how long that might take), then giving now can be the lemonade made from the current economic lemons. Although there are economic and social issues that may have a higher level of priority this year, it is still important to pause at year-end to recommit to staying the course with an effective wealth transfer plan and to consider whether or not there are opportunities that should be considered before 2020 comes to a close.

With this in mind, consider the following four year-end wealth transfer alternatives.



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One: Being mindful of how wealth opportunities are pursued

It is important to remember that providing a business or investment opportunity to an heir or trust is not a gift. From a family wealth perspective, the investment opportunities that attend a market correction should be undertaken not by senior family members, but by their heirs or trusts for the benefit of their heirs. To do so may require senior family members to assist heirs and trusts in financing the acquisition of investments or the pursuit of business opportunities. Additionally, assuming investments are pursued through an existing entity, an individual could consider being redeemed out at fair market value.





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Two: Using the enhanced applicable exclusion amount (AEA)

As discussed in our prior installment, under the TCJA, the applicable exclusion amount (or AEA, the amount that can be left to others by gift or bequest without incurring a gift or estate tax) was increased from \$5 million to \$10 million, indexed for inflation. In 2020, the AEA amount is \$11.58 million. The TCJA states that the increased \$10 million exclusion will only be in place until the end of 2025 (although political exigencies may give rise to an earlier sunset), when it will revert to the previous \$5 million limit indexed for inflation. Under current law, the increased AEA is a “use it or lose it” proposition. Once it sunsets, it will be as if it had never existed.

Therefore, if an individual has any unused AEA, they should consider using it in 2020 or soon thereafter. Having resolved to make a gift, the questions then turn to what the gift should be and how the gift should be made. A transfer could be as simple as gifting cash or marketable securities, but it could also involve other types of investments. Additionally, a gift can be outright to the donee or indirect through use of a trust. For a more detailed discussion about potential wealth transfer planning to utilize any unused AEA, please refer to the [prior edition](#) of the *Guide*. For those interested in tax policy and prospective legislation issues, refer to Deloitte’s [Tax News & Views](#).



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Three: Fine-tuning one's annual gifting plan

In addition to the lifetime AEA, though, there may also be significant impact in making annual exclusion gifts, which are neither subject to gift tax nor offset one's AEA. Additionally, while most uncompensated transfers of property during life are subject to federal gift tax, there are specific exceptions related to the payment of tuition to educational institutions and the payment of necessary medical and dental expenses, which, if paid directly to the educational or medical institution, do not offset the annual exclusion for the benefited party or use the donor's AEA.



Gift tax annual exclusion

In 2020, qualifying gifts of up to \$15,000 per recipient are not subject to gift tax. Qualifying gifts are those that convey a present interest in the gifted property to the donee. A present interest exists when the donee has a substantial present economic benefit arising from the gift property, meaning that the assets received are readily convertible to cash or are income-producing from the outset (such as gifts of cash, marketable securities, and income-producing real estate). However, unless expressly permitted by statute, transfers encumbered by restricted access generally will not qualify (for example, most transfers in trust cannot qualify as a present interest unless the beneficiary is given the immediate right to withdraw value from the trust when transfers are made to the trust). Similarly, in our experience, the IRS has been successful in asserting that transfers of interests in family investment entities that do not consistently distribute earnings to their owners do not represent present interests. However, while highly restricted, transfers under the Uniform Transfer to Minors Act and funds contributed to section 529 educational savings plans qualify as present interests by statute.



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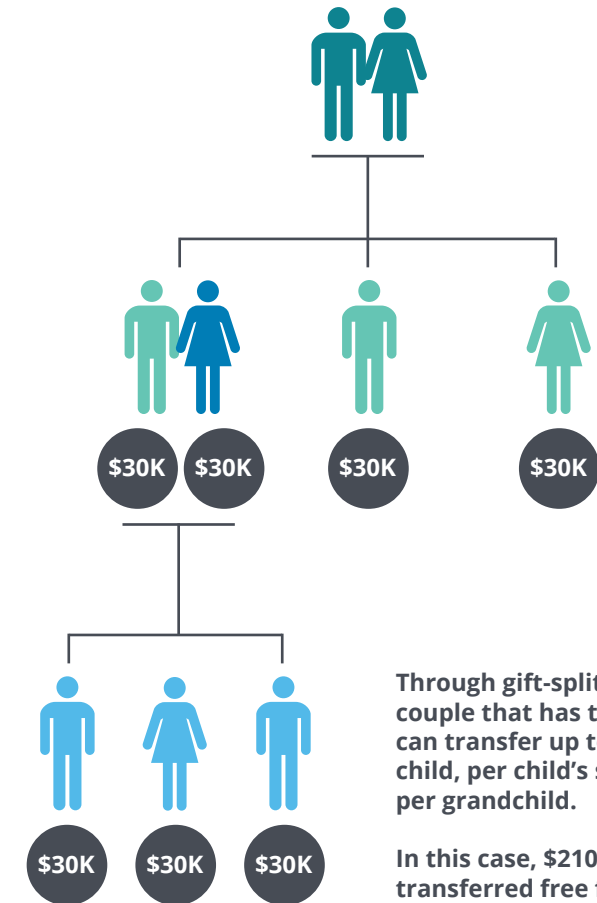
✓ Make annual gifts

Consider shifting wealth down generational lines through an annual gifting program. There may be additional benefit if the gifted asset:

- Can be valued on a discounted basis;
- Is likely to appreciate and/or generate income in the hands of the donee; or
- Is given to a grantor trust that permits the trust assets to grow income-tax free because the grantor, who is required to report and pay income tax on the trust's income, further reduces their estate by the amount of any income tax paid. Because the tax is the donor's legal liability, it is not an indirect gift to the trust.

To demonstrate the power of annual gifting, assume a couple has three children. In 2020, this couple can transfer up to \$30,000 per child, or \$90,000 in the aggregate to all three children. If each child has a spouse, then the maximum amount that can be given to the children and their spouses is \$180,000 without incurring a taxable gift. Additionally, if the couple has grandchildren, then the ability to further reduce their taxable estates through annual gifts expands arithmetically.

Annual gifting scenario





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Make direct payments to educational institutions or medical providers

Such direct payments are not taxable gifts. For example, a grandmother who wishes to help pay for a granddaughter's education can write tuition checks directly to the school without making a taxable gift. However, if she writes the check to the granddaughter, she will have made a taxable gift to the extent the amount gifted exceeds the \$15,000 annual exclusion. Tuition is not limited to college tuition; any qualified school's tuition can be excluded. Medical expense does not just mean those for doctors and hospitals; any qualified medical expense, including health insurance premiums, can be paid under this exclusion.



Make future educational gifts through a Section 529 plan

Using a special election, a donor can fund up to five years of annual exclusions into these plans in year one. Specifically, in 2020, one can contribute \$75,000, or \$150,000 per married couple, to each child's (or grandchild's) Section 529 plan without incurring gift or generation-skipping transfer (GST)² tax. If other gifts are made by the donor to that child or grandchild from 2020–2024, however, those gifts would

use some of the donor's AEA, as well as some of the donor's GST tax exemption, with respect to any gift made for a grandchild. By funding these plans in advance, the growth in the fund occurs in an income tax-exempt environment.



Make transfers to grantor trusts

Grantor trusts are trusts in which the grantor has retained either an economic interest or powers over trust property that are significant enough to require the income of the trust to be taxed to the grantor, thus making the trust a disregarded entity for income tax purposes. Interestingly, the retention of some powers over trust property will not also cause the trust to be disregarded for transfer tax purposes. Properly employed, these powers can cause the grantor to be legally liable for the income taxes arising from the trust's tax attributes, but not in a manner that causes estate tax inclusion. From an estate tax perspective, such trusts represent the gifts that keep on taking (from the grantor's estate)—a situation that can be perpetuated for as long as the grantor is willing to pay the continuing income tax liability.

² GST tax is imposed on transfers during life and at death that are made to a "skip person"—a recipient who is at least two generations younger than the donor or decedent, such as a grandchild. If there were no GST tax, a transfer to a grandchild would be subject to the gift or estate tax once, while a gift to a child who then gifts or bequeaths those assets to a grandchild would be subject to transfer tax twice.



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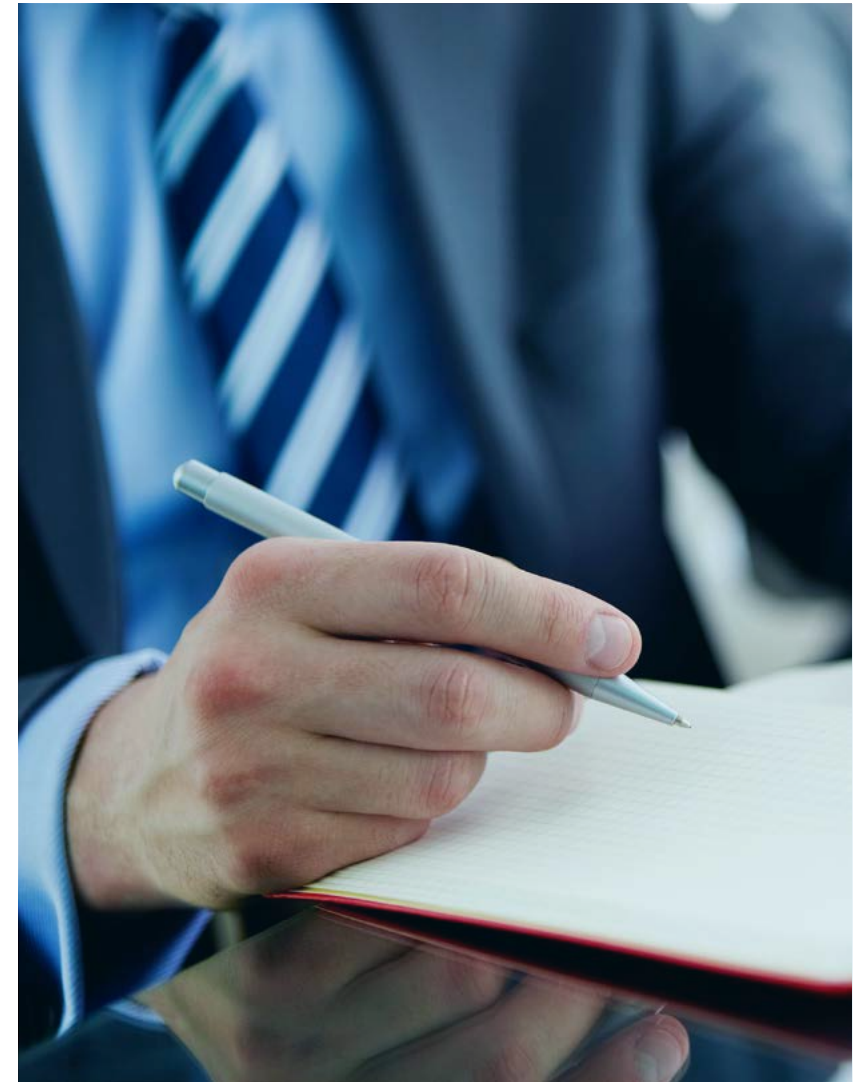
There are many reasons to consider tuning up prior planning now. For example, prior planning may have occurred in a higher-interest-rate environment or contemplated economic outcomes did not materialize, the tax law may have further developed, or personal circumstances may have changed. In any event, it is always important to determine if current circumstances still support prior wealth planning decisions and whether wealth transfer planning goals have changed.



Reflecting the effects of the current economic climate

The general economic downturn has affected many businesses, but not consistently. Some companies have been challenged, but some companies, such as those in the technology industry, may be thriving. Many wealth transfer plans are particularly sensitive to asset performance (such as grantor retained annuity trusts), other plans may be sensitive to interest rate fluctuations (such as intrafamily loans), and some plans are sensitive to both (for example, sales to grantor trusts). Perhaps modifications might be contemplated.

- Many grantor trusts permit the grantor to substitute assets for those of the trust if the exchanged assets have equivalent value. Rebalancing the trust's portfolio in this manner may prove helpful to the overall wealth transfer plan.





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- Debt can, in appropriate circumstances, be modified to reflect the current lower interest rates. However, this should not be done in a vacuum without considering potential gift (and sometimes income tax) consequences.
- Some wealth plans where intrafamily debt plays a large role are simply no longer viable. In certain circumstances, a new infusion of transferred wealth (using the AEA) will be enough to “right” the plan and allow it to function as designed. In other cases, rather than risk other tax exposures, consideration may be given to foreclosing on the old debt and starting fresh.
- Some wealth transfer plans involved the use of grantor trusts. Perhaps consideration should be given to terminating grantor trust status so that the trust begins paying its own income taxes.



Reflecting the evolution of tax law and tax policy

Tax law is never static. With time, laws or the interpretation of existing laws may change, and opportunities may arise to change undesirable tax attributes. Current wealth transfer objectives may be improved by making changes, such as the following nonexclusive list of considerations:

- Time (and tax policy) often catches up with prior wealth plans. For example, family investment partnerships have evolved considerably since they were first introduced in the mid-1980s. Many of these earlier partnerships are no longer conducive to effect wealth management, and consideration should be given to carefully excising them from the overall plan.
- The GST footprint of certain trusts could be improved. Given the greater GST tax exemption currently available, if an existing GST trust has an inclusion ratio between zero and one (that is, a trust where a distribution to a skip person would be partially subject to GST tax), consider allocating the increased exemption to those trusts. When a trust has an inclusion ratio between zero and one, the amount of GST tax exemption required to obtain an inclusion ratio of zero (thus making the trust thereafter fully exempt from GST tax) is a function of the value of the trust’s assets at the time the additional GST tax exemption allocation is made.
- The state taxation of nonresident trusts has been a focus of change over the past decade. The tests applied to determine a trust’s status as a resident have also changed in many states. A comprehensive review of a nongrantor trust’s exposure to state income taxes should be considered, particularly if parties



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that are relevant to the trust (the grantor, trustees, and beneficiaries) have resided in different places in 2020 due to quarantine or other personal circumstances.



Determine whether recent life changes may necessitate document revisions

Wealth transfer documents such as revocable trusts, wills, and powers of attorney should be reexamined frequently. As 2020 has brought unprecedented new pressures to bear, the case for reevaluating testamentary documents is especially strong. What is frequently forgotten is updating the beneficiary designations of contract property (such as life insurance; retirement plans, including individual retirement accounts (IRAs); and deferred compensation regimes) to coordinate them with beneficiary designations under the last will and testament. It may also be a good time to consider whether you have a need or desire to alter fiduciary designations, such as a proposed trustee or trust protector, a guardian of minor children, or an executor or the identity of an attorney if there is a springing power of attorney built into the current wealth management plan.

As 2020 has brought unprecedented new pressures to bear,
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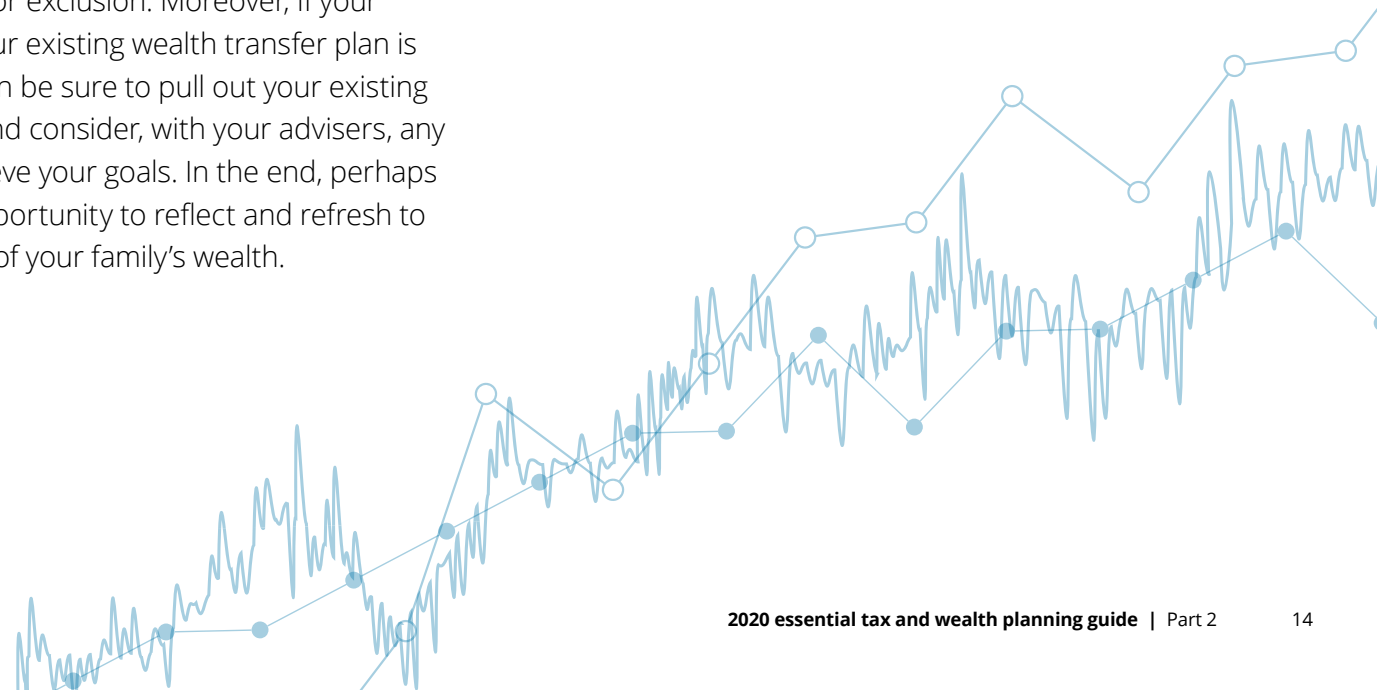
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While the circumstances of 2020 may be unprecedented, the need for an effective wealth transfer plan for efficient and orderly distribution of assets has not changed. It is always very important to pause and consider the effect of the economy, tax law changes, or changes in personal circumstances on your wealth transfer goals and plans; any changes to those plans may have unintended tax consequences. However, while life may have brought lemons, it is important not to miss the opportunity to enjoy some lemonade. Review the prior article about potential planning considerations to utilize any remaining AEA while the fair market value of your assets may have decreased and the AEA has not been reduced by potential tax policy changes. Consider transferring assets in a manner that does not utilize a gift (or GST) tax exemption or exclusion. Moreover, if your priorities have changed or your existing wealth transfer plan is not performing as hoped, then be sure to pull out your existing wealth transfer documents and consider, with your advisers, any necessary fine-tuning to achieve your goals. In the end, perhaps 2020 presents us with the opportunity to reflect and refresh to better prepare for the future of your family's wealth.

It is always very important to pause and consider the effect of the economy, tax law changes, or changes in personal circumstances on **your wealth transfer goals and plans.**





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The complexity and flexibility of interest tracing

When a taxpayer borrows funds, a common misconception is that the deductibility of interest expense is determined by how the loan is collateralized. That is not the case. In fact, the deductibility of interest expense is determined based on how the loan proceeds are used, otherwise referred to as interest tracing. Over time, interest tracing has evolved into one of the more complex facets of the Internal Revenue Code. The rules for interest tracing appear rather elegant and simple in their application when you consider that the character of the interest expense paid is determined merely based on how the borrowed funds were used. However, adding to the complexity of these rules is that interest tracing is an ongoing analysis that must be continually revisited, not simply determined based on how the funds were initially used. For example, what happens when the asset acquired with the borrowed funds is ultimately sold? After borrowed funds are redeployed, the subsequent use of the borrowed funds, not the original use, will determine the character of the interest expense paid.

With the enactment of the TCJA and the rules that now place further limitations on the deductibility of interest expense incurred to fund a trade or business, many taxpayers are now revisiting this issue and recognizing the overall complexity of the interest tracing rules. As part of that endeavor, it is helpful to have a better understanding of how the interest tracing rules work.

Interest tracing is an ongoing analysis that must be continually revisited, not simply determined based on how the borrowed funds were initially used.



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A brief history

Prior to the Tax Reform Act of 1986 (1986 TRA), interest expense, regardless of type, was generally deductible. The 1986 TRA made personal interest, other than qualified residence interest, nondeductible and limited deductions for other types of interest expense. Shortly thereafter, guidance was issued that introduced interest tracing. As mentioned above, the interest tracing rules

determine the character of interest expense by tracing the use of the loan proceeds to specific asset acquisitions or expenditures. These rules place the emphasis on the loan's use, rather than on the underlying asset used to collateralize the loan. The various categories of interest expense are as follows:

 Personal interest	 Investment interest	 Residential interest	 Passive interest	 Trade or business interest
Related to credit card debt, auto loans, and other household borrowing	Related to property held for investment (for example, stocks, mutual funds, land, and other investments); however, interest incurred to produce tax-exempt income is not deductible	Mortgage interest on a primary and/or secondary home	Includes interest on debt for business or other income-producing activities in which the taxpayer does not materially participate	Includes interest on debt for activities in which the taxpayer materially participates



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With that as background, how would you apply the interest tracing rules? As an example, assume a taxpayer borrowed from a bank and used the loan proceeds to purchase a boat. Assume that the loan was secured by an investment account held with the bank. It may feel intuitive to determine the deductibility of the interest expense based on how the loan is secured. Under that approach, the interest expense would be characterized as investment interest expense due to the loan being secured by investment assets. However, as we learned earlier, the interest tracing rules stipulate that, to determine the character of the interest expense, a taxpayer must trace how the loan proceeds were used. Since the loan proceeds were used to purchase a boat, which in this case is a personal asset, the interest expense should be categorized as personal, and therefore nondeductible.

Next, consider what happens when the proceeds are redeployed. Assume that at some time in the future the taxpayer decides to sell the boat and then use the proceeds from the sale of the boat to purchase inventory for their sole proprietorship. The interest expense on the loan is now subsequently traced to a business expense and thus the character of the interest expense changes from personal to trade or business. Note that this does not retroactively affect the interest expense incurred while the proceeds were traced to the acquisition of the boat. As such, the

taxpayer has personal interest expense until the boat is sold and business interest expense once the proceeds from the sale of the boat are used for the taxpayer's business.

Let's now take a step back and add some more complexity to our scenario. Assume that before our taxpayer purchased their boat, the loan proceeds were first deposited into an investment bank account rather than being immediately disbursed to purchase the boat. How would our result change? The interest tracing rules determine that a deposit of loan proceeds into an account is treated as an investment expenditure and amounts held in an account (whether or not the account is interest-bearing) are treated as property held for investment. What that tells us is that upon the deposit of the loan proceeds into our taxpayer's bank account, the interest expense incurred would be characterized as investment interest expense. Recall that the interest tracing rules require the debt to be reallocated whenever the proceeds are used for another expenditure. Therefore, our taxpayer would have investment interest expense upon the deposit of the loan proceeds into their bank account, which would be recharacterized as personal interest expense upon the use of the loan proceeds to purchase their boat, then further recharacterized as trade or business interest expense upon using the sales proceeds from the boat to purchase inventory for their sole proprietorship.



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The **entire \$100,000 of debt is treated as an investment expenditure** because the entire amount of loan proceeds is held in an investment account.

\$20,000 of debt is allocated to a personal expenditure, since \$20,000 of the loan has been used to buy a boat, but the **remaining \$80,000 remains allocated to an investment expenditure**, since that amount remains in an investment account.

\$20,000 of debt is now allocated to a trade or business, since the personal asset was sold, with the sales proceeds being used to fund the taxpayer's business, and **\$80,000 remains allocated to an investment expenditure**, as that amount remains in an investment account.

Let's explore interest tracing further with another example. Assume a taxpayer borrows \$100,000 on January 1 and immediately uses the proceeds to open a non-interest-bearing checking account. No other amounts are deposited in the account during the year, and no portion of the principal amount of the debt is repaid during the year. On April 1, the taxpayer uses \$20,000 of the debt proceeds held in the account to purchase a boat. On September 1, the taxpayer sells the boat and uses the \$20,000 of proceeds from the sale of the boat to purchase inventory for their business. The result of this activity is shown to the left.



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Another factor in the interest tracing rules is that a taxpayer may treat any expenditure made from an account within 30 days before or 30 days after debt proceeds are deposited in that account as being made from those loan proceeds. As an example, suppose a taxpayer spends \$10,000 from an account to acquire a publicly traded stock investment. Ten days later, the taxpayer deposits loan proceeds into the same account. This rule allows the taxpayer to treat the acquisition of their stock investment as being made from the loan proceeds and thus trace the interest expense as investment interest expense. The 30-day rule provides flexibility to taxpayers to analyze the impact of the interest tracing rules; timing is the key.

While we have only reviewed a few scenarios, we hope it is apparent that the interest tracing rules, while quite complex in their application, also provide significant flexibility that can be beneficial to taxpayers. This flexibility provides an opportunity for planning. By anticipating borrowing needs and identifying asset acquisitions or expenses that can yield an interest expense deduction if funded with loan proceeds, a taxpayer can determine what steps they need to take to improve their tax posture.

By anticipating borrowing needs and identifying asset acquisitions or expenses that can yield an interest expense deduction if funded with loan proceeds, **a taxpayer can determine what steps they need to take to improve their tax posture.**



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It is important to note that debt incurred by a taxpayer to acquire an interest in a passthrough entity or debt incurred by a passthrough entity to fund distributions to its owners adds an additional layer of complexity that is beyond the scope of this article. If these facts are a part of your analysis, reach out to your tax adviser to determine how the interest tracing rules will affect you.

Next, we will discuss changes to the deductibility of business interest expense. In the past, business interest expense was often viewed as providing the most benefit for interest expense deduction purposes. While that may still be the case, given the changes discussed next, taxpayers may be surprised to find that something other than business interest expense provides a more tax-efficient result. As such, thoughtful planning in this area is critical.





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New business interest expense implications

The TCJA ushered in several fundamental changes that generally place limitations on the deductibility of business interest expense. These rules are highly complex and are applied differently depending on how a taxpayer's business is structured. For many taxpayers, this new limitation on the deductibility of trade or business interest expense places a renewed focus on the interest tracing rules since, as we learned earlier, interest expense is characterized based on how the loan proceeds are used. The following is a high-level discussion of the business interest expense limitations applied at the individual taxpayer level.

In general, taxpayers can deduct business interest expense, which is interest paid or accrued on indebtedness properly allocable to a trade or business. For example, assume a taxpayer obtains a loan from a bank and uses the proceeds to buy inventory for their business, a single-member LLC that is disregarded for income tax purposes. As the loan proceeds were used to purchase business property, the interest is categorized as business interest expense. Prior to the TCJA, in general, that interest expense would have been deductible in the year in which it was paid.

However, for business interest expense paid in tax years beginning after 2017, the deduction may be limited. The highly complex calculation applied to determine what portion of business interest expense can be currently deducted versus what portion is to be disallowed is beyond the scope of this article other than to note that (1) business interest expense that is disallowed can be carried forward indefinitely and (2) an exception to the business interest expense limitation is available for certain small-business taxpayers. Assuming our hypothetical taxpayer who bought inventory does not meet the small-business exception, the taxpayer may not receive a current deduction for the interest expense incurred.



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New business interest expense implications

Now consider the treatment of business interest expense in comparison to the treatment of investment interest expense. In general, investment interest expense is currently deductible by an individual taxpayer as an itemized deduction, but only to the extent the taxpayer has net investment income, with any excess investment interest expense being carried forward to future years. Assume the same hypothetical individual taxpayer above, but instead of using the proceeds to purchase inventory, the taxpayer used the proceeds to purchase a publicly traded stock portfolio. As before, we begin the analysis with interest tracing. Since the debt proceeds were used to purchase a portfolio of stocks, the interest expense paid will be investment interest expense. Next, the taxpayer must determine the taxpayer's net investment income (generally, interest, dividends, and capital gains) and whether that amount exceeds the investment interest expense paid. Prior to the TCJA, net investment income was reduced by miscellaneous itemized deductions (that is, 2% deductions, such as investment advisory fees and tax preparation fees) before determining the deductibility of investment interest expense. However, as the TCJA suspended the deduction for such expenses for tax years 2018–2025, miscellaneous itemized deductions do not affect the calculation of net investment income for these years. Taxpayers are no longer be able to claim such expenses as itemized deductions, but they may benefit from the resulting

increase in net investment income, which provides the ability to deduct additional investment interest expense—whether that be investment interest expense paid currently or excess investment interest expense carried forward from a prior year.

To summarize, prior to the TCJA, business interest expense generally resulted in a current deduction, but now is subject to additional hurdles that may create a current-year disallowance. While the TCJA did not directly change the deductibility of investment interest expense, as a result of changes to the deductibility of miscellaneous itemized deductions, taxpayers may be able to currently deduct additional investment interest expense. Given these changes, is business interest expense still the “best” type of interest expense? It may or may not be, depending on a taxpayer's individual situation. But as we learned earlier, the interest tracing rules provide flexibility to analyze the impact based on their personal tax situation. With planning, it is possible for a taxpayer to identify what character of interest expense may yield a favorable result.



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Let's consider a final example. Assume that in a prior year, an individual taxpayer borrowed funds to acquire a new asset for their business, operated as a sole proprietorship, and thus has business interest expense. While reviewing their most recent tax return, the taxpayer notices that they are limited on the current deductibility of their business interest expense, and they expect this limitation may continue to apply for years to come. For this taxpayer, business interest expense may not be a favorable result, as they do not foresee being able to receive a current deduction for the business interest expense they incur. However, the taxpayer also has a significant amount of net investment income that would allow for deductibility of investment interest expense. Through proper planning, the taxpayer could repay the loan traced to the business asset and then, at a later date, the taxpayer could establish a new loan using those proceeds to acquire investment assets. Thus, the interest expense would be investment interest expense. This example illustrates not only the flexibility and complexity inherent in these rules, but also that with thoughtful planning and an understanding of the potential outcomes, a taxpayer can use the interest tracing rules to yield a favorable result.

The interest tracing rules provide flexibility based on personal tax situations.





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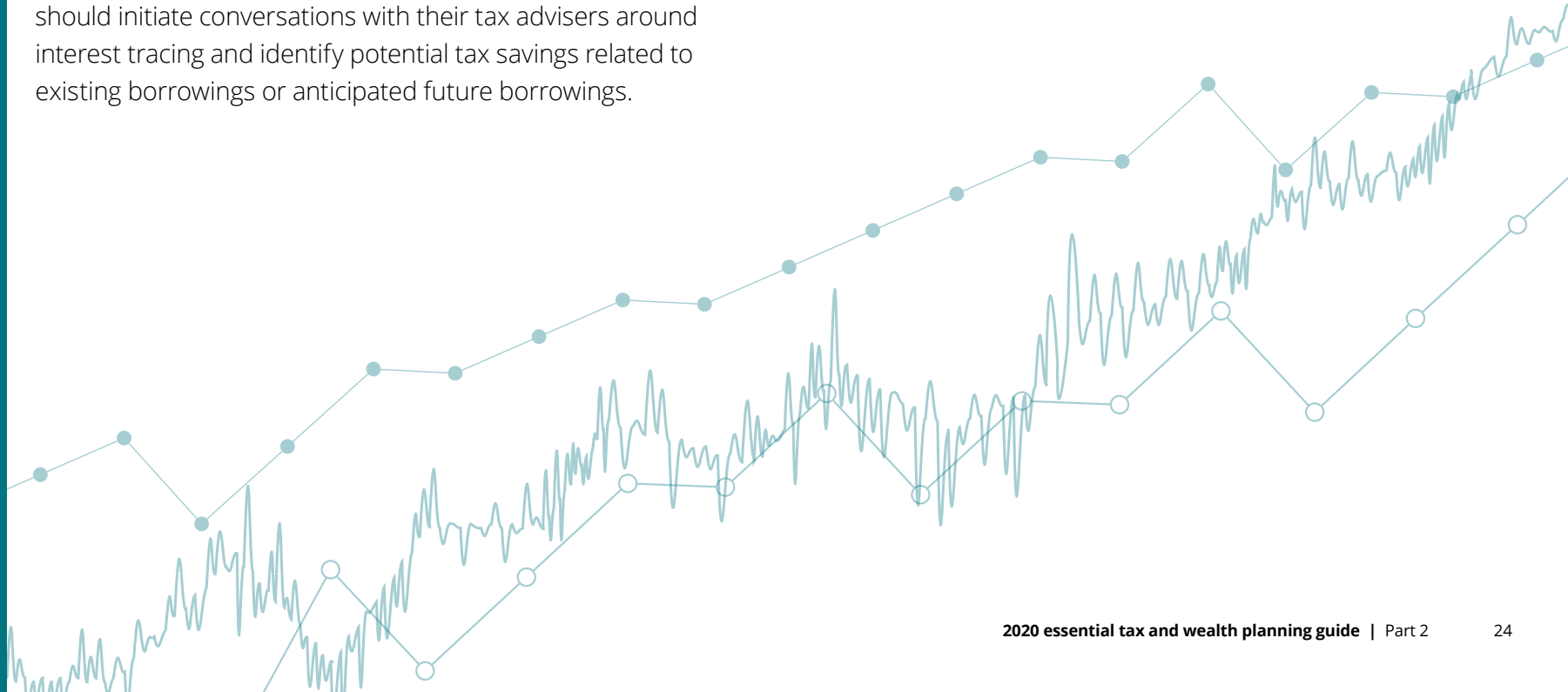
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Some taxpayers may not have been aware of the complexity inherent in the interest tracing rules and how they should be applied to the interest expense incurred each year, while others may have been aware of and applied the interest tracing rules at the time they borrowed the funds, but have not revisited their analysis since. Regardless, the recent changes to the deductibility of business interest expense provide a good reason to revisit this analysis and determine whether the result of interest tracing is providing a favorable tax result and, if not, whether the flexibility of the interest tracing rules provides an opportunity for planning. Taxpayers should initiate conversations with their tax advisers around interest tracing and identify potential tax savings related to existing borrowings or anticipated future borrowings.

With thoughtful planning and an understanding of the potential outcomes, a taxpayer can **use the interest tracing rules to yield a favorable result.**





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The 2020 reboot of individual loss limitations

The [third installment](#) of the *2019 essential tax and wealth planning guide* discussed the existing individual loss limitation rules, explored changes to the loss limitation rules brought about by the TCJA, and discussed new loss planning issues to consider as a result of such changes.

One significant change brought about by the TCJA was the enactment of the excess business loss limitation rules. These rules added an additional hurdle to the monetization of business tax losses for certain taxpayers by disallowing excess business losses. Excess business losses are defined as aggregate trade or business deductions in excess of the sum of (1) aggregate trade or business gross income or gain, plus (2) a threshold amount (\$250,000, indexed annually for inflation, or 200% of that amount in the case of a joint return). Additionally, the TCJA modified the net operating loss (NOL) ruleset such that NOLs arising in tax years beginning after 2017 generally could not be carried back, but instead had to be carried forward. Lastly, utilization of an NOL generated after December 31, 2017, and carried forward was limited to 80% of regular taxable income (as opposed to 100% under prior law). The combined impact of the above changes delayed taxpayers' ability to monetize business losses. Specifically, excess business losses cannot offset nonbusiness income, are carried forward to the next tax year, and are converted to NOLs.

The COVID-19 pandemic has had a significant impact on the economy, leading many taxpayers to incur **significant losses in 2020.**

Although it has only been a year since our last discussion of these rules, the COVID-19 pandemic has had a significant impact on the economy, leading many taxpayers to incur significant losses in 2020. In response to the economic stresses brought about by the pandemic, the government signed into law the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). In this installment, we examine the flexibility that has been provided to assist individuals with monetizing their 2020 business losses as a result of the temporary modifications to the loss limitation rules brought about by the CARES Act and consider those avenues best suited to utilize (and perhaps, in some cases, enhance) the loss deduction.



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The 2020 CARES Act

Signed into law on March 27, 2020, the CARES Act includes wide-reaching support for individuals, businesses, and other groups affected by the pandemic. The CARES Act contains several income tax provisions aimed at stimulating the economy and providing relief to businesses, including a temporary repeal of the excess business loss limitation rules, a temporary reinstatement of NOL carryback provisions, and a temporary repeal related to limiting NOL usage to 80% of taxable income. These changes to the loss limitation provisions and NOL rules were intended to temporarily relax those rules governing the timing of claiming business losses, generally allowing taxpayers to claim losses in the year incurred. Thus, the CARES Act provides taxpayers an opportunity for an immediate reduction in their tax liability and, in some cases, will allow taxpayers to further monetize business losses by filing a refund claim for an NOL carryback.

Specifically, the CARES Act included provisions that allow NOLs generated in tax years beginning after December 31, 2017, and before January 1, 2021, to be carried back to offset taxable income from the preceding five taxable years. Furthermore, the CARES Act suspended the provision in the TCJA that limited usage of NOLs to 80% of a taxpayer's regular taxable income. The suspension of the 80% limitation applies to NOLs generated and utilized in taxable years beginning after December 31, 2017, and before January 1, 2021. However, an NOL generated

after December 31, 2017, and carried forward into 2021 will be subject to the 80% limitation in 2021 and going forward. Note that the NOL change alone may not have much impact on monetizing business losses due to the addition of the excess business loss limitation rules by the TCJA. To address the interplay between the two provisions, lawmakers retroactively postponed the effective date of the excess business loss limitation provisions from tax years beginning after December 31, 2017, to tax years beginning after December 31, 2020. Accordingly, these changes now allow taxpayers the flexibility to carry forward or carry back NOLs created in 2020, and NOLs carried back are not subject to a taxable income limitation.





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Business losses

In general, an NOL is generated by an individual in a year in which current year business losses from a sole proprietorship and/or passthrough entity exceed current year taxable income. Note that business loss limitation rules in existence before the enactment of the TCJA are still applicable. As such, only those losses not disallowed under the basis, at-risk basis, and/or passive business loss rules will contribute to the current year NOL.

Changes to the loss limitation provisions brought about by the CARES Act mean that excess business losses incurred in tax year 2020, which are allowable after considering the loss limitation rules above, will fully offset current-year taxable income, including nonbusiness income. Furthermore, to the extent allowable current-year business losses exceed other taxable income, an NOL will be generated that can be:

- Carried back five years;
- Utilized against 100% of taxable income in such years; and
- Then, to the extent any of the NOL remains after the carryback, be carried forward indefinitely.

Alternatively, taxpayers may choose to elect to bypass the carryback provisions and simply carry forward the loss. As discussed above, 2020 NOLs carried forward and used in

taxable years beginning after December 31, 2020, are subject to the 80% regular taxable income limitation in the carryforward years.

The result of these changes allows business owners to more immediately monetize the tax benefit of their business losses. For those businesses that are in need of a cash infusion and already anticipating that 2020 will be a loss year, thought should be given to tax planning alternatives that may enhance their 2020 business loss. For example, consideration should be given to filing accounting method changes that would accelerate deductions and defer revenue. The acceleration of deductions and deferral of revenue can also be accomplished through actions that do not require a change in method of accounting. One such example is the acceleration of large planned business asset purchases into 2020. Note that if such purchases qualify for the additional depreciation allowance (bonus depreciation), the full cost of the asset will be deductible in the year purchased. Given the economic effects of the pandemic, this option may not be feasible for many taxpayers. However, some businesses and business owners may have significant assets that allow them to fund additional asset purchases.



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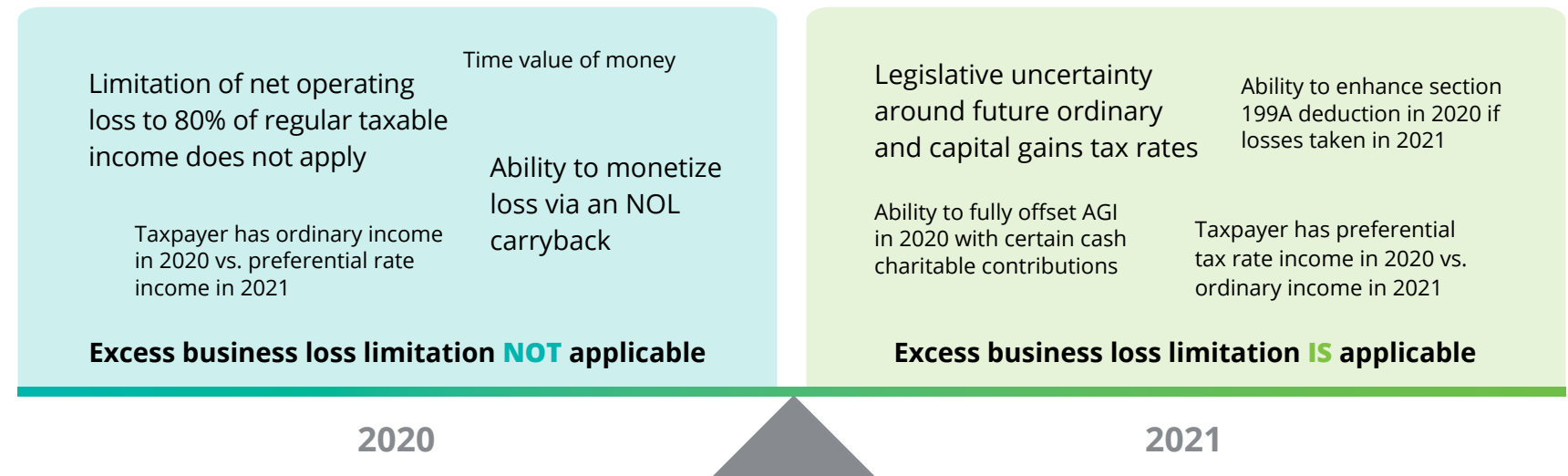
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It is highly recommended that taxpayers who anticipate business losses for 2020 reach out to their business and/or tax advisers to discuss possible planning considerations, as well as the interaction and impact of an increased business loss on not only basis, at-risk basis, and passive loss limitations, but also charitable deduction planning, the business interest expense limitation, and the qualified business income (section 199A) deduction. Note that this list is not all-encompassing; there are other issues to consider that have not been mentioned here.

The nontax concerns and challenges that taxpayers may face from COVID-19, coupled with the limited time frame available

to utilize the taxpayer-friendly provisions of the CARES Act, have made the loss limitation rules even more complex. Tax planning should be considered in light of changing business concerns and changing tax laws. We encourage you to work closely with your business and/or tax advisers to understand the rules and to gain perspective on your income tax posture based on your specific facts and circumstances. Careful modeling through multiyear income tax projections can identify potential scenarios, assist you with understanding cash flow considerations, and arm you with the information needed to make tax-efficient decisions in an unprecedented time.

Weighing various factors related to 2020 versus 2021 NOLs





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Alternatives for filing an NOL carryback claim

The NOL carryback claim is filed by individuals with an NOL on Form 1045, *Application for Tentative Refund*, or Form 1040-X, *Amended U.S. Individual Income Tax Return*. While there are some instances in which filing Form 1040-X is required or favored, Form 1045 is most commonly used to claim a refund for an NOL carryback. The IRS must generally act on a claim filed on Form 1045 within 90 days of filing, and interest will be due to the taxpayer if the refund is not issued within 45 days of filing the claim. Thus, Form 1045 is often the preferred filing method because a taxpayer will typically receive a refund check from the carryback claim faster than when filing the claim on Form 1040-X. Also note that when a carryback claim is filed via Form 1040-X, an amended return is considered a claim for refund and subject to screening procedures in advance of issuing the refund. The IRS could audit the return before issuing the refund, which may cause a significant delay in the issuance of the refund check.

Form 1045 must be filed within the 12-month period following the year of loss. Therefore, for a calendar-year taxpayer with an NOL reflected on the 2020 income tax return, Form 1045 is required to be filed by December 31, 2021. Note that processing of the application for refund on Form 1045 and issuing a check to the taxpayer does not mean the IRS has accepted the application as correct. The refund claim can be audited after the

refund is received. Additionally, the refund claim filed on Form 1045 may be rejected if it includes material omissions or math errors. If you generate an NOL in the current year, speak to your tax adviser regarding filing the carryback claim.

Form 1045 is often the preferred filing method because a taxpayer will typically receive a refund check from the carryback claim **faster than when filing the claim on Form 1040-X.**



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While many taxpayers are focused on business losses, others may have concerns regarding capital losses. There are many sectors of the market that have been negatively affected by COVID-19, and thus, taxpayers may find that certain investments in their portfolio are currently in a loss position. The difference in treatment between business losses and capital losses is that business losses may offset ordinary income with any excess creating an NOL, whereas capital losses may only be offset against capital gains plus up to \$3,000 of ordinary income. Any excess capital loss is carried forward as a capital loss in future years.

As mentioned above, many taxpayers may find themselves in a position of owning capital assets that have fallen in value to the point that, if sold, would generate a capital loss. This may provide an opportunity for tax planning. If a taxpayer has capital gains, either from the direct sale of capital assets or indirectly from passthrough investments, “harvesting” capital losses prior to year-end can allow those losses to offset previously recognized capital gains. However, there are limitations to keep in mind when harvesting losses.

The first limitation to consider is whether the wash-sale rules will apply to the transaction. Losses subject to the wash-sale rules are disallowed. The wash-sale rules apply to a transaction

if the transaction generates a loss on the sale or disposition of stock or securities and if, within a period beginning 30 days before and ending 30 days after the date of the disposition, the taxpayer acquires substantially identical stock or securities. As an example, if a taxpayer sells stock in a publicly traded security for a loss and then proceeds to repurchase the same security within 30 days, the wash-sale rules would result in the loss being disallowed.

The second limitation to consider is the overall limitation on net capital losses. As mentioned earlier, capital losses may be recognized to the extent the taxpayer has capital gains in the current year. Any excess loss can offset up to \$3,000 of ordinary income, with the balance disallowed in the current year and carried over to future years to once again be offset against capital gains plus up to \$3,000 of ordinary income.

In some situations, taxpayers may find that they are unable to sell or otherwise dispose of stocks in their investment portfolio, perhaps due to the stocks having very little to no value. A taxpayer may deduct the cost basis of stock in the year it



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becomes completely worthless. Losses that are generated from worthless securities are treated as capital transactions and thus generate a capital loss. In some instances, such as when a taxpayer owns an investment in a partnership that becomes worthless, a taxpayer may be able to generate an ordinary loss. For example, assume that a taxpayer owns a partnership interest and that the value of the partnership has decreased to the point of having little to no value. If the taxpayer determines there is no opportunity for recovery and thus decides to abandon their interest in the partnership, such abandonment may result in either a capital or ordinary loss. The determination as to whether an abandonment will generate a capital or ordinary loss is a highly complex matter, the details of which are beyond the scope of this article. If you own a partnership interest that may be worthless, initiate a conversation with your tax adviser to discuss the potential outcome.

Finally, taxpayers who have made loans in either business or nonbusiness settings should consider whether the COVID-19 pandemic and its economic impacts will limit the ability of the debtor to repay the loan. For the purposes of this discussion, we will focus on the treatment of nonbusiness debt. If a taxpayer makes a nonbusiness loan and determines that the loan has become completely worthless, the taxpayer may be able to take a bad debt deduction. A debt becomes worthless when there is no longer any possibility that the amount owed

will be repaid. This may occur on the date the debt is due or prior to that date. To demonstrate worthlessness, a taxpayer must show that they have taken reasonable steps to collect on the debt, but were unable to do so. If it is determined that the taxpayer has nonbusiness bad debt, a deduction is available as a short-term capital loss without regard to how long the debt was held. Taxpayers should note, however, that there are additional tax return reporting requirements with regard to nonbusiness bad debts, as detailed below.



Reporting nonbusiness losses

A nonbusiness bad debt deduction requires a separate detailed statement attached to your return. The statement must contain:

- A description of the debt, including the amount and the date it became due;
- The name of the debtor, and any business or family relationship between you and the debtor;
- The efforts you made to collect the debt; and
- Why you decided the debt was worthless.



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As a result of the COVID-19 pandemic, many individuals have incurred significant losses from their businesses and/or investments. While incurring a loss is never ideal, it does provide an opportunity for tax planning with the objective of either (1) reducing current or future income tax liabilities or (2) the carryback of losses to receive a refund of prior tax paid. In all instances, careful planning involving tax and investment advisers is recommended to determine what impact realizing losses will have and how to best move forward.



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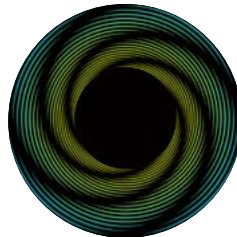


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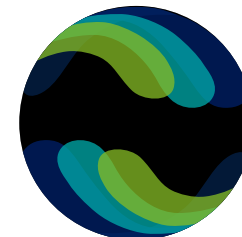
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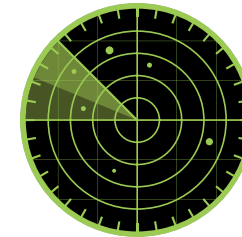
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